CORPORATE TRANSITION CONSULTING

Converting Business Equity Into Diversified Assets

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What if there were a way for the owner of a <u>privately held company to …</u>

- Sell the company stock at "fair market value," paying no tax on the proceeds,
- Sell all or a majority share and still keep voting control of the company?
- Increase the company's working capital and cash flow with no cash expenditure and no additional productive effort?
- Buy out minority or majority stockholders?
- Cut the cost of borrowing nearly in half by tax deductions of principal payments as well as interest?
- Make acquisitions with tax deductible principal payments, tax free proceeds to the seller?
- Provide employees retirement benefits with equity with no employee deferral or company cash contributions?
- Deduct the payment of dividends from taxes?
- Increase productivity, profitability, and company value with no cash outlay?

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What if there were a way for the owner of a <u>privately held company to …</u>

- Improve employee benefits dramatically with no cash outlay?
- Allow heirs or management team to buy a division, a subsidiary, or the company with the government paying nearly half the cost of the loan principal and the business paying the rest?
- Allow the corporation to operate in a totally tax-free environment?
- Restructure ownership without losing control?
- Convert some of their equity to cash in order to diversify personal assets?
- Maximize their after-tax liquidity for retirement?
- Avoid inheritance tax?
- Take care of their heirs, management, and employees while instilling a culture of ownership and accountability?

<u>Too good to be true?</u>

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Employee Stock Ownership Plans
<u>maximize the after tax proceeds of selling equity</u>

- Conventional sales of companies today are valued by a buyers market usually receiving only 3 to 5 times EBITDA. Gone are the days of LBOs and IPOs that paid very high multiples of EBITDA. (Many dot.com company failures changed much of the financial worlds perceptions.)

- ESOPs have historically paid between 6 - 12 times EBITDA (less CapEx and LT Debt).

- Tax code provisions allow ESOPs exceptional tax advantages and savings passed in the Tax Reform Act of 1969 and continuously enhanced in 1978, 1987, 1998, 2002 and 2004.
  - Possible permanent deferral of capital gains tax for Sub-S corps coming in 2010.

- Properly designed ESOPs can also enhance existing 401(k) plans, allowing senior management to maximize their participation, while minimizing (or eliminating) the company's cash contributions (KSOPs).

- But all ESOPs aren't created equal. They must be designed by experts in both ESOPs and corporate financing.

Designing and implementing financial structures to…

- maximize market value of existing equity compared to other alternatives;
- dramatically increase after-tax cash flows;
- reduce the potential cost of borrowing by 30-50%;
- improve the company's ability to repay debt faster;
- significantly increase management performance incentives (MSOP);
- motivate employees to focus on bottom-line results, competitive gains, productivity, innovation, and loyalty;
- reward management and employee teamwork to reduce costs, streamline operations, and expand market share to ensure the company's long-term viability;
- maximize employee retirement benefits while reducing cash required for contributions.

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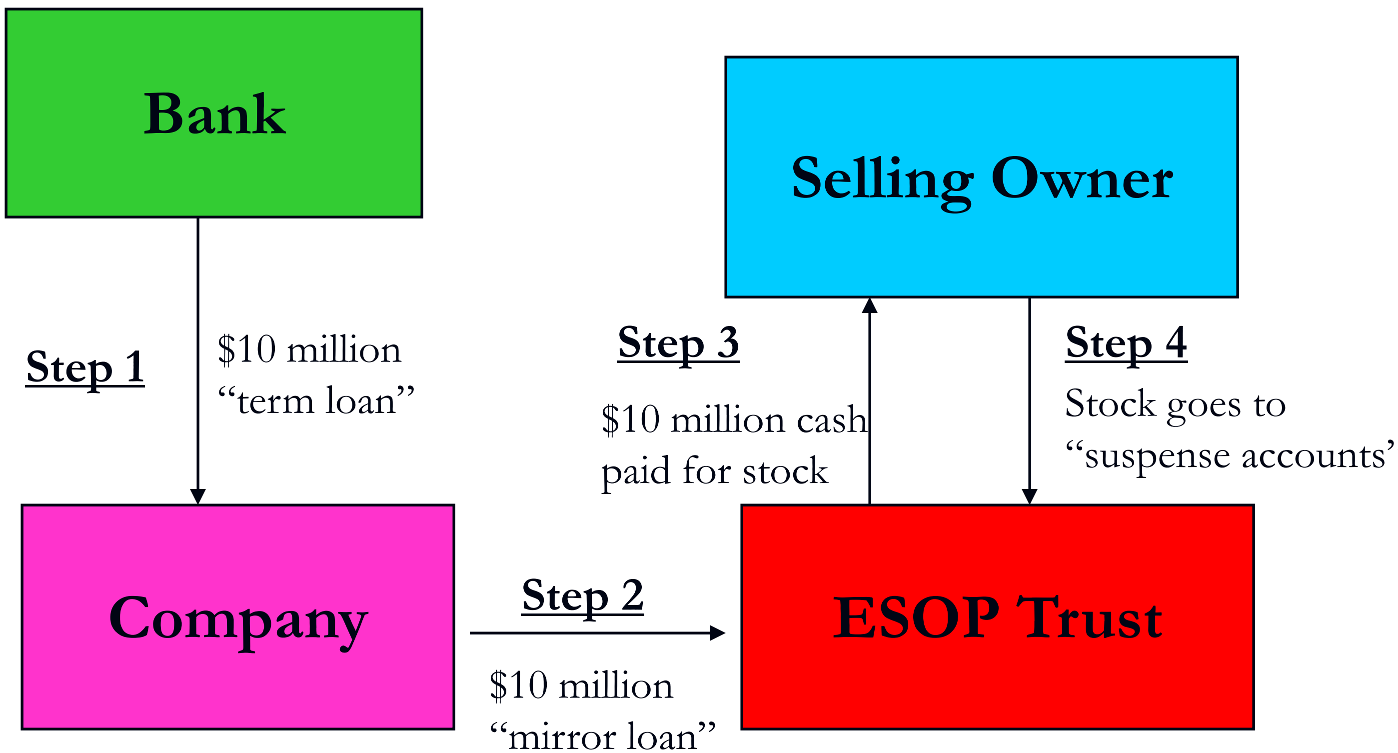
Transaction Diagrams for Sale of a C-Corporation with <u>No Tax</u> !

