



MENKE & ASSOCIATES, INC.
ESOP ADVISORS AND INVESTMENT BANKERS

The ABCs of ESOPs Web Seminar September 16th, 2011

Should you have any questions prior to the event,
please contact Jeanie Kluga at 800-347-8357

www.menke.com

1

Meeting Logistics

- ▶ **Audio**
 - Broadcast mode
 - Operator will coordinate questions and answer on the phone following each section
- ▶ **Web Conference**
 - Main window to view slides
 - To ask a question, type in your query in Chat

2

Background of Menke

Oldest ESOP advisor

– Menke was founded in 1974. 2011 marks our 37th anniversary!

Most ESOPs created

– over 2,500 ESOPs created

Largest number of Administration clients

– over 800 ESOPs

Largest ESOP advisor

– Over 50 expert advisors, lawyers, accountants and plan administrators

Largest regional presence

– 9 offices throughout the United States

3

Today's Presenters



John D. Menke
President



Kyle Coltman
Chief Executive Officer



Bruce Armstrong
Sr. Vice President



Sherman Coultas
Managing Director –
Investment Banking



Richard Rose
Managing Director –
Investment Banking

4

Today's Agenda

- ▶ Why ESOPs
- ▶ Liquidity & Diversification for Seller
- ▶ Employee Productivity
- ▶ Increase Company Cash Flow
- ▶ Business Succession
- ▶ ESOPs vs. Other Alternatives
- ▶ ESOP Disadvantages
- ▶ Menke Services
- ▶ Q&A

5

Why ESOPs are Popular

1. Pay no tax on sale of your stock (C corp.)
2. Pay little or no income taxes (C corp. or S corp.)
3. Control your company just as you do now
4. Deduct not just loan interest, but also principal
5. Employees become more productive

6

ESOP

Beauty is in the Eye of the Beholder...

- ▶ To Business Owners the ESOP is.....*a buyer of stock and/or a means of succession planning.*
- ▶ To Companies the ESOP is.....*an alternative to a merger and a means to increase productivity & a qualified retirement plan.*
- ▶ To Employees the ESOP is.....*a company – funded retirement plan and an incentive to affect their own personal wealth.*

7

You are not alone

- ▶ Over 21,000 U.S. corporations have adopted ESOPs since 1974.
- ▶ Today, U.S. ESOPs have over 12.7 million participants with over \$900 billion in assets, an average of \$71,000 per participant!

8

Beneficial vs. Direct Ownership

- ▶ The ESOP Trust is the **DIRECT** owner of company stock, **NOT** the employees.
- ▶ Employees are **BENEFICIAL** owners, and thus, do not have the same rights as direct owners of stock.
- ▶ Required Information Disclosure is limited to employee account balance.

9

Is My Company:

- ▶ Big Enough for an ESOP ?
- ▶ In the Right Industry ?
- ▶ Ready for an ESOP ?

10

Uses of ESOPs

- ▶ **Liquidity & Diversification for Seller**
- ▶ **Employee Productivity**
- ▶ **Increase Company Cash Flow**
- ▶ **Business Succession**

11

Questions to Consider

- ▶ Is there an exit strategy for the business?
- ▶ Do any shareholders want liquidity?
- ▶ Do current shareholders want to retain control while achieving liquidity?
- ▶ Is selling to an insider or an outsider attractive or viable?

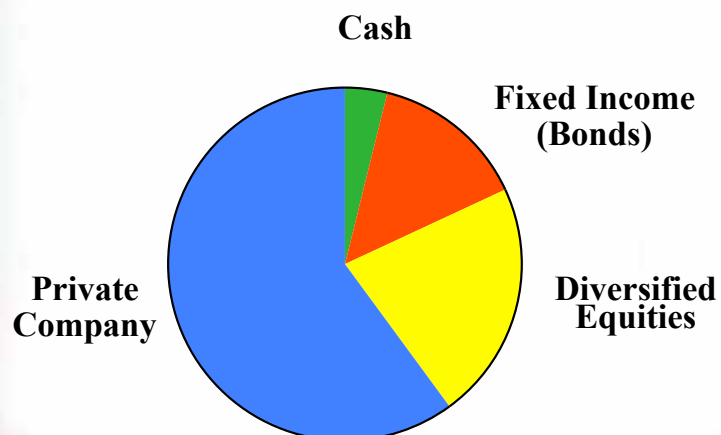
12

Liquidity & Diversification

- ▶ ESOP creates a market to sell shares
- ▶ Owners can sell all or part of their shares
- ▶ Can spread sale of shares over years
- ▶ No change of control
- ▶ No third party participation
- ▶ Low transaction cost

