

Setting up your Business for Success: Long-Term Profitability and Succession Planning

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Agenda

- What are the components in a succession plan?
 - Financial Plan
 - Business succession
 - Documentation of your succession plan
- Breakout Session
- What is my Company worth?
 - Elements of Value
 - Multiple of Earnings
- Is an ESOP a viable alternative?
- ESOP Practical Experiences

Personal Financial Planning – ABC's



Personal Financial Planning – ABC's

- Net Worth Total – To Maximize, Focus on “A” first, then “B” and “C”
- A – Business / Long-Term Assets
- B – Life Insurance
- C – Liquid / Invested Assets



Personal Financial Planning – ABC's Net Worth

- What is Net Worth?
 - Assets minus Liabilities = Net Worth
- Assets – What you Own
 - Cash, Investments, House, Business, etc.
- Liabilities – What you Owe
 - Credit Cards, Mortgage, Student Loans, Taxes, etc.

Personal Financial Planning – ABC's Business Equity

- “Your Business is the Goose that Laid the Golden Egg” – Ed Callahan, Famous Quotes – Volume One
- Building a Profitable, Sustainable Business must be the #1 Priority in Growing your Wealth
- Don't get distracted
- Invest in your business first, before someone else's (Amazon, Apple, etc.)



Personal Financial Planning – ABC's Other Long-Term Assets

- Personal Residence #1
- Personal Residence #2 / Vacation Home
 - “Why should I rent when I can afford to buy?”
- Business Real Estate
 - “Can I forecast my long-term space needs?”
 - “Is the building a vital part of my Company’s operations?”
- Investment Real Estate
 - “Why play in the stock market when I understand real estate more?”

Personal Financial Planning – ABC's Life Insurance

- Term vs. Whole
- Mortgage – Personal and Investment Real Estate
- Income Replacement
- Unfunded College Tuition
- Estate Tax – “Kid’s worry or mine?”
- Business – Key Man Insurance
- Executive Whole Life – Forced Savings, Tax Free Build Up
- Purchase Life Insurance when you are young and healthy

Personal Financial Planning – ABC's Liquid / Invested Assets

- Pension funding
 - Less expensive if funded early
- College/Education funding
 - 529 Plan – Conservative, but Forced Savings will add up
- Excess Liquidity Investments
 - Diversification
- Long Term Care
 - No one wants to think about it, but comforting when it's taken care of

Business Succession



Business Succession

- Focus on what is valuable to a potential buyer from the 1st day in business
 - Doesn't always mean selling to outsider
- Elements of Sustainability

1 - Character: Do the Right Thing

2 - Competency: Technical Excellence

3 - Commitment: Customer, People, Process

4 - Courageous: Risks Worth Taking

5 - Compassionate: See thru Others Eyes

6 - Consistent: Discipline

7 - Creative: Innovation

Business Succession

- Customer / Market / Brand Value
- Revenue streams
- “Am I the VP of Sales in addition to the CEO?”



Business Succession

- People / Resource Value
- “Have I developed a team that can execute without me driving the process?”
- Cost of Revenue – Labor and Subcontractors

GET
WORK

DO
WORK

KEEP
SCORE

Business Succession

- Process Value
- “How do we execute our mission / job?”
- “What makes us different?”

GET
WORK

DO
WORK

KEEP
SCORE

Business Succession

- Financial Value
- Because of Customer, People, and Process Value, has my Revenue, Gross Profit, and Net Profit been consistent?
- “Does it justify me potentially selling or being valued at a multiple of earnings?”

GET
WORK

DO
WORK

KEEP
SCORE

Business Succession Exit Strategy

1) Sale to a 3rd Party

- What am I worth?
- How do I determine what price to sell at?
- How do I determine if there is a market and/or strategic buyer interested in my company?

2) Sale to an Employee Stock Ownership Plan (ESOP)

- What am I worth?
- How does it work?
- Are there tax advantages?
- Are there additional costs?
- Will my company's culture be changed for the better or worse?
- How do I prevent a socialistic culture overtaking our need to compete with the "Best and Brightest"?

