



## **Tri-Chapter Regional Conference**

**Pinehurst, North Carolina**

**March 24-26, 2013**

# **An ESOP CPA Examines Your Balance Sheet**

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# Financial Statement Impact of Different Types of ESOP Transactions

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## ESOP Transaction Structures

- **Pre-Fund**
  - Bank Example
    - Capitalization Requirements
- **Non-Leveraged Cash Purchase**
- **Non Leveraged Stock Contributions**
- **Leveraged-Bank Finance**
  - Manufacturing Company Example
    - Bank Covenants
- **Leveraged Seller Financed**
  - Construction Company
    - Surety Support/Bonding Requirements



# Is An ESOP a Good Idea?

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- **Feasibility Study**
  - **Viable ESOP Candidate**
    - Owner desires to stay locally owned and operated/some control of employee destiny
    - Willing to forego potential higher deal of strategic sale
    - Going concern
    - Stable cash flow
    - Significant payroll
    - Good second tier management
    - Employee focused corporate culture (can be developed)

# Example #1: The Pre-Funded ESOP

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Year 1  
Company  **\$1,000,000** ESOP

Year 2  
Company  **\$1,000,000** ESOP

**Results: Corporation taxes tax deductions and the ESOP accumulates \$2,000,000 for a future stock purchase.**

# The Pre-Funded ESOP (cont.)

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- How Would ESOP cash warehouse contributions work assuming a payroll sufficient to support a \$1,000,000 contribution?

| Current No ESOP    |                      |
|--------------------|----------------------|
| Pre-Tax Income:    | \$3,216,000          |
| ESOP Cont.         | <u>\$(0)</u>         |
| Taxable Income     | \$3,216,000          |
| Net Taxes & Adj.   | <u>\$(1,163,000)</u> |
| Net After Tax Inc. | \$2,053,000          |

| Current W/ ESOP    |                      |
|--------------------|----------------------|
| Pre-Tax Income     | \$3,216,000          |
| ESOP Cont.         | <u>\$(1,000,000)</u> |
| Taxable Income     | \$2,216,000          |
| Net Taxes & Adj.   | <u>\$ (801,000)</u>  |
| Net After Tax Inc. | \$1,415,000          |

# The Pre-Funded ESOP (cont.)

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## Bank Example Key Questions:

- How does this impact the capital and leverage ratios?
- How does this affect the stock value?
- How will investors/outside shareholders view higher employee benefits and lower earnings?

## Capitalization During Funding Phase

- While the 20% of pay or \$1M ESOP contribution may be possible....what is the impact of \$2.05M vs. \$1.41M net income?