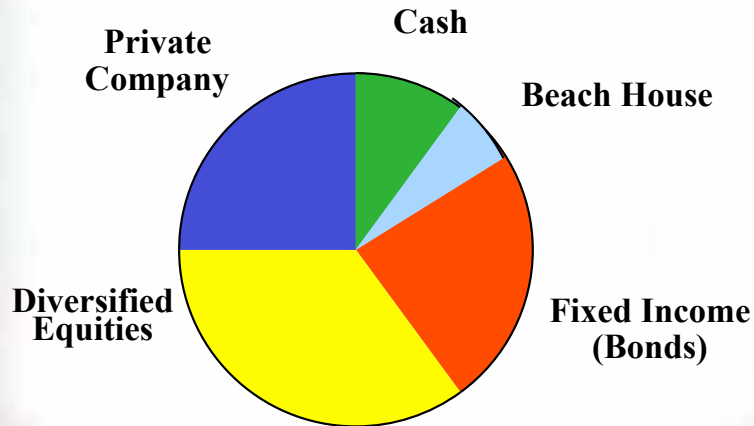
13

Your Current Asset Allocation



14

Allocation after ESOP Diversification



15

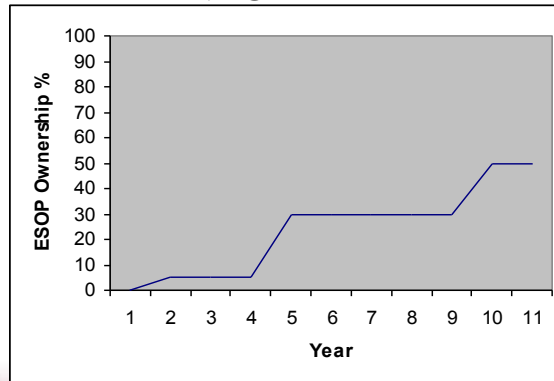
The Company Incorporated (TCI)

Sales		\$ 10,000,000
Annual Payroll		\$ 1,000,000
Pre-tax Profit		\$ 600,000
Net Worth (Book Value)		\$ 2,000,000
Fair Market Value		\$ 3,000,000
Owners:	John	75%
	Pat	25%

16

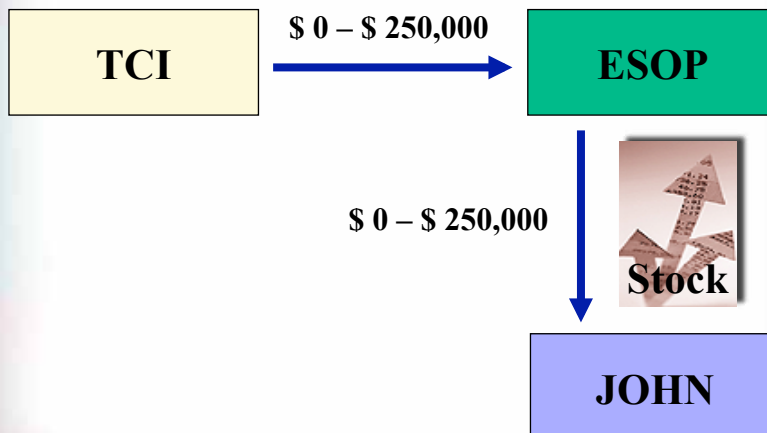
Case I – Gradual ESOP

John wants to cash out on a gradual basis (e.g. start with 5% sale)



17

Case I – Gradual ESOP



18

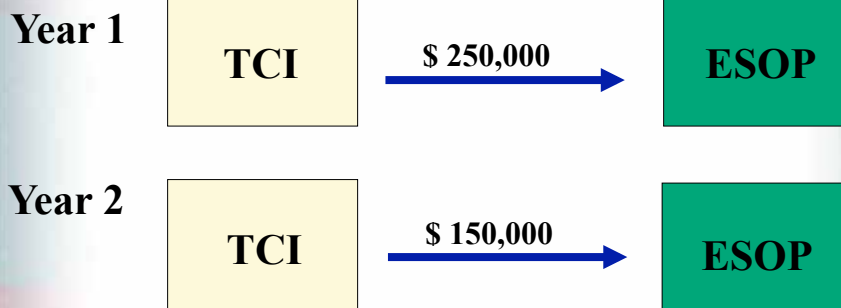
Case II – The Prefunded ESOP

Shareholder(s) do not want to sell any stock this year.



19

Case II – The Prefunded ESOP



Results:

- ▶ ESOP accumulates \$400,000 (+) for future purchase of stock.

20

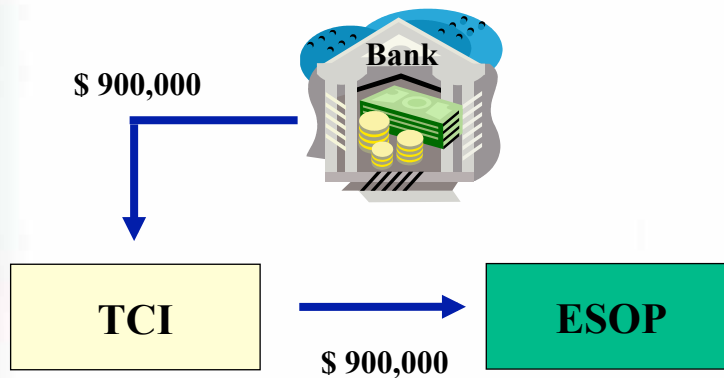
Case III – Leveraged C Corp ESOP

- ▶ John wants to cash out more quickly
- ▶ At capital gains rates or tax deferred