Business Succession Exit Strategy

- 3) Sale to an empowered/selected group of employees
 - Compare and contrast with ESOP
- 4) Winddown / Liquidation
 - Exhausted all other options

Business Succession Exit Strategy

5) Unexpected Exit

- Is the “hit by a bus” scenario documented or known?
 - If owner is gone, “Who is the boss?”
 - Is long term family/employee business continuity a desire?
 - Benefit
 - Burden
 - Should a sale be considered?
 - Leaders / advisors surviving spouse should turn to
 - Advisory board – who would be on it?
 - Is there a plan to resolve any unanswered questions?

Business Succession Exit Strategy

5) Unexpected Exit - Continued

- Do shareholder agreements exist? Are they clear relating to transition plan?
- Is there sufficient Key Man Insurance in place to get through transition period?
- Are the leases between operating companies and real estate company formalized and at fair market rates?

Business Succession Plan Documentation

- Legal Documents to Update
 - Wills & Trusts
 - Shareholder Agreements
 - Buy / Sell Agreements
 - “Who’s the Boss?” direction
 - Personal correspondence clarifying wills and trusts
 - Related Party Leases
 - Life Insurance Summary
 - Who owns?
 - Death Benefit
 - Purpose of Insurance
 - Taxability

Breakout Session

True Confessions / Best of Class Practices

- How many of these Best of Class Practices do you and/or your Company follow?
 - Update Personal Financial Plan (PFP) Annually
 - Share PFP with Family / Advisor
 - Review/Update Current Wills & Trusts with estate attorney at least every 3 years
 - Revisit Insurance needs at least every 5 years or in tandem with a major financial event
 - Document Company Succession Plan
 - Exit Strategy Documented

What is my Company Worth?



What is my Company Worth?

- Elements of value
- Multiple of Earnings
- Sale Structures
- Payout Methods

Is an ESOP a Viable Alternative?



Continue a Legacy and...

- Implement an ownership transition plan
- Preserve culture, jobs and community
- Continue to manage the business and operations
- Provide stockholder liquidity (generally over time) in a tax efficient sale while possibly retaining some upside and controlling timing
- Reduce or even eliminate corporate income tax
- Reward long-term employees
- Reward key management
- Uniquely position company for growth via acquisitions

What is an ESOP?

- Qualified retirement plan
- Similar to profit sharing plan, except
 - Designed to invest primarily in company stock
 - ESOP can borrow money (leveraged ESOP) to purchase company stock
- Stock is held by ESOP trust
 - ESOP trust is legal shareholder
 - Employees are beneficial (not actual) owners in value of stock allocated to their account
 - Employees do not receive stock
- Governed by IRC and ERISA, with oversight by IRS and DOL

Benefits to Owner

- Can continue to manage company
 - Receive reasonable compensation
 - Participate in ESOP (unless 1042 is elected)
 - Select and mentor next generation management
- Favorable tax treatment
 - Treated as stock sale (vs asset sale)
 - IRC Section 1042 gain deferral
 - Installment treatment available to extent seller financed
- Depending on financing structure, possibly retain some upside in company (via warrants)

Can the ESOP Pay Fair Market Value for my Stock?

- Absolutely - requirement is that ESOP not pay MORE THAN fair market value
 - ESOP is viewed as a financial buyer
- ESOP trustee has own valuation performed by an independent appraiser, to determine fair market value
 - That valuation is NOT shared by ESOP trustee with seller or any other parties
- Seller and ESOP trustee negotiate the purchase price and other economic terms
 - Seller will often engage financial advisor to perform valuation on seller's behalf for purposes of negotiating with ESOP trustee