Assume $10 million was the negotiated sales price



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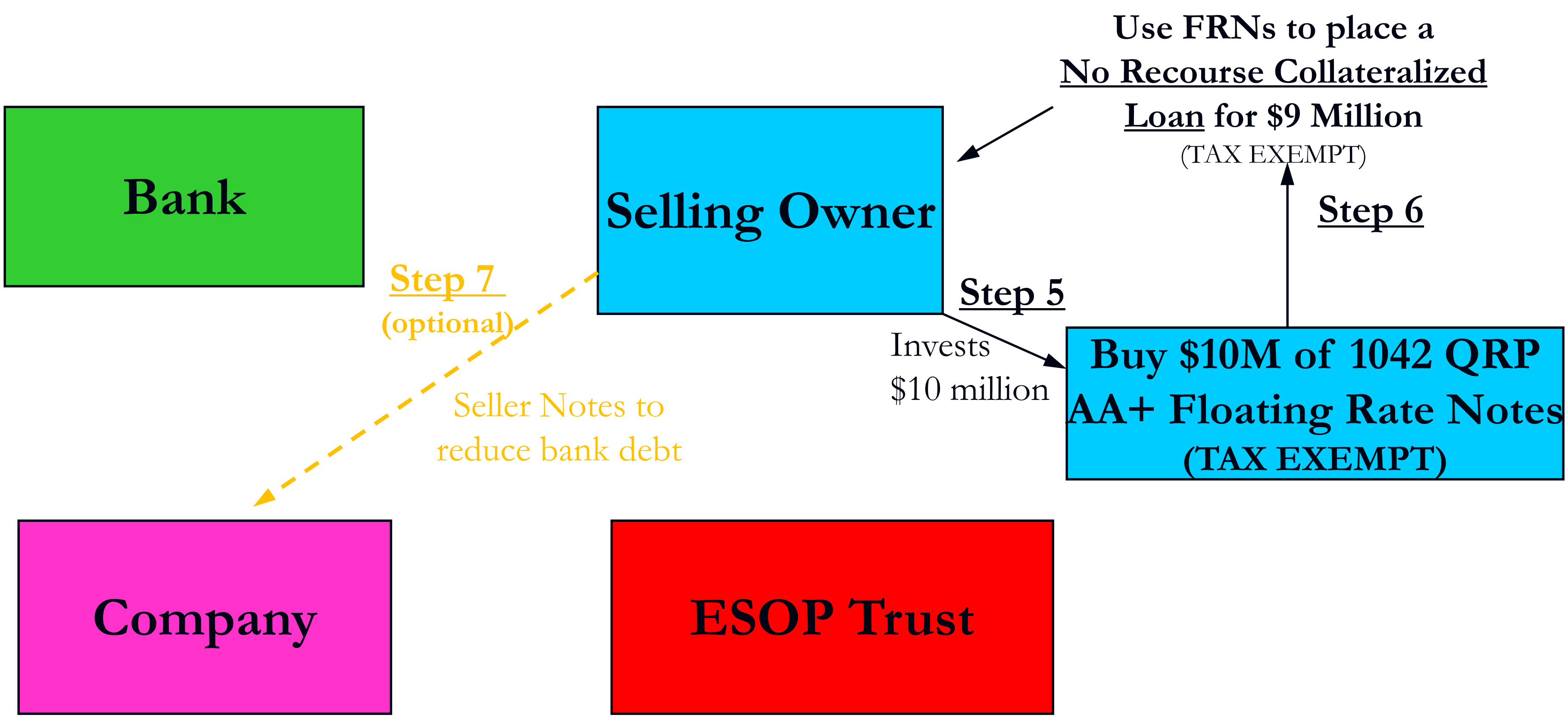
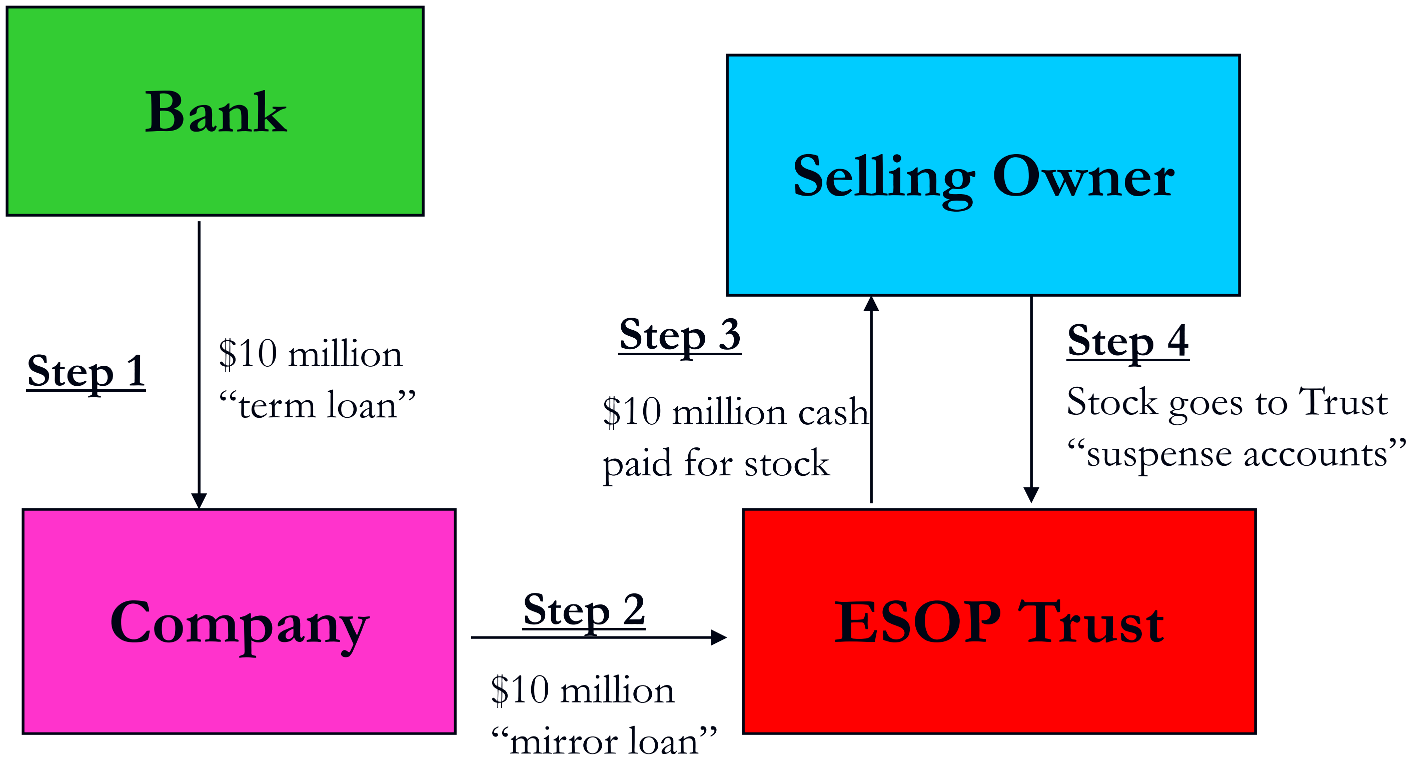