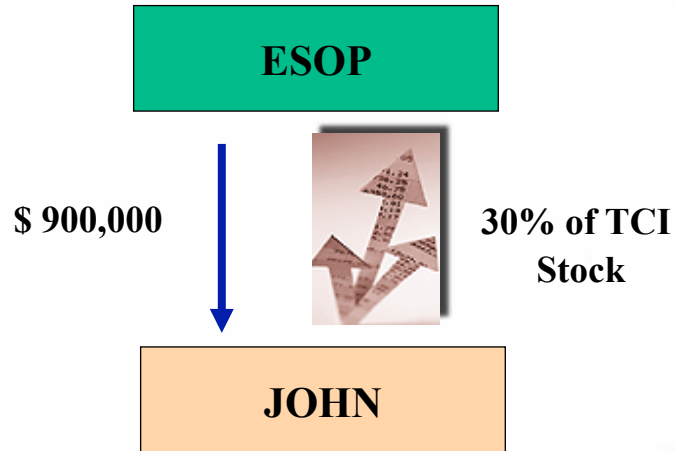
21

Bank Lends to Company, then Company Lends to ESOP



22

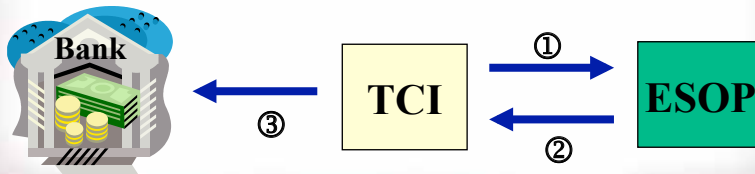
ESOP Purchases Stock



23

TCI Repays the Bank with Deductible Dollars (Principal + Interest)

- ① TCI makes a deductible cash contribution to the ESOP.
– Up to \$250,000 plus interest.
- ② The ESOP uses that contribution to repay interest and principal on the company loan.
- ③ TCI repays the bank loan.



24

More Cash To Reinvest (C corp. only)

	Tax-Free ESOP	Taxable Sale at 15%	Taxable Sale at 20%
Gross Purchase Price	\$ 900,000	\$ 900,000	\$ 900,000
Less Tax	-0-	(\$ 135,000)	(\$ 180,000)
Net to Seller	\$ 900,000	\$ 765,000	\$ 720,000

Seller's Extra Cash \$ 135,000 = 18% More Capital
 \$ 180,000 = 25% More Capital

25

Case IV – Combining ESOP Prefunding and later 30% Tax-Free Rollover Sale

Assumes the Seller's 30% Sale to the ESOP occurs in the Third Year rather than the First Year.

Year	Company's Fair Market Value	30% of FMV Tax-deferred sales proceeds To seller	Prefunding --- annual	Prefunding --- cumulative	Required bank loan	Annual Debt Service
1	\$ 3,000,000	\$ 900,000	\$ 250,000	\$ 250,000	\$ 900,000	\$ 243,000
2	N/A	N/A	150,000	400,000	N/A	N/A
3	\$ 3,333,333	\$ 1,000,000	N/A	\$ 400,000	\$ 600,000	\$ 162,000

Results:

1. Seller receives additional \$ 100,000 in tax-deferred rollover funds.
2. Seller can participate in Prefunded assets in years prior to year of tax-deferred sale.
3. The required loan is reduced by 33% (\$ 600,000 rather than \$ 900,000) and the Company's first-year principal + interest debt service is reduced by \$ 81,000 pretax.

26

Case V – Combining Year-by-Year Sale and later 30% Tax-Free Rollover Sale

Capital-gains sales followed by a tax-free rollover sale

Year	% Sale -- Annual	% Sale -- Cumulative	Taxable or Tax Deferred	S or C
1	3 %	3 %	Capital-gains	S or C
2	4 %	7 %	Capital-gains	S or C
3	5 %	12 %	Capital-gains	S or C
4	18 %	30 %	Tax Deferred	C

27

Case VI – The Two-Stage ESOP Buyout

<u>Year</u>	<u>Market Value</u>	<u>Sale Proceeds</u>	<u>Loan Balance</u>	<u>Debt Service</u>
1	\$3,000	\$1,500 (50%)	\$1,500	\$450
2	3,200		1,200	420
3	3,500		900	390
4	3,800	\$1,900 (50%)	2,500	550
5	4,100		2,200	530
6	4,400		1,900	490
7	4,800		1,600	460
8	5,200		1,300	430
9	5,600		1,000	400
10	6,000		700	370

(\$ thousands)

28

Tax-Deferred Rollover

(Section 1042 Transaction)

- ▶ ESOP must acquire 30% or more of the stock of a privately-held C corp. (not an S corp.)
- ▶ Seller must reinvest the proceeds within 12 months
- ▶ Funds must be reinvested in “Qualified Replacement Property”
- ▶ Tax deferral continues as long as seller holds QRP

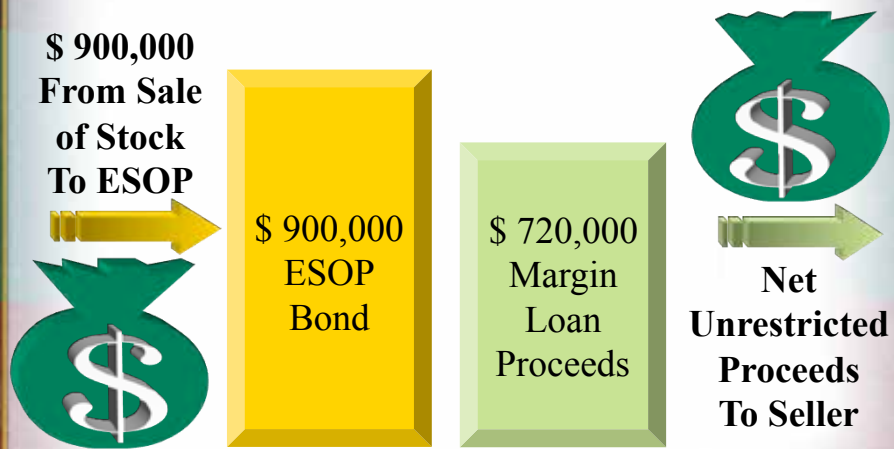
29

Qualified Replacement Property “QRP”