IRC Section 1042 Gain Deferral

- Not heavily used in today's environment
 - Relatively low capital gain tax environment
 - Credit market has negatively impacted strategies
- Requirements include:
 - Stock must have been held for 3 years
 - Company must be a C corporation on date of sale
 - ESOP must own 30% or more of company after sale
 - Must reinvest proceeds in qualified replacement property (QRP) within 12 months of sale
 - Proceeds includes cash and seller notes
- Do not have to elect 1042 on total proceeds

How QRP Works

- QRP is generally stocks or bonds of domestic operating companies
- QRP receives “carryover basis” from stock sold to ESOP
- Sale of QRP during lifetime triggers income tax
- If hold QRP until death, receive “step up” in tax basis of QRP and income tax is never paid
- ESOP Floating Rate Notes
 - Can margin up to 85% - 90% with carrying cost

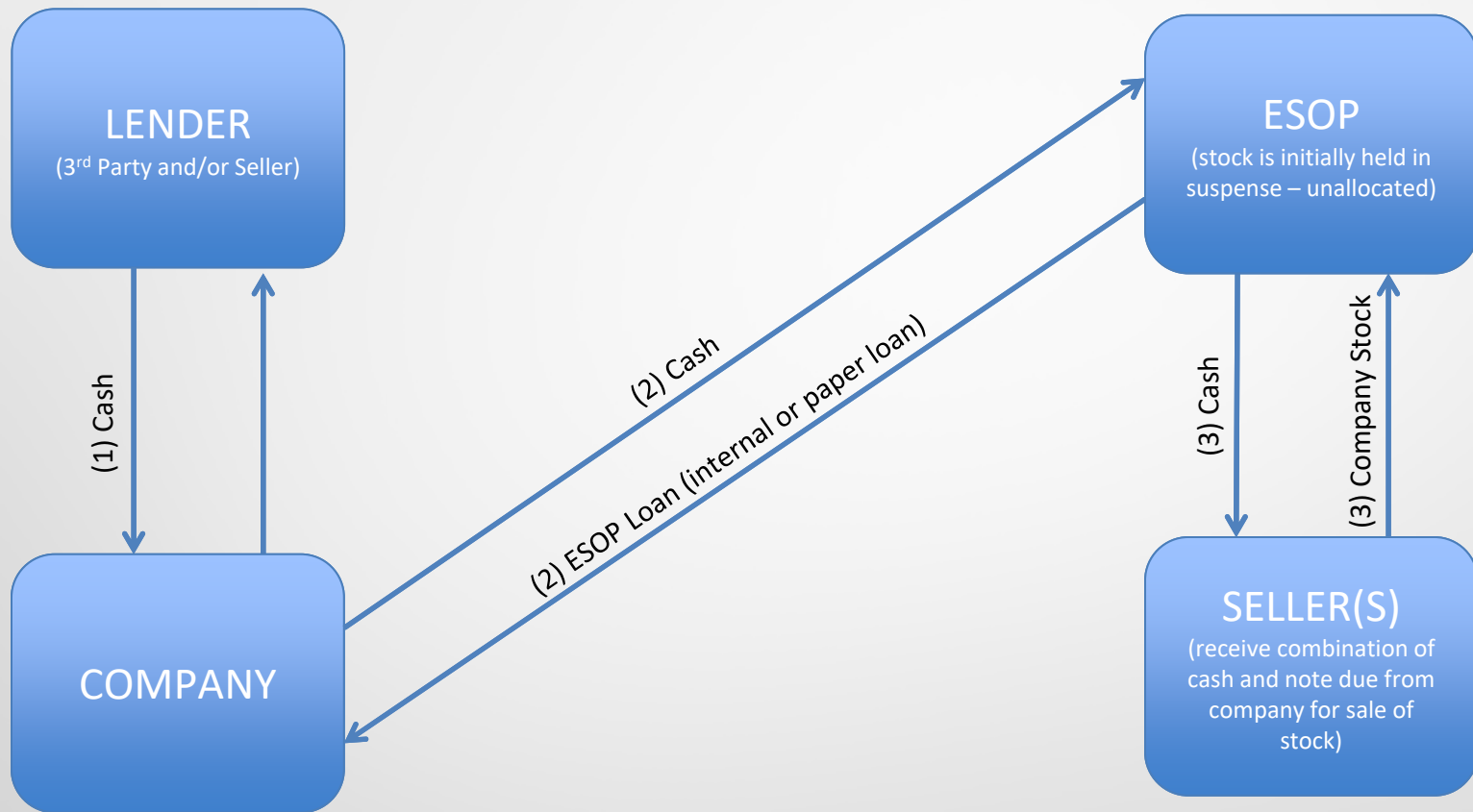
Company Benefits

- Company repays acquisition debt with pre-tax dollars
 - Interest and PRINCIPAL on acquisition debt is tax deductible
- If 100% ESOP owned S corporation, the company is exempt from federal and generally state income tax
 - Maximum federal income tax rate of 37%
- Can result in a more productive workforce
 - More communication = better results