How 1042 QRP is Purchased and Funded		
Sources of Cash		
Seller	$ 1,000,000	
Swiss Bank	$ 9,000,000	
Uses of Cash		
AA Rated FRNs	$ 10,000,000	
Cash Flow		**If LIBOR is 3%**
Interest Income Annually	$ 600,000	$ 300,000
LIBOR Average of 6%		
Interest Expense Annually		
LIBOR plus 0.6%	$ 594,000	$ 324,000
Surplus (Deficit)	$ 6,000	$ (24,000)

Transaction Diagrams for Sale of S-Corp to ESOP

-- Assume $10 million bought 60% of the company --



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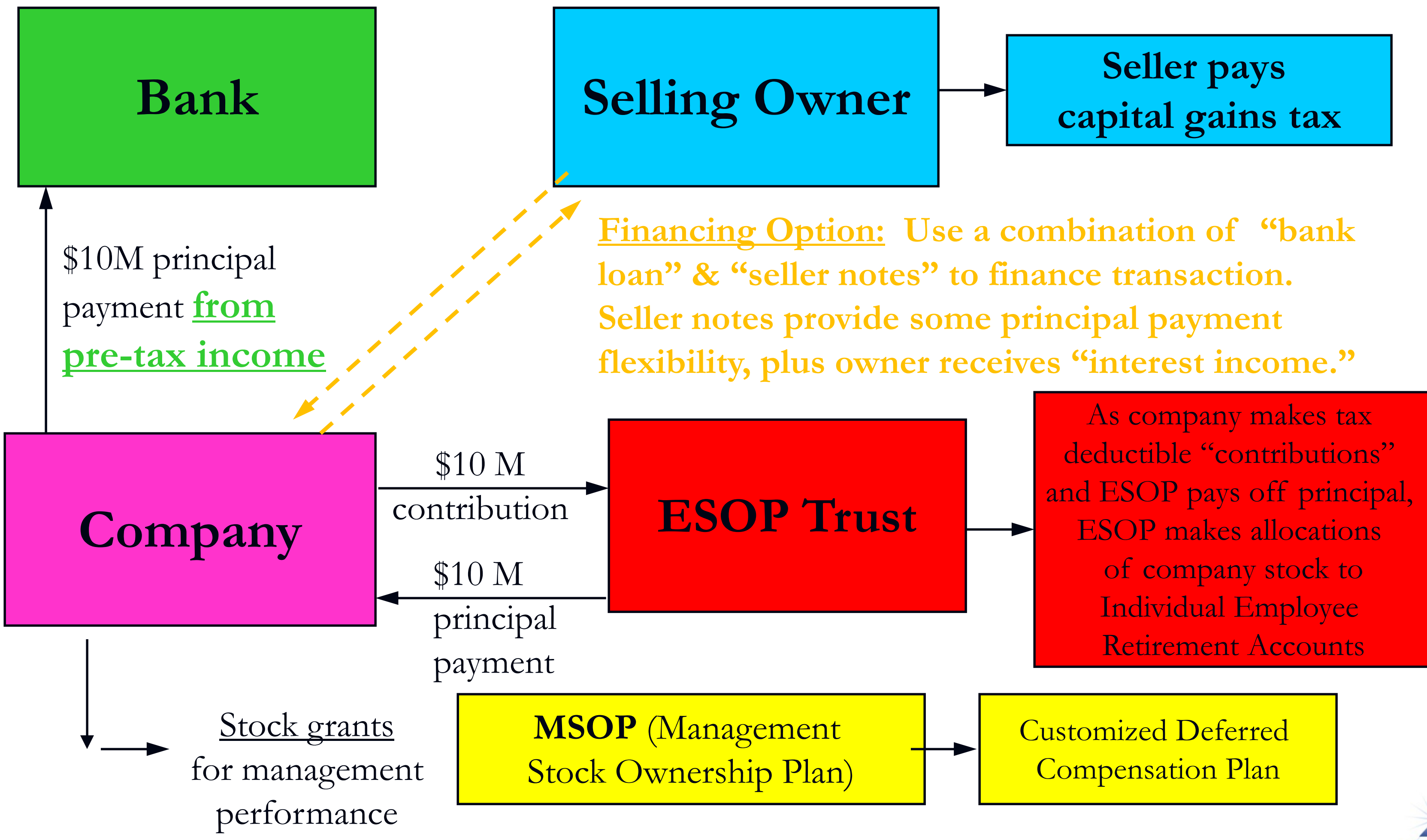