- ▶ Stocks or Bonds or Notes
- ▶ U.S. Corporations, Public or Private
- ▶ Can be a Brother/Sister, but not a Subsidiary of the ESOP Company

30

Unlocking the QRP Lockup



31

Case VII – Cash Out the Minority Shareholder

Pat, who owns 25%,
wants to retire & cash out



32

Case VIII – Pro Rata Sale

John & Pat
want to cash out pro rata



33

The **S** CORPORATION ESOP



34

Benefits of S Corp. ESOPs

- ▶ ESOP's share of S corp. earnings is exempt from unrelated business income tax (UBIT).
- ▶ Taxation is delayed until distributions are made to ESOP beneficiaries.
- ▶ Thus, a 100% ESOP-owned S corp. would NEVER pay income taxes.
- ▶ However, an S corp. ESOP must meet "broadly based" test.
- ▶ Selling Shareholders participate in ESOP allocation

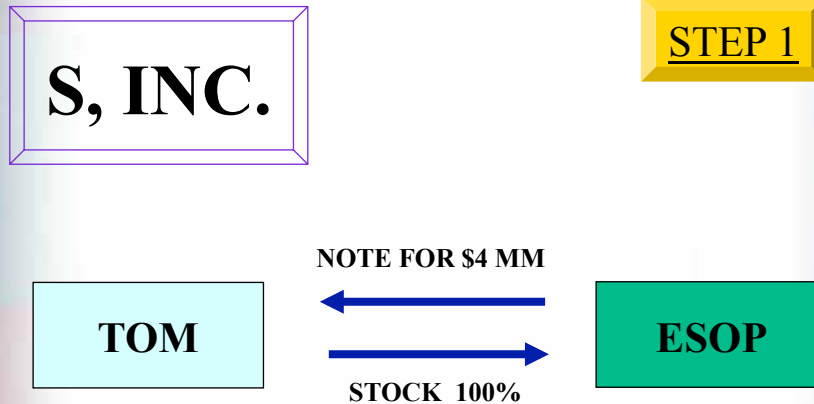
35

S Corp. ESOPs

- ▶ Tom, age 50, owns 100% of company, "S, Inc.", an S corp.
- ▶ Tom's compensation is \$210,000/year
- ▶ S, Inc. employs 20 other employees with total compensation of \$840,000/year
- ▶ S, Inc.'s annual pretax earnings are \$800,000
- ▶ The fair market value of S, Inc. is \$4MM

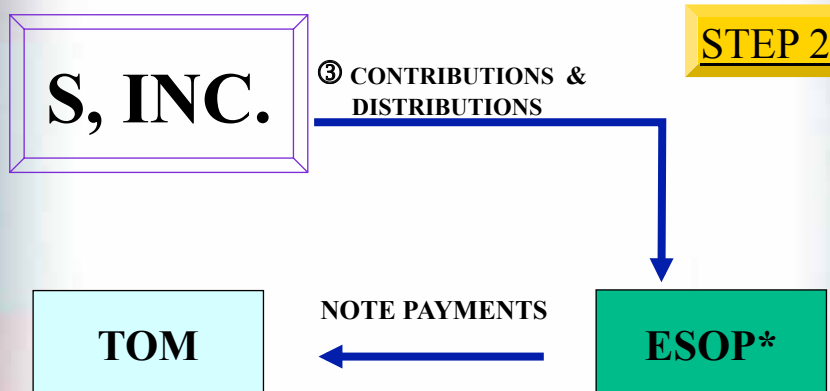
36

Case IX – Leveraged S Corp. ESOP (Seller Financed)



37

Leveraged S Corp. ESOP (Seller Financed)



* Stock is allocated to participants as a note payments are made

38

Leveraged S Corp. ESOP (Seller Financed)

Seller Note Option

- ▶ Conventional Seller Note
 - 10 to 15 year term with prepayment provisions
 - 6% to 8% interest rate
- ▶ Fully Priced Seller Note
 - 10 to 15 year term with prepayment provisions
 - IRR of 13%, based on comparable mezzanine loan rates
 - 6% to 8% current-pay interest
 - Warrants for 10% - 20% ownership to make up the difference

39

Leveraged S Corp. ESOP

END RESULTS:

1. S, Inc. shareholders pay no more income tax!
2. Tom receives \$ 4MM and, on the gain, pays only capital gains tax (not ordinary income tax)
3. Tom is allocated 20% of ESOP stock (which he will be able to cash out when he leaves Company)
4. Since Company avoids making distributions to fund S corp. shareholders' income tax (now nonexistent), additional Company funds are available to repay debt and increase Company value

40

Uses of ESOPs

- ▶ **Liquidity & Diversification for Seller**
- ▶ **Employee Productivity**
- ▶ **Increase Company Cash Flow**
- ▶ **Business Succession**

41

Human Nature

People Work Best When
They Work For Themselves

Nobody Washes a Rental Car



42

Do ESOPs Really Increase Employee Productivity?