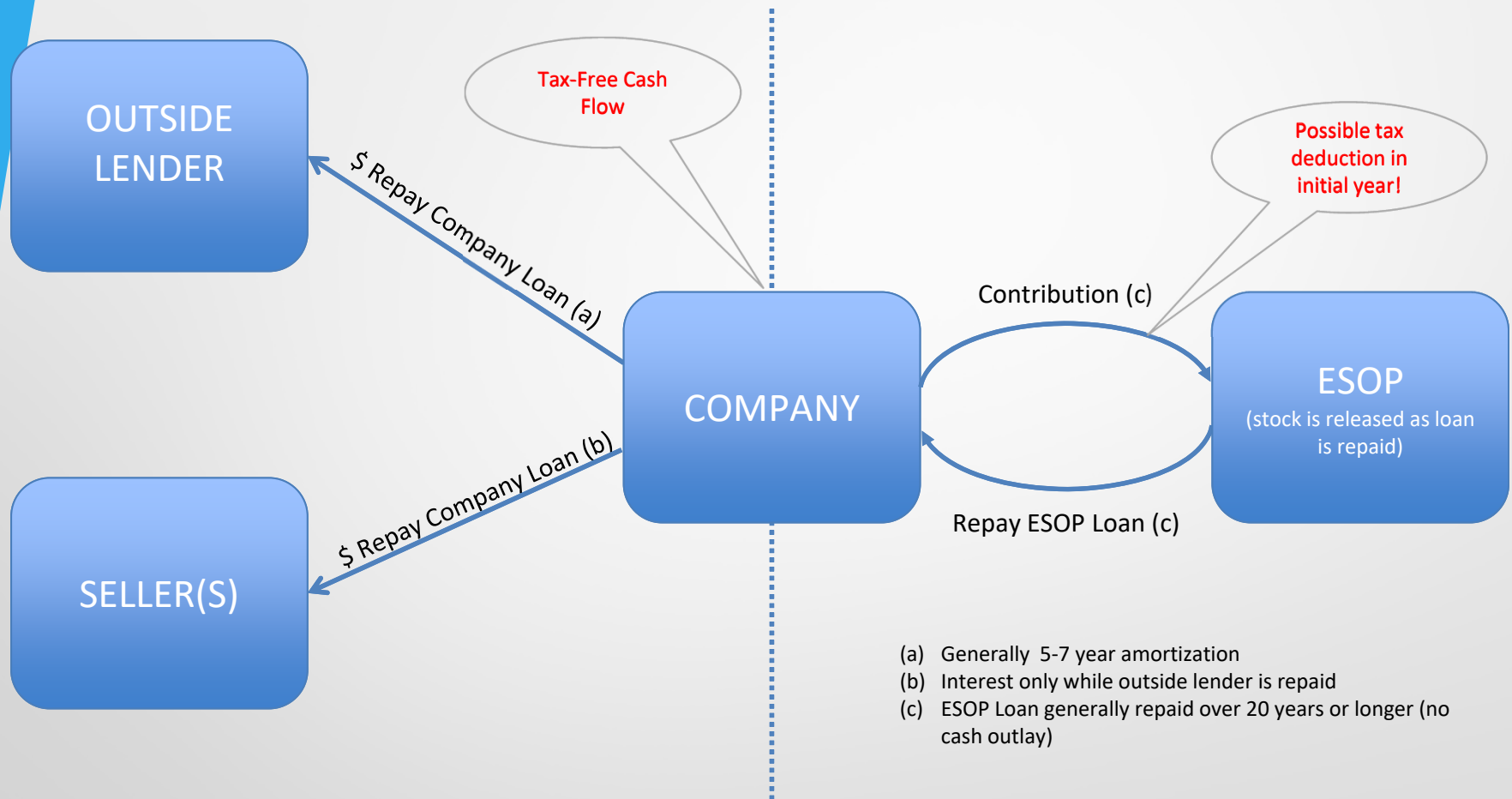
Leveraged ESOPs in General

- ESOP borrows money to purchase stock, usually from the company or selling stockholder(s)
- Similar to traditional leveraged buy-outs, except
 - Allows owner to remain in control of operations and management
 - Tax benefits to seller and company
 - Over time, wealth is transferred to a broad based group of employees who participate in the ESOP

How Does a 100% Leveraged ESOP Work?



How Does Repayment of a 100% Leveraged ESOP Work?



Company Loan Options

- Traditional bank financing
 - Collateral, cash flow and strength of management
- Seller financing
 - Transaction can be 100% seller financed, if desired
 - Subordinated to bank, if bank financing is obtained
 - Increased repayment flexibility
 - Interest rate generally between 6% to 10%
 - Straight interest
 - PIK
 - Warrants
- 3rd party alternative financing

ESOP Loan Considerations

- Has no cash flow impact!
- Contributions and dividends can be used to repay ESOP Loan
 - Contributions generally limited to 25% of compensation
- Contributions to repay loan are tax-deductible
 - Tax planning opportunity in initial year of 100% ESOP
- Shares are released and allocated to employees annually as loan is repaid
- ESOP loan in 100% ESOP is generally minimum of 20 years
- Use loan length to calibrate the percentage of compensation being provided as a benefit to employees via the ESOP

How Employees Benefit

- Retirement benefit invested in company stock
- Employees incentivized to improve stock value, and as a result their retirement benefit
 - Communication!
- Longer an employee stays, the more stock they should receive
- Once receive retirement benefit, generally can continue to defer taxes by using IRA