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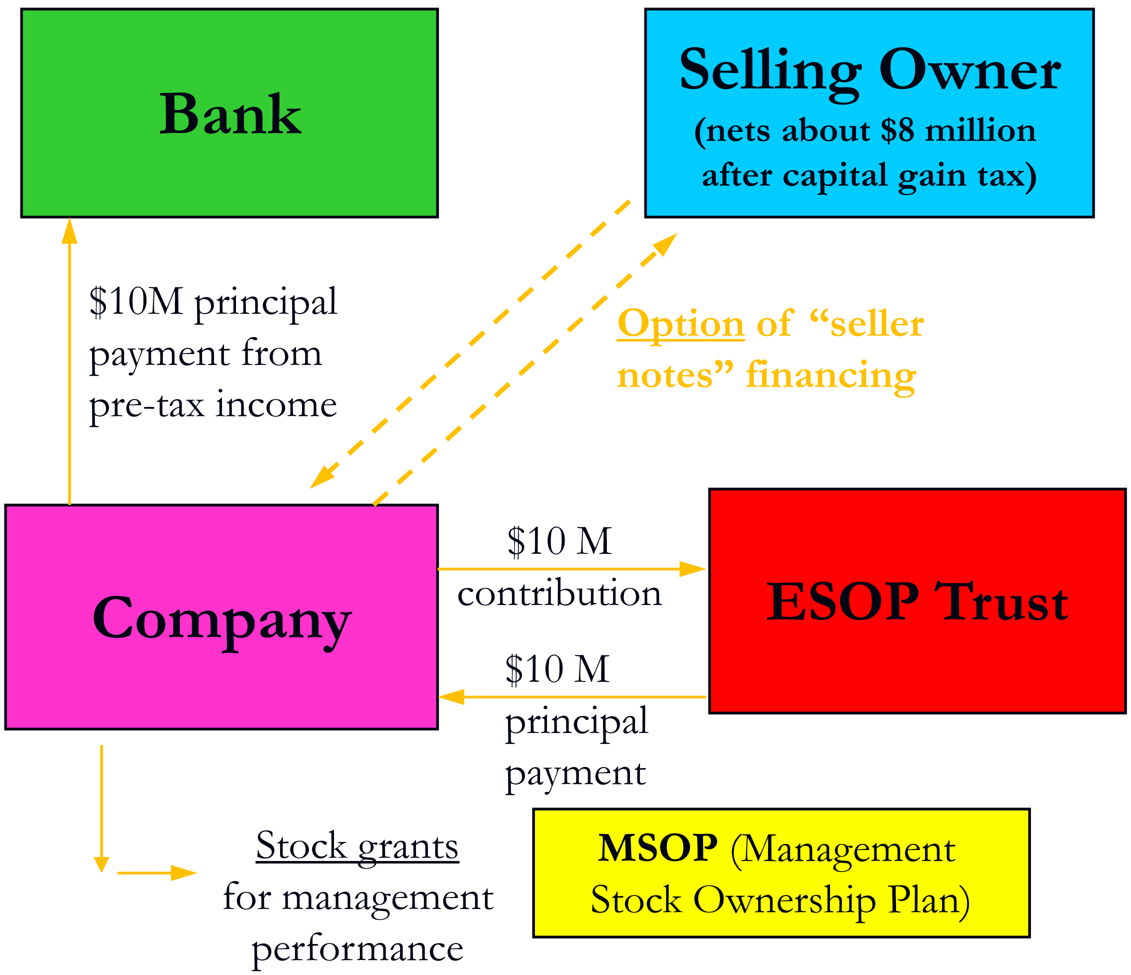
Transaction Diagrams for Sale of S-Corp to ESOP

-- Assume $10 million bought 50% of the company --



Benefits:

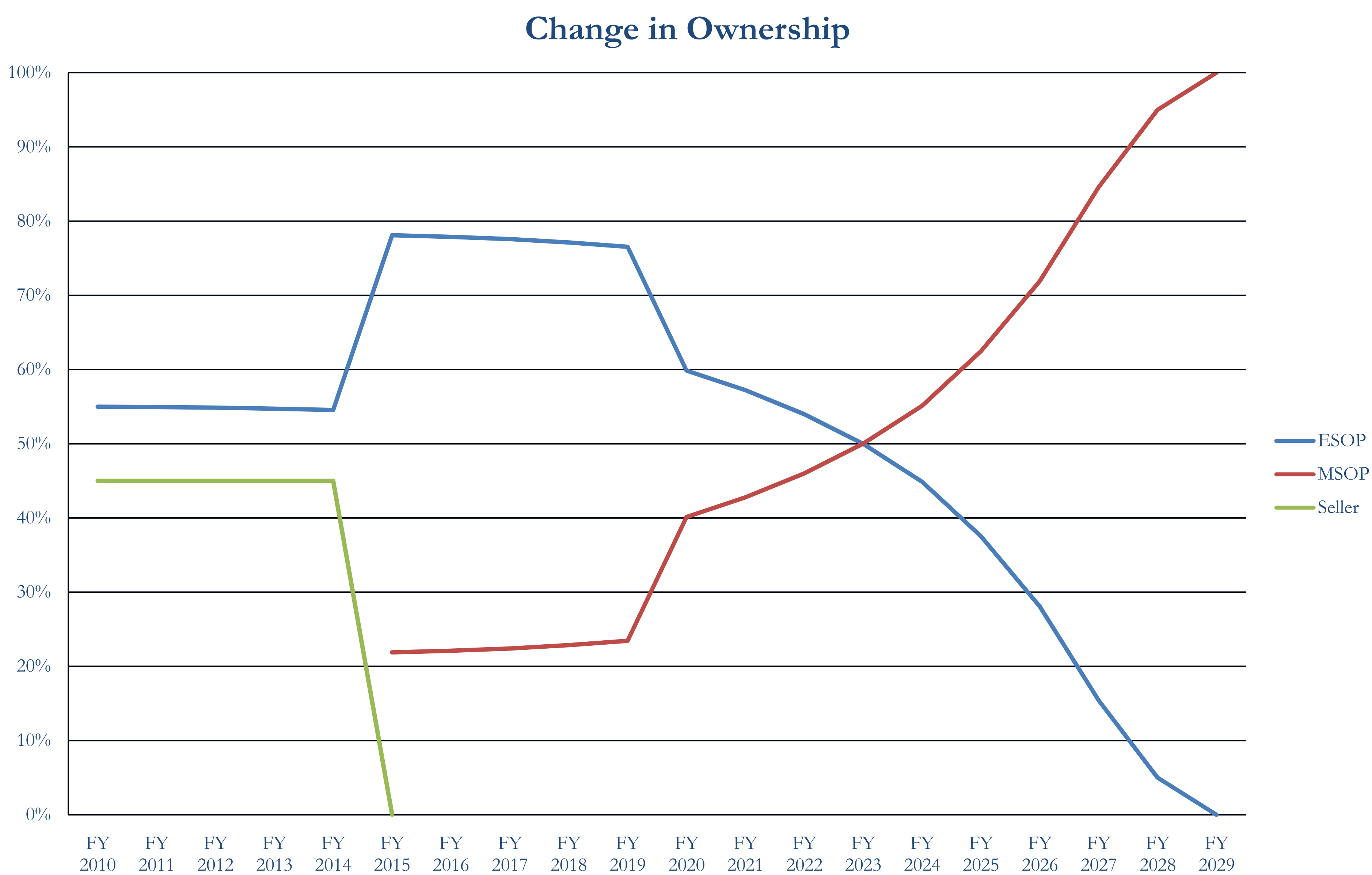
Since 50% of profits are tax free, company can accelerate paying off bank loan/seller notes, other debt, or reduce working capital.

Selling Owner(s) can retain 100% control of voting stock through "directed trustee."

Unique opportunity to add key leadership and offer MSOP incentives to motivate & reward management team.

Owners still retain 50% of stock with a "put right," allowing them to sell stock in the future. As "fair market value" of company increases the company could be 100% tax free.

Qualified ERISA retirement plan for employees enhances loyalty, teamwork, and accountability.


Change in Ownership
100%
90%
80%
70%
60%
50%
40%
30%
20%
10%
0%
FY 2010
FY 2011
FY 2012
FY 2013
FY 2014
FY 2015
FY 2016
FY 2017
FY 2018
FY 2019
FY 2020
FY 2021
FY 2022
FY 2023
FY 2024
FY 2025
FY 2026
FY 2027
FY 2028
FY 2029
ESOP
MSOP
Seller

Traditional methods of making acquisitions leave "money on the table"

Whether your business is a C-Corporation or a Sub-S, acquisitions can be designed that:

- Minimize purchase price for buyer;
- Maximize after-tax proceeds for seller;
- Create a win-win for buyer, seller, and banker;
- Allow proceeds in C-Corp acquisition to be tax-free;
- Create continuous tax exemptions of profits;
- Dramatically increase "net after tax income" to Sub-S owners;
- Increase company's "debt capacity" for more attractive bank loans.