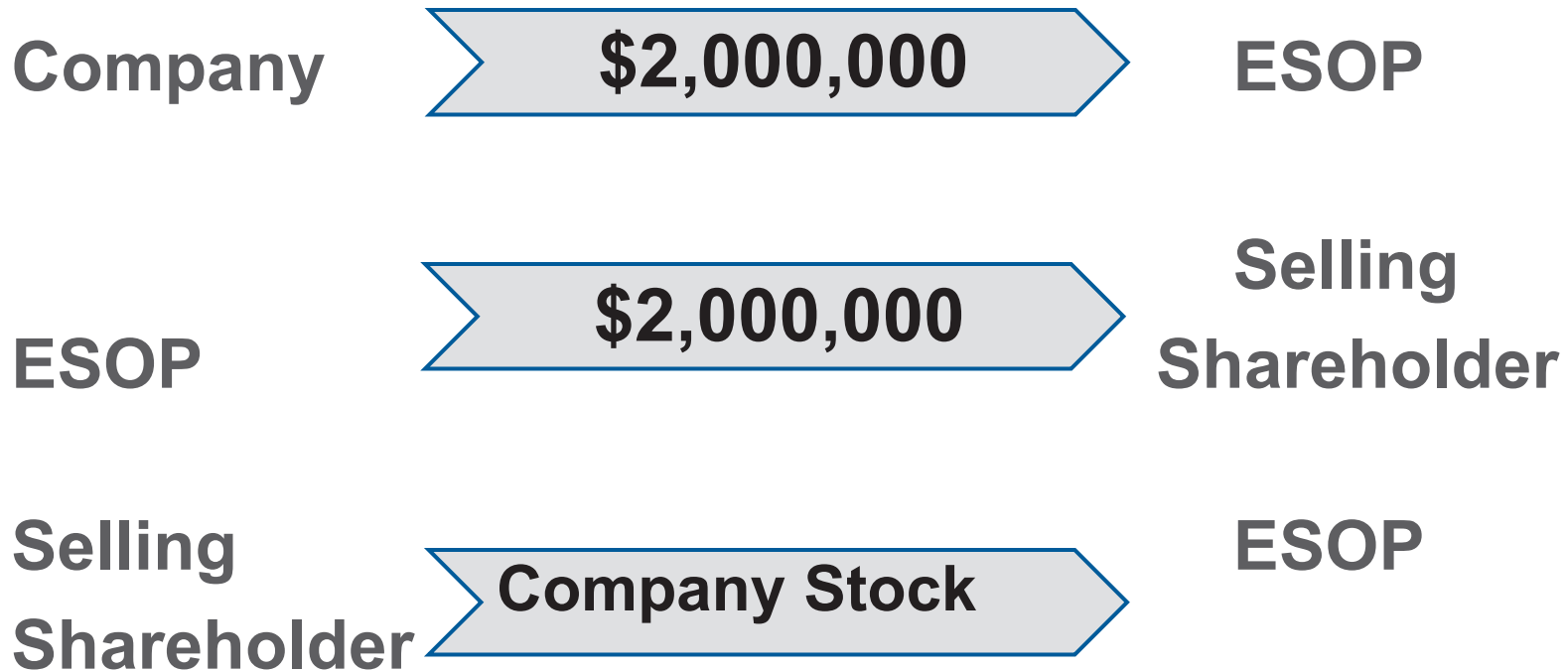


# The Pre-Funded ESOP (cont.)

| Bank Ratios No ESOP         |                | Ratios with ESOP            |                |
|-----------------------------|----------------|-----------------------------|----------------|
| Total common equity capital | \$28,957       | Total common equity capital | \$27,957       |
| Less unrealized gains       | <u>(1,232)</u> | Less unrealized gains       | <u>(1,232)</u> |
| Tier Capital                | 27,725         | Tier Capital                | 26,725         |
| Allowable ALLL              | <u>3,401</u>   | Allowable ALLL              | <u>3,401</u>   |
| Total capital               | \$31,126       | Total capital               | \$30,126       |
|                             |                |                             |                |
| Leverage assets             | 342,318        | Leverage assets             | 341,318        |
| Risk weighted assets        | 272,036        | Risk weighted assets        | 271,036        |
|                             |                |                             |                |
| Leverage ratio              | 8.10%          | Leverage ratio              | 7.83%          |
| Tier 1 weighted ratio       | 10.19%         | Tier 1 weighted ratio       | 9.86%          |
| Total risk weighted ratio   | 11.44%         | Total risk weighted ratio   | 11.11%         |
|                             |                |                             |                |

# ESOP Example #2 Non Leveraged Cash Purchase

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# ESOP Example #3 Non Leveraged Stock Contribution

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- Company issues newly issued shares to the ESOP on a fully diluted basis
- Tax deductible
- Increases cash flow
- Dilutive to shareholders