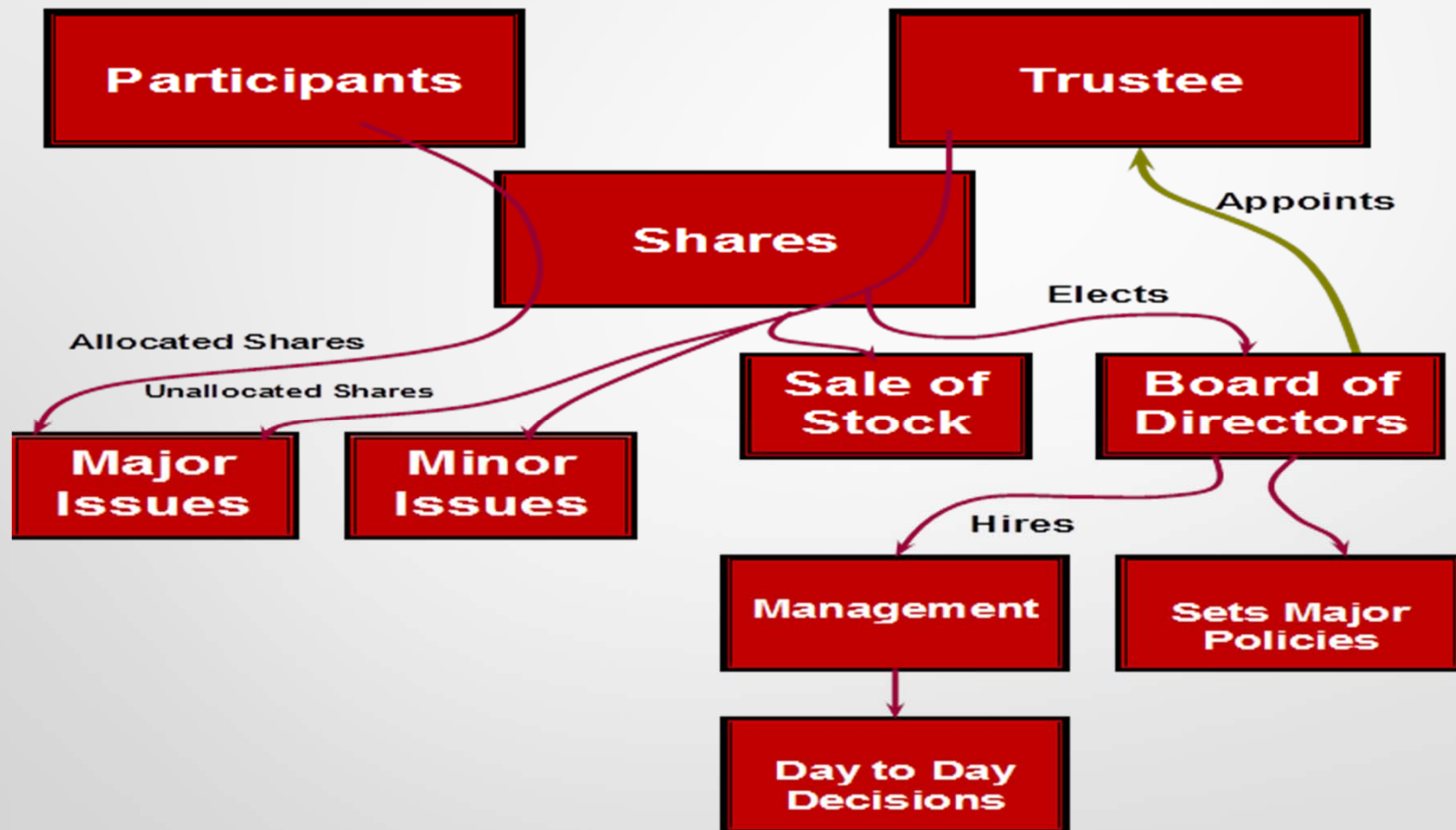
ESOP Plan Design

- Eligible employees participate
 - Subject to age and service requirements
- Shares allocated annually based on compensation (subject to limits)
- Annual statement of ESOP account balance
 - Do not have to share company financial information
- 6 year graded or 3 year cliff vesting
- Repurchase liability
 - Receive benefit in cash at retirement, disability or death
 - Delay in receiving cash benefit if leave for normal termination
 - Wait longer of 5 years or repayment of ESOP Loan
 - Paid in installments over 5 years

Executive Compensation

- Attract and retain quality management team and align ESOP and management interests
- Employment contracts
 - Salary and bonus structure
 - Non-compete
- Synthetic equity
 - Incentive stock options
 - Stock appreciation rights
- Approval by independent ESOP trustee during the initial transaction and by independent board members post-transaction
 - Reasonable compensation
 - Dilution and overall fairness

Corporate Governance – 100% ESOP



Disclaimer

- Information contained herein is intended to provide a general overview of certain ESOP structures/transactions and should not be acted upon without seeking professional guidance. ESOP laws and regulations are complex and specific recommendations and courses of action are dependent on a thorough review of facts and circumstances.