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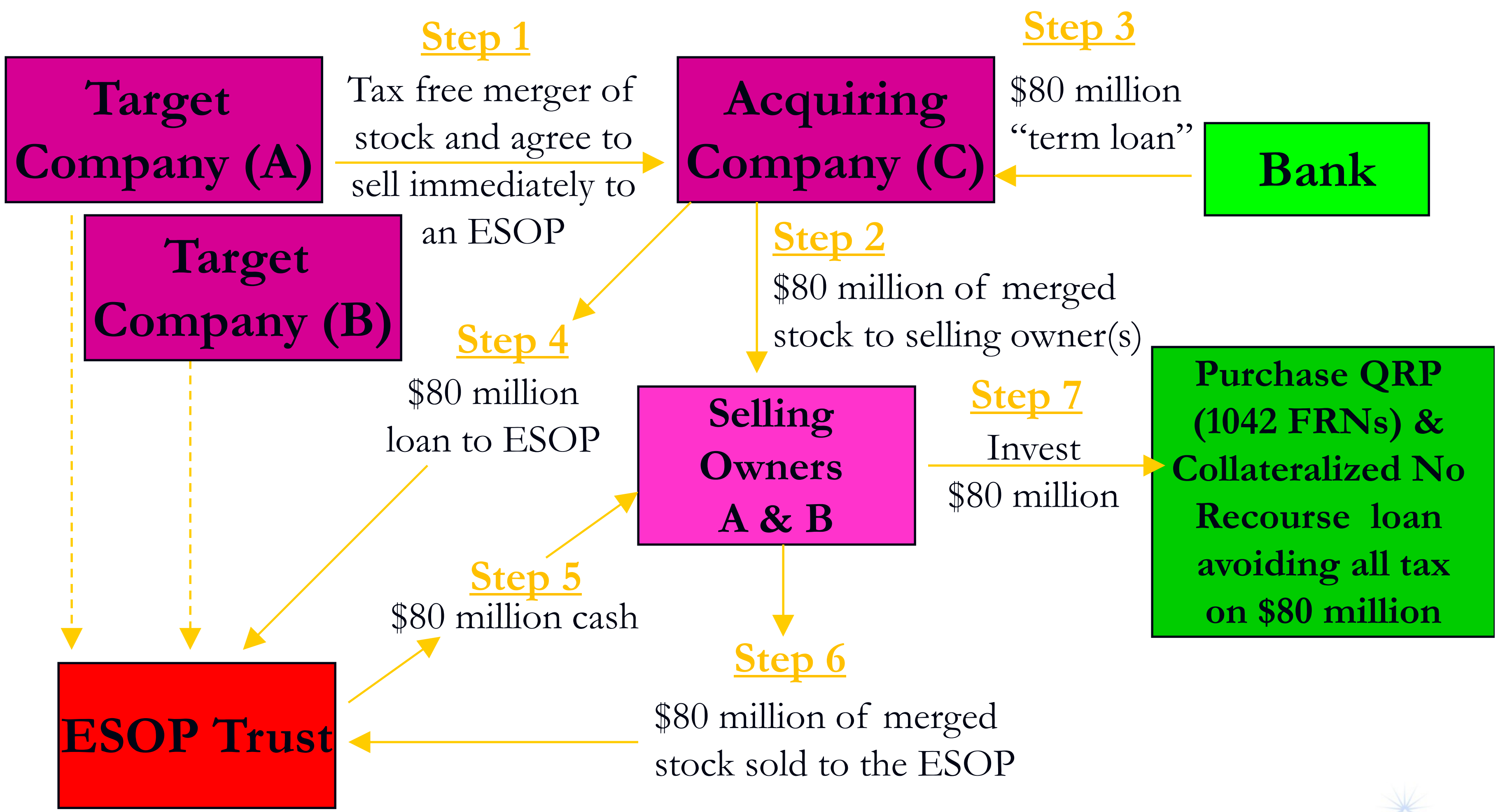
Sample transaction of a $100 million acquisition for a C-Corp <u>that saved the buyer $52 million</u>

1. Company C wished to acquire two companies A & B for $50 million each. A & B owners would receive $37 million each after-tax.
2. A selling price of $80 million <u>after-tax</u> is negotiated($40 million each for target companies A & B, versus $100 million. Savings of $20 million.
3. Acquiring company (C) agrees to a tax-free "reorganization" with companies A &B, and all agree to sell immediately to an ESOP.
4. Bank agrees to $80 million loan to Company C, which in turn is loaned to ESOP trust to buy $80 million of merged stock from owners A & B.
5. Company C deducts loan principal payments off taxes, allowing loan to be paid back with pre-tax dollars, thereby saving the company $32 million.
6. Since this is a C-Corp, the selling owners A & B can invest proceeds of $80 million in a QRP (1042 QRP in floating rate notes) and avoid all capital gains tax and all inheritance tax with a new "step-up basis" upon their death.

Design of $100 million acquisition that saved the C- Corp buyer $52 million



There are significant advantages for Sub-S corporations to use ESOPs when making acquisitions

(vs. traditional methods)

- ✓ Sub-S owners typically have very little incentive to aggressively pursue acquisitions, because traditional acquisition designs have minimal positive impact on "net after tax income" for the owners.
- ✓ Using a "creeping ESOP" for acquisitions, Sub-S owners can:
  - ➢ <u>Reduce</u> their "taxable income" and taxes;
  - ➢ <u>Dramatically</u> increase acquisition company owner "after tax income;"
  - ➢ Fund their 401(k) contributions with <u>stock vs. cash;</u>
  - ➢ Provide a <u>continuing</u> tax exemption on profits;
  - ➢ <u>Increase</u> the company's "debt capacity," making additional bank loans more attractive.
- ✓ Maintain total voting control and operational control.

