CONSIDERING AN ESOP? START HERE!

An ESOP can be an excellent exit option for business owners, but there are key characteristics that are generally required to make them a good fit. Maybe you already know a little about ESOPs. You probably know that an ESOP can offer employee ownership and preserve the legacy of your business, which may not be guaranteed with a sale to a competitor or a private equity firm. Likely, you have also heard something about an ESOP's tax benefits. Regardless of where you are in the process of exploring an ESOP as a business transition option, here are some important considerations to be mindful of before getting too far down the path.

Before diving into the key elements that make for a good ESOP, it is important to understand the fundamentals of what an ESOP is. An ESOP is an Employee Stock Ownership Plan. True to its name, an ESOP provides employee ownership and creates a retirement benefit for employees. An ESOP can own any amount of company stock, including 100%, and there are many options for structuring an ESOP. Although an ESOP can offer a lot of flexibility around structure and plan design, certain ingredient make for a good ESOP candidate.

If you like the idea of employee ownership, maintaining your company's independence, and saving on taxes, let's find out if an ESOP is practical for your company.

OWNER PRIORITIES

Legacy > Cash: Setting expectations around the sale and sale price is important. An ESOP can be a great option for a business owner when legacy is more important than receiving top dollar. However, if liquidity and maximizing value are important to your exit and retirement plan, generally an ESOP is not going to be the best fit. In most cases, selling to an ESOP will almost always result in both a lower purchase price and less cash at closing than selling to a third party. On the other hand, you will not have to go through the intrusive process of taking the company to market with an ESOP. ESOP deals are also stock deals, rather than asset deals, which combined with other tax advantages can help close the price gap.

Flexibility: An ESOP offers business owners something that most third-party buyers cannot: the ability to manage the timing of your succession plan. The ESOP does not require the owner to retire. Business owners have the flexibility to control the pace and timing of their exit and can plan an exit based on the needs of the business and their personal goals. The business owner's current involvement in the company and the remaining leadership team's reliance on the business owner generally dictates how quickly a business owner chooses to exit.

BUSINESS AND ECONOMIC CONSIDERATIONS

Team Stability: Employee continuity and a strong leadership team are necessary for an ESOP to be successful. An ESOP provides an ownership transition, but it does not automatically provide a leadership transition. Long-term leadership needs to be in place to support the ongoing viability of the ESOP and the company. Furthermore, the requirement for ESOPs to buy back company stock of exiting employees can make the cost and administration burdensome for companies with high-turnover rates.

Profit Threshold: EBITDA of approximately $1.0 million or greater is an informal size threshold. An ESOP is a retirement plan and annual retirement contributions to the plan are necessary for the plan to function as designed. Therefore, meaningful profits and cash flow are necessary to make an ESOP sustainable when employees begin to retire and cash out their accounts.

Costs: ESOPs come with significant costs. Implementing an ESOP requires a team of skilled professionals and ongoing administration has recurring costs. Implementation for smaller ESOPs can cost between $150,000 to $250,000. Below a certain size, the benefits may not justify the costs. A minimum of 40 employees is generally a good starting point. There is no regulatory requirement for 40 employees, and it can be done with fewer, but the cost-benefit trade-off becomes less attractive with fewer employees.

ADAMY VALUATION

ADMINISTRATIVE CONSIDERATIONS

Regulation and Oversight: For many small to mid-sized companies, increased regulation and government oversight are to be expected. ESOPs are subject to federal ERISA regulations which are governed by the Department of Labor (DOL). This oversight requires increased reporting and regulatory compliance. Audits and investigations are also not uncommon.

Annual Cost: Like any qualified retirement plan, an ESOP requires ongoing administration. Given the nuances of an ESOP, experienced ESOP advisors are necessary to maintain and administer the ESOP on an ongoing basis. The advisory team includes a trustee, a third-party administrator, and a valuation firm. These annual administrative costs generally range from $30,000 to $50,000.

Financial Statement Quality: If a company's financial statements have inconsistencies in reporting or do not comply with GAAP, a CPA that can prepare high-quality statements and also has a solid understanding of ESOP accounting may need to be hired.

These considerations can help inform you about ESOP expectations and potential roadblocks before investing time and money into the process, but some major benefits can offset these costs and considerations. Business owners who understand the value of ownership may find an ESOP to be a successful and effective way to preserve the legacy and independence of the company. If legacy is more important than receiving the highest dollar possible out of the company, an ESOP is worth exploring further. The biggest cost benefit comes from a 100% ESOP owned S-corporation that pays NO federal income taxes!

Contact one of our ESOP experts today to learn more.

INFO@ADAMYVALUATION.COM