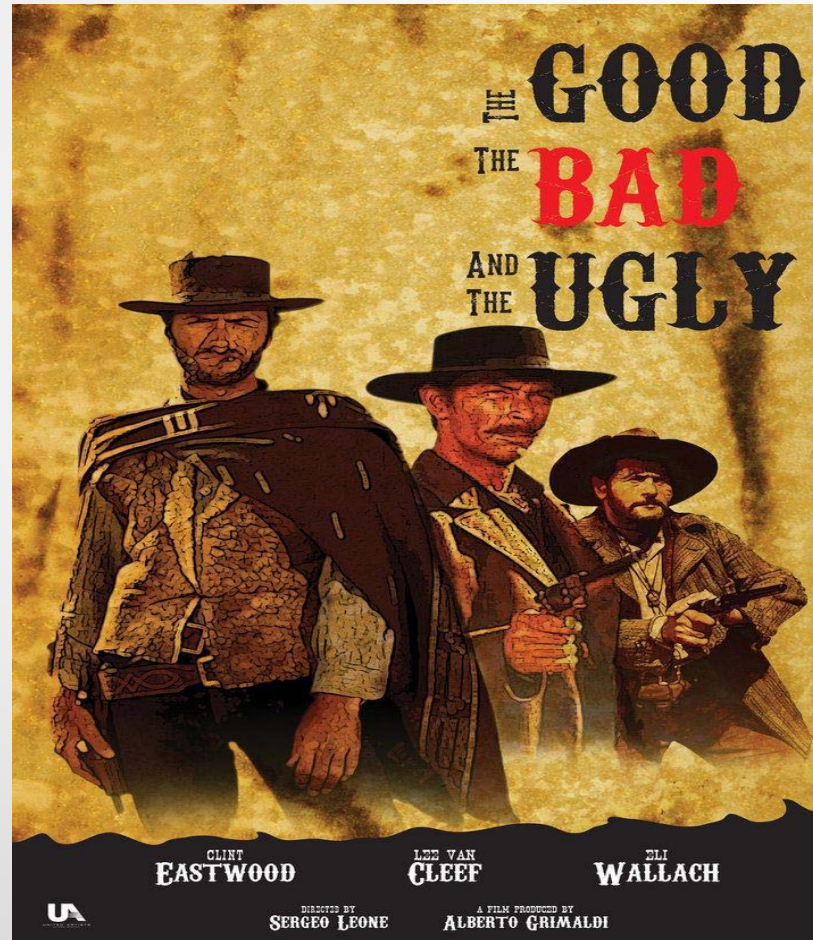
Practical Implications for ESOPs



Quick Bio

- 20+ Years in Leadership positions with GE and Johnson Controls
- Joined Shawmut Design and Construction in 2000 - President and COO
 - Led company during 100% ESOP transaction in 2005
 - Post ESOP Leadership position through retirement on 12/31/11
- Post Shawmut
 - Business Strategy Consulting
 - Privately held Board Work in the US and Canada
 - Specific focus on fiduciary ESOP Boards (4)

This Afternoon's Focus



Of ESOPs!

The Good

- Ownership for many!
 - Not possible for most
- A source of pride and common goals (retention value)
- Viable exit option for Founders where one may not exist
 - “Make a Market” for their company
- Great tax benefits for the company to accelerate debt repayment and assume ownership
- Growth opportunities for employees in the current/future absence of the Owner/Founder(s)
- “Cashless” retirement building opportunity
 - Sweat in = \$\$ Out!!

The Bad

- The Company has debt (institutional or “friendly”)
 - The Company MUST drive profitable growth over time
 - Debt repayment, repurchase liability and share price growth
- Succession imperative
 - New Leadership MUST drive the company as if they are the Founder/Owner
- ESOP’s cannot discriminate ESOP compensation
 - Requires deferred/phantom comp to retain/recruit/motivate future leadership
- “The gift that keeps on giving” – Repurchase Liability
 - See the first bullet!
- ESOP is viewed as JUST another benefit – Culture does not shift
 - Salary, bonus, 401k, health, dental and oh ya.....ESOP!