- ▶ Yes!
- ▶ Numerous studies conducted over the last 17 years have all concluded that ESOPs increase company performance.
- ▶ The results are consistent and statistically significant.

43

Do ESOPs Really Increase Employee Productivity?

- ▶ 1987 – National Center for Employee Ownership:
 - ESOP companies with active employee participation programs had higher sales growth: 8-11%.
- ▶ 1987 – U.S. General Accounting Office:
 - ESOP companies with high levels of employee participation increased productivity growth rates by 52% per year.
- ▶ 1998 – Reish & Luftman:
 - 600 respondents – 93% had reduced absenteeism, 88% had reduced turnover, and 79% had increased morale.
- ▶ 2004 – National Center for Employee Ownership:
 - ESOP company workers' compensation incidents were up to 9% lower than non-ESOP companies.

44

Do ESOPs Really Increase Employee Productivity?

- ▶ **1992** - Washington State, New York State:
 - Study found that ESOPs are **more effective than profit sharing** at increasing results.
- ▶ **2001** – Wharton:
 - Larger than usual stock grants to executives (CEO, VPs, directors) did not significantly affect stock price.
 - **Grants to managers, technical and non-technical employees, produced significant stock price increases, 5.1% on average.**

45

Do ESOPs Really Increase Employee Productivity?

- ▶ **1998** – Washington State:
 - Average **retirement benefits for ESOP employees were 2.5x higher** than employees of comparable non-ESOP employees.
- ▶ **1998 & 2000** – Rutgers University:
 - ESOP companies had **higher survival rate** (fewer bankruptcies).
- ▶ **2004** – Department of Labor
 - The **annual rate of return for ESOPs** with more than 100 participants during the ten year period from 1990-1999 **was approximately 10% higher than for 401(k) plans** with more than 100 participants (13.3% vs. 12.0%).

46

Increase Revenues 2%

	<u>Before ESOP</u>	<u>After ESOP</u>	<u>% Change</u>
Sales	\$10,000,000	\$10,200,000	2%
Expenses	\$9,600,000	\$9,600,000	0%
Profits	\$400,000	\$600,000	50%

47

Decrease Expenses 2%

	<u>Before ESOP</u>	<u>After ESOP</u>	<u>% Change</u>
Sales	\$10,000,000	\$10,000,000	0%
Expenses	\$9,600,000	\$9,400,000	2%
Profits	\$400,000	\$600,000	50%

48

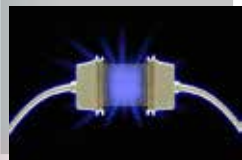
Increase Revenues 2% and Decrease Expenses 2%

	<u>Before ESOP</u>	<u>After ESOP</u>	<u>% Change</u>
Sales	\$10,000,000	\$10,200,000	2%
Expenses	\$9,600,000	\$9,400,000	2%
Profits	\$400,000	\$800,000	100%

49

Employee Productivity

Communication is the Key



SEND

50

Uses of ESOPs

- ▶ **Liquidity & Diversification for Seller**
- ▶ **Employee Productivity**
- ▶ **Increase Company Cash Flow**
- ▶ **Business Succession**

51

The “Cash Flow ESOP”

- ▶ Issue new shares to ESOP.
- ▶ Take tax deduction for full market value of shares.
- ▶ Company conserves cash by:
 - Paying less taxes.
 - Replacing cash compensation program, like 401k match or profit sharing, with non-cash ESOP.

52

Increased Cash Flow

	<u>Profit Sharing</u>	<u>ESOP</u>
Earnings Before Taxes	\$ 500,000	\$ 500,000
Plan Contribution	(\$ 300,000)	(\$ 300,000)
Adjusted 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
Increased Company Cash Flow		\$ 300,000

53

Uses of ESOPs

- ▶ **Liquidity & Diversification for Seller**
- ▶ **Employee Productivity**
- ▶ **Increase Company Cash Flow**
- ▶ **Business Succession**

54

**ESOP IS INHERENTLY
THE LEAST STRESSFUL MEANS
OF TRANSFERRING OWNERSHIP**

- ▶ Draws on pre-tax cash flow
- ▶ Done in stages – less leverage, less interest expense
- ▶ No change of management control

55

**Getting Additional Equity
To Key Employees**

- ▶ Stock Sale To:
 - ESOP
 - Key Employees
- ▶ Stock Gift To:
 - Family
 - Key Employees (MSBP)

56

ESOP
vs.
OTHER ALTERNATIVES



57

Liquidity Options for Private Companies

- ▶ Sale
- ▶ Merger
- ▶ Going Public
- ▶ Redemption
- ▶ Management Buyout
- ▶ ESOP (for 1% to 100% of the Company)
- ▶ Combination of Alternatives

58

ESOP vs. SALE

- | | |
|----------------------------------|---------------------------|
| ▶ You Control Timing | ▶ Must Find a Buyer |
| ▶ Retain Flexibility | ▶ All or Nothing |
| ▶ Usually Gradual | ▶ Cash on the Barrelhead? |
| ▶ Share Future Growth | ▶ Get Best Price You Can |
| ▶ Remain on the Job | ▶ Walk Away ? |
| ▶ Keep Jobs for Valued Employees | ▶ ? |

59

ESOP vs. MERGER

Tax-Free ESOP Rollover

- ▶ You're the Boss
- ▶ You Choose Diversified Securities for Your Replacement Portfolio
- ▶ Company Continues As Independent Business
- ▶ Requires Sale of 30% or More

Tax-Free Merger

- ▶ You May Become An Employee
- ▶ You Take the Stock of the Acquiring Company
- ▶ Company Often Disappears
- ▶ Usually Requires Sale of 80% or More

60

ESOP vs. Going Public

▶ For Shareholder Liquidity

▶ For Expanding Capital

▶ Mature, Profitable Co.

