

Financing The Sale Of Your Business

Why an ESOP may be the Perfect Buyer for Your Company

You've reached your twilight years. It's time for retirement. You plan to sell your company for \$5 million and live off the proceeds. But how will the buyer raise the money needed to buy your company?

Selling To An Outside Buyer

The chances are better than 9 in 10 that you will be required to finance at least some part of the sale price for the buyer. In fact, most business sellers finance more than 50% of the sale price by accepting a subordinated note from the buyer, with the principal payable after the bank-financed portion has been repaid¹.

The reasons are quite simple. Most successful businesses are worth considerably more than the value of their assets. The difference is generically called goodwill, and banks will not loan money on goodwill. The following example illustrates what a business buyer can reasonably expect from a bank². We will assume your company's fair market value is \$5 million, and your hard assets are worth \$3.5 million.

Asset	Book Value	Advance Rate	Loan value
Inventory	1,500,000	50%	750,000
FF&E	1,500,000	50%	750,000
Real Estate	500,000	80%	400,000
Good Will	1,500,000	0%	0
Total			1,900,00

Therefore, the buyer can borrow \$1.9 million for the purchase, based on the collateral. We will also assume the buyer has \$500,000 in savings to offer, leaving a shortfall of \$2.6 million. This portion you will be asked to finance.

Selling Price	5,000,000
less Bank Loan	(1,900,000)
less Cash	(500,000)
Seller Financing	2,600,000

Consequently, on the day of the sale you will receive \$2.4 million in cash, for which you will owe taxes of roughly \$720,000³, and a note for \$2.6 million, from which you will receive interest payments monthly, and principle payments once the bank loan is fully repaid. Taxes will be due on the seller note as the payments are received. This leaves you with \$1,680,000 (2,400,000 minus 720,000) in after-tax "walk away cash" from the \$5,000,000 sale.

So you were expecting to receive a check for \$5 million and spend the rest of your days relaxing in retirement. Instead, you got about 30% cash and a note. If the company continues its success under the new owner's leadership, you should reasonably expect to receive the remaining \$2.6 million within the next 5-10 years. Unfortunately, the reality is that only a tiny fraction of lower middle market⁴ business sellers are lucky enough to find all cash, no strings attached buyers for their companies. But there may be a better way.

"If you sold your company to an ESOP, you could fully defer the taxes on the sale, indefinitely"

¹ 2006 Business Reference Guide, 16th Edition, Business Brokerage Press, 2006.

² According to Mary Sullivan Josephs of LaSalle Bank N.A., typical rule of thumb advance rates are 80% of eligible accounts receivable, 50% of eligible inventory, 70% of real estate (we use 80% in the example), and 50% of the book value of fixed assets. See "Senior Credit Underwriting for ESOP Transactions", Leveraged ESOPs and Employee Buyout, Fifth Edition, National Center for Employee Ownership, 2005.

³ This assumes an assets sale of S corporation assets taxed at 35%. When business assets are sold, much of the gain will normally be taxed at ordinary income tax rates, considering depreciation recapture and capital structure makeup (see IRS Pub 544, Sales and Other Dispositions of Assets). While a detailed analysis of gain classification is beyond the scope of this paper, this example estimates the tax consequences of selling the typical business asset bundle.

⁴ The lower middle-market for private companies is defined generally as those businesses with annual revenues between \$4 million and \$20 million.

Selling to an ESOP

For qualified companies, a sale to an employee stock ownership plan (ESOP) may make sense. If you sold your company to an ESOP, you could fully defer the taxes on the sale, indefinitely⁵. And while the ESOP buyer will face the same borrowing constraints as any other, you can control the buyer to ensure the company's continued success. Moreover, most ESOP lenders will provide unsecured loan portions to facilitate the sale.

The following example illustrates a typical ESOP sale. In this example, rather than receiving a seller note from the buyer, the seller will pledge a portion of the sale proceeds to the bank, which will give the ESOP the ability to borrow the entire \$5 million. The example further assumes the ESOP lender advanced a 10% unsecured portion.

Asset	Book Value	Advance Rate	Loan value
Inventory	1,500,000	50%	750,000
FF&E	1,500,000	50%	750,000
Real Estate	500,000	80%	400,000
Unsecured	500,000	100%	500,000
Proceeds Pledge	2,600,000	100%	2,600,000
Total			5,000,000

As a result, on the day of the sale you will receive \$5 million in cash, with no taxes due. You will be asked to pledge \$2.6 million to the loan for collateral, which should be fully released in 3 to 5 years. Assuming you chose to invest the proceeds, you will receive investment earnings on the full \$5 million. And the continued success of the company is assured because you can retain full voting control of the company for as long as you choose. It's the classic "have your cake and eat it too".

To summarize, the following illustration compares the financial (walk-away cash) benefits available through an ESOP to a traditional or third-party company sale.

	3 rd Party Sale	ESOP Sale
Selling Price	5,000,000	5,000,000
Cash at Closing	2,400,000	5,000,000
Seller Note	2,600,000	0
Proceeds Pledge	0	2,600,000
Current Taxes Due	840,000	0
"Walk Away Cash"	1,560,000	2,400,000

Other tangible and intangible benefits also accrue to the business seller who sells to an ESOP such as the ability to keep the company in "safe" hands, rewarding employees who had a hand in the company's success, and the chance to leave a seller's legacy.

The company itself also benefits through powerful tax advantages available to ESOP companies. For example, the company can take a tax deduction, not only on the interest from the buyout loan, but on the principle. This means the entire \$5 million sale price is tax deductible. In other words, the income taxes the company normally pays on the shareholder's behalf can be used to repay the buyout loan.

ESOPs are nothing new. In fact they have been around since 1974, and more than 11,000 companies have ESOPs. So they should not be overlooked when contemplating your exit strategy. ESOP can be a highly competitive and economically favorable buyer for your company, one that is often overlooked or misunderstood by the normal business seller.

Dynasty Capital Advisors is a specialty investment banking firm catering to the sellers of middle-market private companies. Dynasty Capital Advisors is a registered trade name of Rogers Smith, Inc., headquartered in Hammond, Louisiana. Interested sellers can reach the firm at 888-542-5556 or by email to info@dynastycapital.net.

⁵ See IRS Code Section 1042. In brief, to qualify for the tax deferral, the seller must invest the sale proceeds in Qualified Replacement Property (QRP), which includes stocks, bonds, and other corporate obligations of domestic operating companies, within twelve months following the sale. The ESOP must also own at least 30% of the company after the sale, and the seller cannot be an ESOP participant.