And the Ugly

- Company performance is inconsistent
 - Economic downturn
 - Leadership / Succession issues
 - Lack of long term strategy
- Company takes on too much debt
 - Causes cash restraints
- Poor planning for Repurchase Liability
- RESULTS IN:
 - BOARD INVOLVEMENT
 - BANKING/BONDING ISSUES
 - SALE
 - BANKRUPTCY

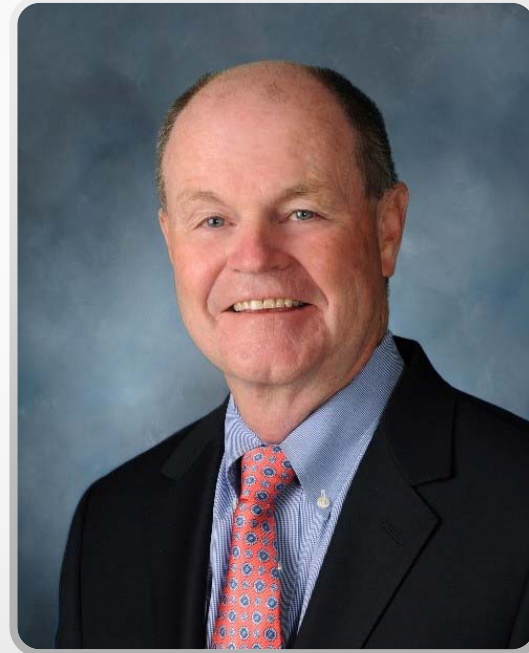
Closing Thoughts on ESOPs

- ESOP's can be great exit strategies (short and long term) for Founders/Owners and for the Employees
- ESOP transactions are highly technical and require expert help.....
 - But that is only 1/2 of it!
- What is the short and long term strategy for your company?
- Who will lead the company as good/better than you?
- How do you leverage the ESOP internally to create something special?

Final Thoughts on Succession Planning

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With more than 30 years of experience in public accounting, Ed Callahan specializes in accounting, tax and business planning issues as they apply to contractors, suppliers and professional service organizations. His other areas of expertise include information management systems (job costing, accounting, and estimating), operational and financial analysis, workers compensation planning, surety bonding, and banking assistance. A lifelong Bostonian, he holds a BS degree in business administration from the University of Massachusetts (Amherst) and an MS in taxation from Bentley University. In 2005, Ed was honored by the University of Massachusetts as he was awarded the prestigious Accounting Alumni Award.



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With a decade of experience in public accounting, Steve has an extensive background in auditing, taxation, and business consulting for clients in the construction, real estate, manufacturing, and professional services industries. His specialized services include financial reporting, tax planning, and employee benefit plans. Steve is a frequent speaker on the topics of Project Management and Employee Stock Ownership Plans (ESOPs). A member of the AICPA and MSCP, Steve holds a Bachelor of Science in Accounting from Merrimack College and a Master of Science in Accounting from Northeastern University.



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Cara is a Partner with BKD. E.J. Callahan & Associates is a member of the BKD Strategic Alliance Program.

Cara's area of focus is employee stock ownership plans (ESOPs) in privately held companies. She structures and facilitates the creation of new ESOPs and works with existing ESOPs in matters ranging from acquisition structuring to repurchase planning and analysis. Cara's experience with ESOPs also includes providing financing assistance, tax planning, ongoing plan administration, employee communication and structuring of executive incentive plans. She is frequently asked to speak to companies, trade organizations and other professional services firms throughout the country on the benefits of using ESOPs as a business succession tool.



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Bill leverages his combination of skills to develop and execute strategies to enable companies to grow. Bill is able to utilize his 40 years of business leadership experience applying the methodologies, disciplines and passion that have attributed to his success.

Before his strategy consulting and board work, Bill was President and Chief Operating Officer at Shawmut Design and Construction, a leading national general contracting and construction management firm headquartered in Boston. For 11 years he was responsible for the day-to-day operations of the company as it grew from \$100+ million to almost \$1 billion. In his role, he led the Senior Management Team in promoting the unique culture while maintaining strong financial performance and revenue growth including the transition to becoming an 100% ESOP Company.