▶ Fast Growing, Sexy Co.

▶ Profitable, Tax Paying

▶ Minimum Capitalization:
\$50 Million

▶ Start Up Costs Low

▶ Start Up Costs High

▶ Some Management Time

▶ Considerable
Management Time

61

ESOP vs. Redemption

Redemption More Costly

	<u>Amount</u>	<u>After-Tax Cost</u>
ESOP Contribution	\$100,000	\$ 66,000
Redemption	\$100,000	\$100,000

62

ESOP vs. Conventional Approach

Conventional Approach Significantly More Costly

<u>Conventional Approach</u>	<u>Amount</u>	<u>After-Tax Cost</u>
Profit Sharing Contribution	\$100,000	\$ 66,000
Redemption	\$100,000	\$100,000
Total	\$200,000	\$166,000
<u>ESOP Approach</u>		
ESOP Contribution	\$100,000	\$ 66,000

63

ESOP vs. Management Buyout

▶ May Be Done in Stages, Which Requires Fewer Bankable Assets

▶ Requires More Collateral

▶ Almost All Companies

▶ “Hard Asset” Companies

▶ Principal Deductible

▶ Principal Not Deductible

▶ All Employees Own Some

▶ Some Employees Own All

64

Valuing Private Companies



65

ESOP Can Not Pay More Than FMV

Revenue Ruling 59-60

“Fair Market Value (FMV) is the price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts.”

66

ESOP Valuation Procedures

- ▶ Independent appraiser required (unless publicly traded).
- ▶ Why? Required by DOL and IRS.
- ▶ Responsibility of ESOP trustee.
- ▶ Frequency:
 - As of transaction date.
 - At least annually.

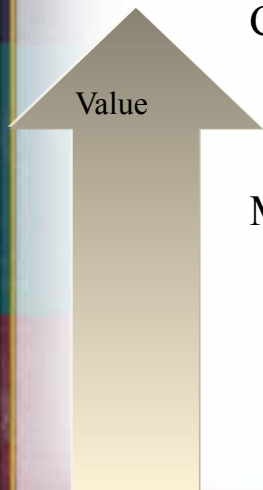
67

What Defines “Independent?”

- ▶ “Independent Appraisal” is required by statute
 - Appraiser may not be a party to the transaction.
 - Appraiser’s primary business is valuing privately owned companies.
 - Usually can not be your outside accounting firm.
 - Appraiser can not be currently or in the future valuing the business for other purposes (e.g., estate planning)

68

Tiers of Value



CONTROL VALUE

- Control Block – Strategic Buyer
- **Control Block - Financial Buyer**

MINORITY VALUE

- Public Market
- **Private Market With an ESOP**
- **Private Market/Estate Planning**
- Orderly Liquidation

69

Valuation Criteria

- ▶ General economic outlook.
- ▶ Nature and history of the industry.
- ▶ Nature and history of the company.
- ▶ Earnings capacity:
 - Normalized historical earnings & cash flow
 - Discretionary expenses
 - Projected earnings

70

Multiple of Adjusted Earnings

▶ Pre-Tax Earnings	\$400,000
▶ Possible Adjustments (Non-Recurring Expenses or Revenues):	
▶ Unusual Bad Debt	\$50,000
▶ Discretionary Expenses	\$25,000
▶ R & D	\$25,000
▶ Discontinued Compensation	\$190,000
▶ Gain on Sale of Assets	<u>(\$25,000)</u>
▶ Adjusted Pre-tax Earnings	\$665,000
▶ Pre-tax Price Earning Multiple	x 5.5
▶ Fair Market Value	\$3,650,000

71

Multiple of Cash Flow

Adjusted Pre-Tax Earnings	\$665,000
Plus: Depreciation, Amortization, and other Non-Cash Expenditures	250,000
Minus: Capital Expenditures	(100,000)
Minus: Working Capital increases	<u>(50,000)</u>
Net Cash Flow	\$765,000
Price/Cash Flow Multiple	x 5
Fair Market Value	\$3,825,000

72

Selection of Price/Earnings Multiple and Cash/Flow Multiple

- ▶ Determine multiples of comparable privately held firms from various databases of privately held firms.
- ▶ Determine multiples of publicly-traded companies in the same industry as subject company.
 - Apply “small company” discount.
 - Normalize for growth

73

Discounted Cash Flow

- ▶ Management makes projections for future earnings and cash flows from operations. Differences from historical patterns are analyzed for reasonableness.
- ▶ Projected earnings and operating cash flows are discounted to arrive at their “present value” equivalent.