For Sub-S Corps, traditional acquisition methods <u>typically offer minimal return compared to risks</u>

(Note: Simply truncate numbers to make example more relevant to smaller Sub-S companies)

	Company A **"prior to"** <u>acquisition</u>
EBIT **	$90,000,000
Taxable income	$90,000,000
Cash contribution to 401(k)	$10,000,000
Interest payment on debt	$0
Principal payment on debt	$0
ESOP tax exemption	$0
Taxes paid by owners	$40,500,000
After tax income to owners	$49,500,000
Company debt capacity	$235,125,000

Annual distribution to owners $90,000,000

- Owners receive all EBIT, since the company has $ 0 debt

** EBIT = Earnings before interest and taxes

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Many Sub-S owners do not aggressively seek acquisitions, because "after tax" financial rewards are not significant

Example: Sub-S corporation prior to an acquisition

Company A

Before Acquisition…

- **EBIT is $90 million**
- **Taxable income is $90 million**

$90M annual distribution

Owners Pay Taxes:
$40.5 million

Net after tax income to owners:
$49.5 million

Assume 45% total tax (fed & state)

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Example of Sub-S corporation after "traditional" acquisition method

(without an ESOP)

Bank

$100M loan
10 yr amortization
$5M interest/yr

$15M/year
bank payment

Owners pay taxes: $42.75 million

Net after tax income to owners: $52.25 million

$95M annual distribution

Company A
After Acquisition…
- **EBIT is $110 million**
- **Taxable income is $105 million**

NOTE:
Owners net only $2.75M more for $100M additional risk of an acquisition!
…why bother?

Sub-S corporation after making a $100M acquisition using "traditional methods"

	Company A "prior to" acquisition	Company A **after "traditional"** acquisition	
EBIT **	$90,000,000	$110,000,000	
Taxable income	$90,000,000	$105,000,000	
Cash contribution to 401(k)	$10,000,000	$10,000,000	
Interest payment on debt	$0	$5,000,000	
Principal payment on debt	$0	$10,000,000	
ESOP tax exemption	$0	$0	
Taxes paid by owners	$40,500,000	$42,750,000	
After tax income to owners	$49,500,000	$52,250,000	
Company debt capacity	$235,125,000	$226,812,500	Note: "debt capacity" reduced
Annual distribution to owners	$90,000,000	**$95,000,000**	

EBIT ….$110,000,000
- less … ($15,000,000) ..P & I on debt
= net .... $ 95,000,000 .. annual distribution

** EBIT = Earnings before interest and taxes.

- It is assumed that a $100 million acquisition adds $20 million to EBIT
- $100M bank loan is amortized over 10 years ($15M annual P & I)

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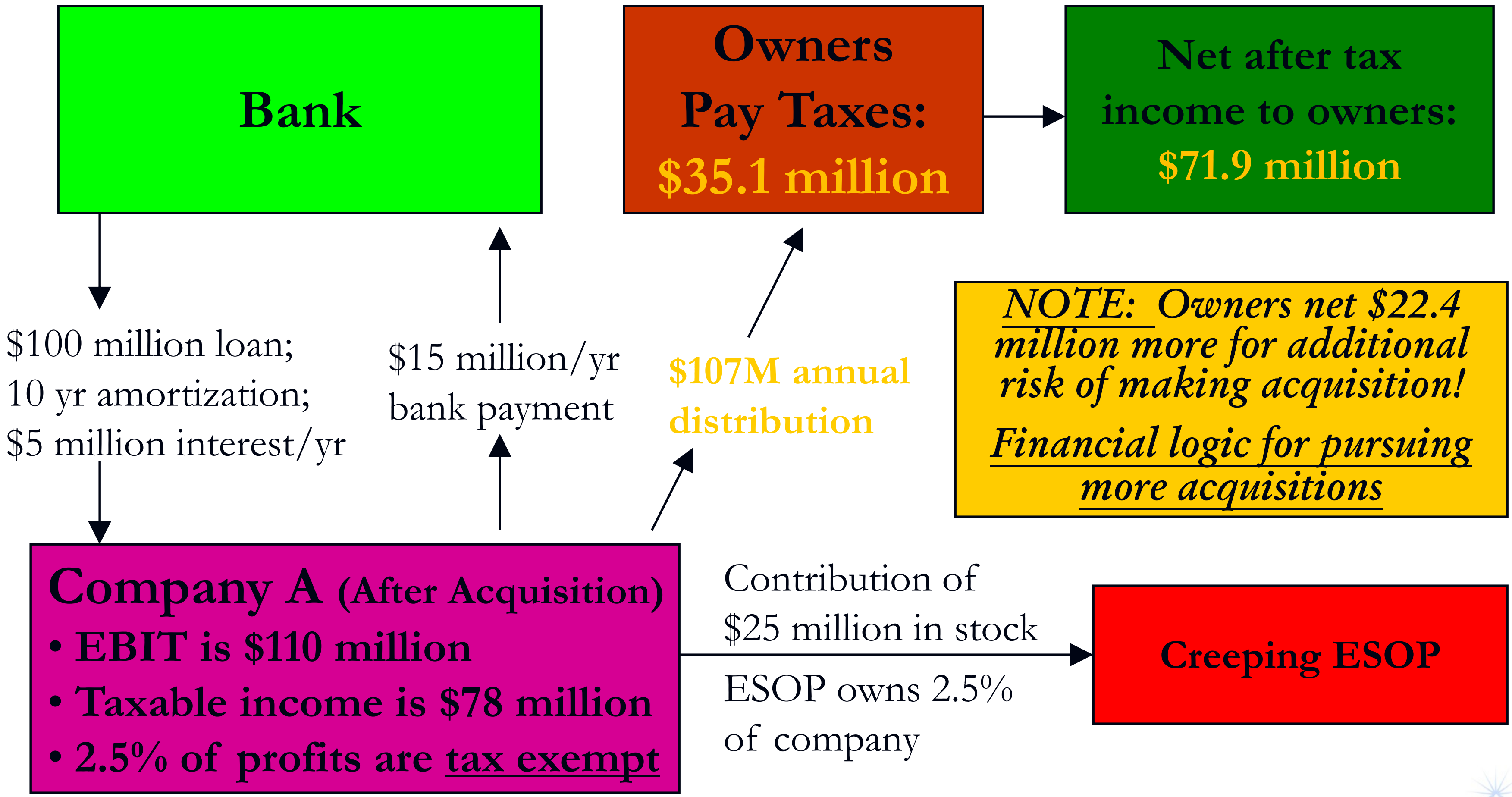
Example of Sub-S corporation acquisition transaction utilizing an ESOP