# Non Leveraged Stock Contribution (*cont.*)

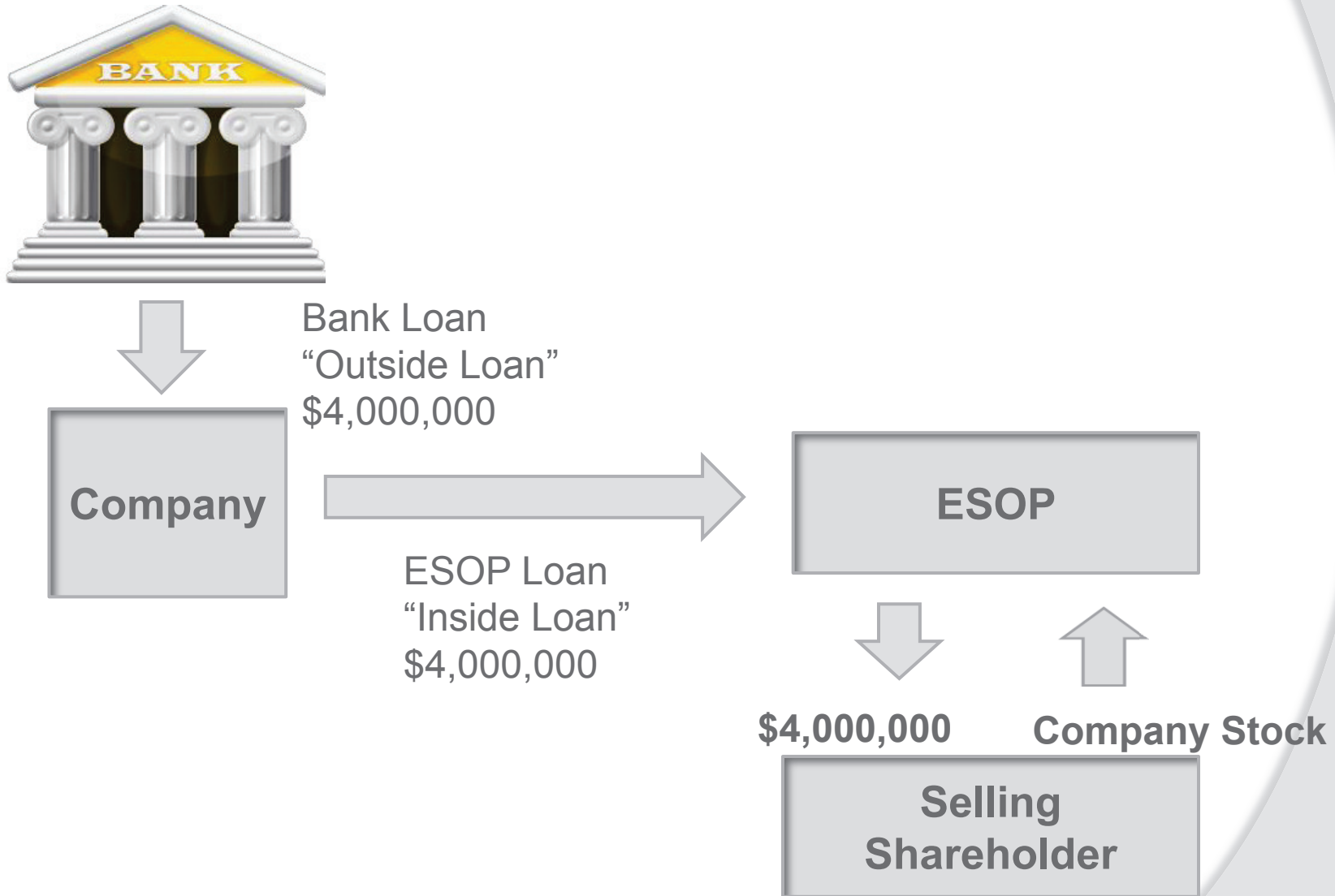
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## Stock Contribution Increases Cash Flow by \$300,000

|                            | Cash Contribution | Stock Contribution |
|----------------------------|-------------------|--------------------|
| Earnings Pre-Tax           | \$500,000         | \$500,000          |
| Plan Contribution          | (300,000)         | (300,000)          |
| Adj. Pre-Tax Earnings      | 200,000           | 200,000            |
| Federal & State Taxes 44%  | (88,000)          | (88,000)           |
| After Tax Income           | 112,000           | 112,000            |
| Plus Non-Cash Contribution | 0                 | 300,000            |
| Cash Flow                  | \$112,000         | \$412,000          |



# ESOP Transaction Example #4; Bank Financed Leveraged Purchase “Mirror Loans”

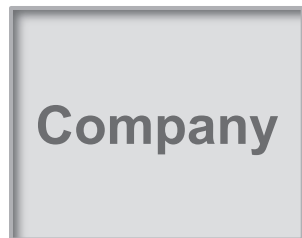


# Bank Financed Leveraged ESOP (cont.) Loan Payments

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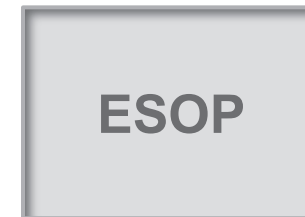
Bank Loan Payment  
"Outside Loan" \$400,000



Contribution/Dividend  
\$400,000



ESOP Loan payment  
"Inside Loan" \$400,000



# Bank Financed Leveraged ESOP (cont.)

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## Manufacturing Company Example Key Questions:

- How does this impact covenant ratios for existing senior debt?
- Do the terms on the outside bank loan have to mirror the inside loan to the ESOP?
- How does this affect the stock value?
- How will investors/outside shareholders view higher employee benefits and lower earnings?
- Cash flow; does the backlog/gross profit support Gen/Admin and the ESOP debt service?