74

Final Weighted Average Valuation

Multiple of Adjusted Earnings	\$3,650,000	40%
Multiple of Cash Flow	3,825,000	40%
<u>Discounted Cash Flow</u>	<u>4,500,000</u>	20%
Final Appraised Fair Market Value	\$3,890,000	

75

How the ESOP Operates



76

Plan Operations - The Five Steps

1. Company contributions
2. Eligibility / Participation
3. Allocations
4. Vesting
5. Distributions

77

Step 1 – Company Contributions

- ▶ Each year the company may elect to make a “ESOP contribution” to the ESOP trust.
- ▶ The contribution may range from 0% to 25% of eligible payroll.
- ▶ **There are no contributions from the employees.**

78

Maximum ESOP Deduction

- ▶ Up to 25% of Eligible Payroll (§404)
 - For C Corporations, interest can be contributed over and above 25% of eligible payroll.
 - For S Corporations, interest must be included within 25% of eligible payroll.
- ▶ 25% includes Profit Sharing + ESOP + Employer 401(k) match.

79

Deduct More Than 25% (C Corporations Only)

- ▶ Use “Deductible Dividends.”
- ▶ Dividends are deductible when:
 - Applied to pay down the loan used to buy those particular shares.
 - Paid-out directly to plan participants.
- ▶ Must be “reasonable” (recommend $\leq 6.5\%$).
- ▶ Must be paid by fiscal year end.

80

Contribute More Than 25% (S Corporations Only)

- ▶ Each year the company may also elect to make an S corporation distribution to the ESOP.
- ▶ S corporation distributions made to an ESOP can be used to pay down an ESOP loan, or can be accumulated in the plan for future liquidity purposes.

81

Step 2 - Eligibility

Which employees are typically eligible?

- All employees

Possible exclusions:

- Union members
- Part time or short term employees
- Employees under age 21
- Employees of subsidiaries

82

Eligibility

When does a new employee join the Plan?

- Immediately.
- or
- Deferred - maximum is 1.5 years.
 - Most common: 1 year & 1,000 hours.

83

Step 3 - Allocations

How is the company's annual contribution apportioned among the participants?

- In proportion to eligible payroll,
- or
- UNITS – a combination of salary and seniority

84

What is Eligible Payroll ?

- ▶ W-2 base pay wages, including or excluding:
 - Bonuses and overtime.
 - Commissions.
- ▶ Limitations per participant:
 - Contribution limitation - only first \$245,000 of pay counts.
 - Allocation limitation - lesser of 100% of pay or \$49,000.

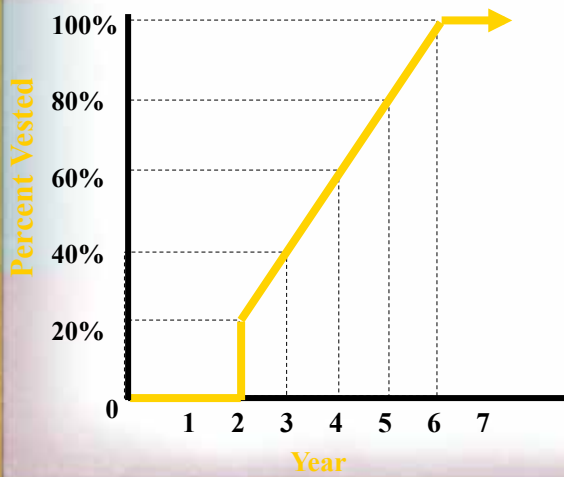
85

Step 4 - Vesting

- ▶ Years of Service:
 - Inception date of ESOP (required by ERISA, but can elect a more generous vesting schedule), such as
 - All prior years of service
 - Service under prior plan (e.g., 401k plan).

86

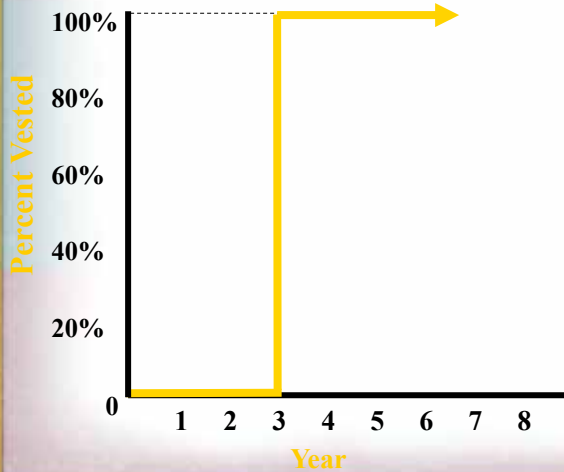
Vesting – 6 year graduated schedule (ERISA option 1)



Service Years	% Vested
1	0
2	20
3	40
4	60
5	80
6	100

87

Vesting – 3 year “cliff” schedule (ERISA option 2)



Service Years	% Vested
1	0
2	0
3	100

88

Step 5 - Distribution at Retirement, Death or Disability

- ▶ Paid in year following event:
 - In a lump sum (small amounts), or
 - In up to 5 equal annual installments
 - Note: Distribution could start at age 68 if that is the year the participant decides to retire.

89

Distribution for Involuntary or Voluntary Departure

- ▶ Years 1 to 5: no distributions.
- ▶ Thereafter:
 - In a lump sum (small amounts), or
 - In up to 5 equal annual installments.

90

Participant Diversification Option

A Participant who:

- is over the age of 55, and
- has 10 Years in ESOP.

May direct a portion of his/her account to be transferred from Company Stock into Other Investments:

- up to 25% first five years
- up to 50% after age 60

91

WHAT ARE THE DISADVANTAGES OF ESOP

Perceived vs. Real

92

Availability of Bank Financing

- ▶ Company cash flow
- ▶ Company assets not already pledged
- ▶ Possible seller's personal guaranty or partial pledge of QRP
- ▶ Possible use of seller's financing

93

Accounting for Leveraged ESOPs

Balance Sheet Effects

- ▶ ESOP debt recorded as employer debt
- ▶ Equity is reduced
- ▶ Equity is restored as debt is repaid
- ▶ Bonding availability?