Utilizing a "creeping" ESOP in making acquisitions can dramatically increase after tax income to owners

	Company A "prior to" acquisition	Company A after "traditional" acquisition	Company A after acquisition "using an ESOP"
EBIT **	$90,000,000	$110,000,000	$110,000,000
Taxable income	$90,000,000	$105,000,000	$78,000,000
Cash contribution to 401(k)	$10,000,000	$10,000,000	$10,000,000 (in stock vs. cash)
Interest payment on debt	$0	$5,000,000	$5,000,000
Principal payment on debt	$0	$10,000,000	$10,000,000
ESOP tax exemption	$0	$0	$2,000,000
Taxes paid by owners	$40,500,000	$42,750,000	$35,100,000
After tax income to owners	$49,500,000	$52,250,000	$71,900,000
Company debt capacity	$235,125,000	$226,812,500	$284,525,000
Annual distribution to owners	$90,000,000	$95,000,000	$107,000,000

Owner Distribution Calculation

EBIT …. $110,000,000
- less … ($15,000,000) ..P & I on debt
+ plus … $10,000,000 .. cash saved by 401k stock contribution
+ plus … $ 2,000,000 .. ESOP tax exemption
= net .... $107,000,000 .. Available for annual distribution

Taxable Income Calculation

110,000,000 … EBIT
($25,000,000)…$25M to ESOP
($ 5,000,000)…interest deduct
($ 2,000,000)…ESOP tax exempt
$78,000,000 … Taxable Income

** EBIT = Earnings before interest and taxes

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Advantages of a Sub-S Corporation utilizing an ESOP to make acquisitions versus traditional methods

	Company after "traditional" acquisition	Company after acquisition "using an ESOP"	Advantage of acquisition using an ESOP	% Chg
EBIT **	$110,000,000	$110,000,000	$0	
Taxable income	$105,000,000	$78,000,000	-$27,000,000	-26%
Cash contribution to 401(k)	$10,000,000	$10 M (stock)	-$10,000,000	-100%
Interest payment on debt	$5,000,000	$5,000,000	$0	
Principal payment on debt	$10,000,000	$10,000,000	$0	
ESOP tax exemption	$0	$2,000,000	$2,000,000	
Taxes paid by owners	$42,750,000	$35,100,000	-$ 7,650,000	-18%
After tax income to owners	$52,250,000	$71,900,000	$19,650,000	38%
Company debt capacity	$226,812,500	$284,525,000	$57,712,500	25%

Conclusions:

Using an ESOP for acquisitions in a Sub-S Corporation can:

1. Reduce taxable income by 26%;
2. Increase "after tax" income to owners by 38% over "traditional" methods and a 45% increase over doing nothing;
3. Increase the company's debt capacity by 25%.

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FEP Engagement Process

- <u>Step 1: Preliminary Design</u>
  - Review company financial statements and projections
  - List client goals and objectives
  - Create applicable transaction scenarios
  - Calculate tax incentives and saving
  - Create statement of cash flow for each scenario
  - Provide a one day planning session
    - ✓ All advisors are encouraged to attend

CTC Engagement Process

- Step 2: Feasibility Study
  - Select preferred scenario
  - Create formal, detailed transaction description
  - Create detailed financial statement for transaction (& post)
  - Create financing memorandum
  - Detailed repurchase liability study
  - Detailed employee retirement benefit study
  - Detailed seller proceeds and benefits
  - Detailed management MSOP benefits
  - ESOP sources and uses of cash
  - Detailed analysis of tax savings

CTC Engagement Process

- Step 3: Implementation
  - Obtain and negotiate bank loan term sheets
  - Prepare ESOP documents for legal drafting
    - ESOP plan documents
    - ERISA filings
    - Board of Directors Resolutions
    - MSOP plan
    - Stock Purchase Agreement
    - Negotiate Transaction Fairness Opinion
    - Summary Plan Descriptions
    - Selling Notes
    - Coordinate Private Letter Ruling (if required)

CTC Engagement Process

- Step 4: Transaction Closing
  - Coordinate closing documents, meetings and signing
  - Coordinate bond purchases of FRNs for 1042 and surety bonds (if applicable)
  - Coordinate legal document filings
  - Conduct management and employee roll out meetings
  - Coordinate loan documents

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