# Bank Financed Leveraged ESOP (cont.)

| Manufacturing Co. No ESOP    |                   | Manufacturing Co. with ESOP  |                   |
|------------------------------|-------------------|------------------------------|-------------------|
| Cash                         | 1,000,000         | Cash                         | 1,000,000         |
| Receivables                  | 2,964,207         | Receivables                  | 2,964,207         |
| Other Current Assets         | <u>630,357</u>    | Other Current Assets         | <u>630,357</u>    |
| Total Current Assets         | 4,594,564         | Total Current Assets         | 4,594,564         |
| Fixed Assets                 | <u>11,132,185</u> | Fixed Assets                 | <u>11,132,185</u> |
| Total Assets                 | <u>15,726,749</u> | Total Assets                 | <u>15,726,749</u> |
|                              |                   |                              |                   |
| Current Liabilities          | 2,748,022         | Current Liabilities          | 3,148,022         |
| Long Term Debt               | <u>2,172,523</u>  | Long Term Debt               | <u>5,772,523</u>  |
| Total Liabilities            | 4,920,545         | Total Liabilities            | 8,920,545         |
| Owner's Equity               | <u>10,806,204</u> | Owner's Equity               | <u>6,806,204</u>  |
| Total Liabilities and Equity | <u>15,726,749</u> | Total Liabilities and Equity | <u>15,726,749</u> |
| EBITDA                       | \$2,370,072       | EBITDA                       | \$2,370,072       |

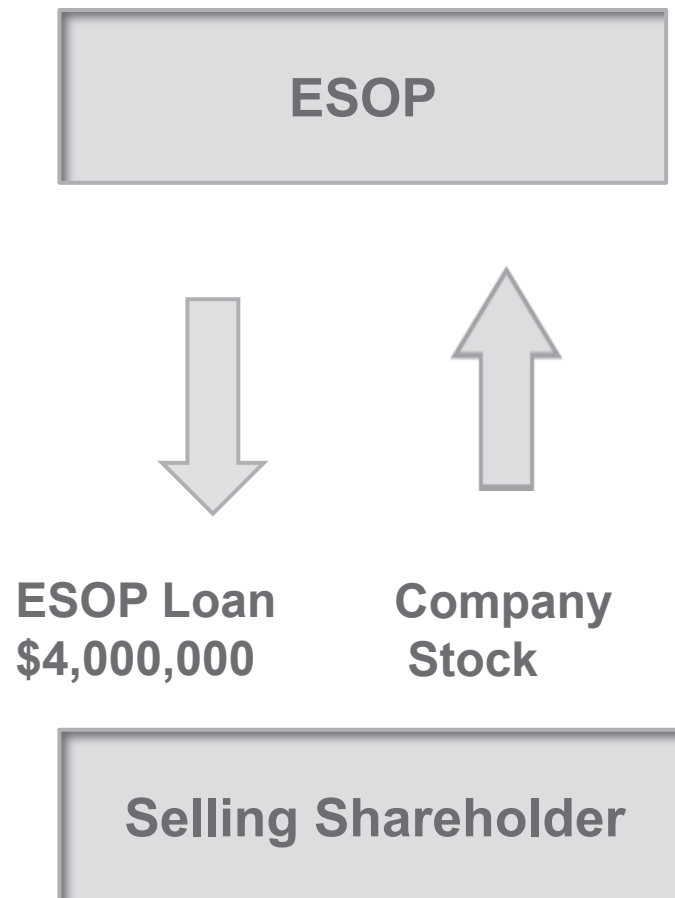
# Bank Financed Leveraged ESOP (cont.)

| Manufacturing Co. No ESOP |        | Manufacturing Co. with ESOP |        |
|---------------------------|--------|-----------------------------|--------|
| Senior Funded Debt/EBITDA | .70%   | Senior Funded Debt/EBITDA   | 2.38%  |
| Total Funded Debt/EBITDA  | .92%   | Total Funded Debt/EBITDA    | 2.44%  |
| Minimum Assets Coverage   | 1.36%  | Minimum Assets Coverage     | .51%   |
| Current Ratio             | 1.67%  | Current Ratio               | 1.46%  |
| % Total Equity            | 68.70% | % Total Equity              | 43.28% |
| Int. Debt/Inc. Capital    | 13.38% | Int. Debt/Inc. Capital      | 36.71% |
| Total Liab./Equity        | .5     | Total Liab./Equity          | 1.31   |



# ESOP Transaction Example #5; Seller Financed Leveraged Purchase

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# Seller Financed Leveraged Purchase

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## Construction Company Example Key Questions:

- How does this impact the net worth ratio and analyzed working capital?
- How does this impact surety bonding?
- How does this affect the stock value?
- How will investors/outside shareholders view higher employee benefits and lower earnings?
- Does the backlog/gross profit support Gen/Admin and the ESOP debt service?
- Seller subordinated to senior debt?
- Corporate guarantee on note?

# Strategy

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- **The strategy to evaluate the appropriate timing for funding and execution of an ESOP transaction involves a great deal of analysis including:**
  - **Financial outlook and forecast**
  - **Cash flow analysis**
  - **Bank/Surety bonding requirements**
  - **Shareholder expectations**
  - **Evaluation of financing strategies/blend of strategies**
  - **Proper communication with all parties**



# ESOP Company Balance Sheet

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## Questions?

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