94

Limitations of S Corp. ESOPs

- ▶ No tax-free rollover (capital gains tax)
- ▶ No deductible dividends
- ▶ Interest and forfeitures are included in 25% company contribution limit

95

Dilution (Only When New Shares Are Issued)

Company Value	\$5,000,000
Contribution	\$150,000
Dilution of Ownership Percent	3%

How much will the Company's cash and capital increase?

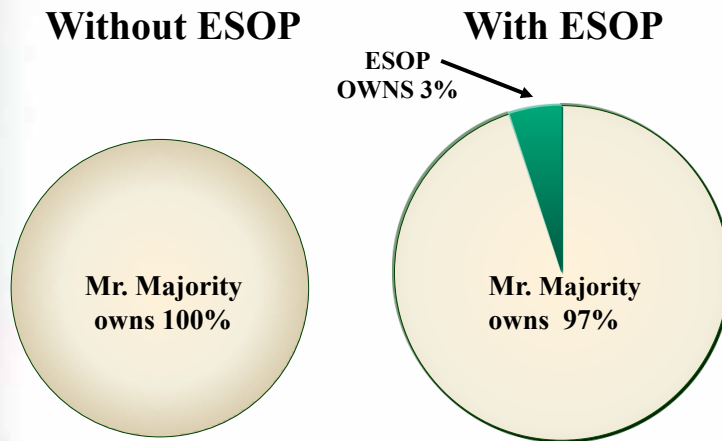
- a) If there is no prior plan - ESOP is incremental benefit \$ 60,000
- b) If ESOP replaces prior Profit Sharing Plan \$150,000

How profitably can the Company reinvest the extra cash?

“Smaller piece of a bigger pie”

96

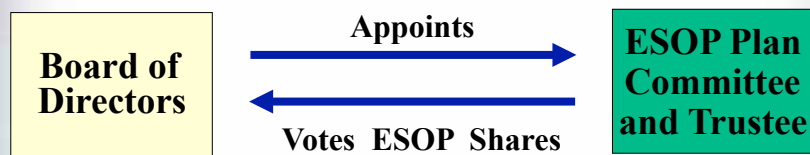
Smaller Piece of a Bigger Pie



“Percentage” Dilution May Not Be “Economic” (Per-Share) Dilution

97

Control



- ▶ Bill initially owns 100%
- ▶ Bill appoints himself as the Plan Committee and Trustee
- ▶ Bill sells 60% to ESOP
- ▶ Bill votes his own remaining 40%
- ▶ As the Plan Committee and Trustee, Bill also votes the 60%
- ▶ Hence, Bill still votes 100%

98

Voting Rights

- ▶ On Ordinary Issues
- ▶ On Special Issues

99

Voting Rights Special Issues

- ▶ On Merger, Consolidation, Recapitalization, Liquidation or Sale of Substantially All Corporate Assets
- ▶ Employees only vote allocated shares
- ▶ No voting rights on sale of stock for cash

100

Selling the Company

- ▶ You can sell your non-ESOP shares
- ▶ Plan Committee can sell the ESOP shares
- ▶ Company can terminate ESOP

101

Disclosures

	<u>Yes</u>	<u>No</u>
Account Balance	<input checked="" type="checkbox"/>	
Vested Percentage	<input checked="" type="checkbox"/>	
Per Share Value of Stock	<input checked="" type="checkbox"/>	
Financial Statements		<input checked="" type="checkbox"/>
Salaries of Officers		<input checked="" type="checkbox"/>
Valuation of Company		<input checked="" type="checkbox"/>

102

Company Name				
EMPLOYEE STOCK OWNERSHIP PLAN				
PAT DOE				
Your account(s) have been credited as follows for the period ended December 31, 2003:				
COMPANY STOCK ACCOUNT				
	<u>SHARES</u>	<u>PRICE</u>	<u>VALUE</u>	<u>VESTED--% VALUE</u>
Last Year's Balance	1,000,000	\$ 13.50	\$ 13,500.00	100%
This Year's Contribution	1,153,846	\$ 15.00	\$ 17,307.00	
Share of Forfeitures	0.000	\$ 15.00	\$ 0.00	
Transfers To/From OIA	42,799		\$ 577.78	
Unrealized Gain/(Loss)			\$ 1,564.90	
Distributions/Transfers			\$ 0.00	
BALANCE AS OF 12/31/03	2,196,645	\$ 15.00	\$ 32,949.68	\$ 32,949.68
OTHER INVESTMENTS ACCOUNT				
			<u>VALUE</u>	<u>VESTED--% VALUE</u>
Last Year's Balance			\$ 1,000.00	100%
This Year's Contribution			\$ 384.62	
Share of Forfeitures			\$ 0.00	
Transfers To/From CSA			\$ (577.78)	
Investment Gain/(Loss)			\$ 27.03	
Distributions/Transfers			\$ 0.00	
BALANCE AS OF 12/31/03			\$ 833.87	\$ 833.87
TOTALS			\$ 33,783.55	\$ 33,783.55
Menke & Associates, Inc., San Francisco, CA				

Fiduciary Liability		
	<u>Profit Sharing</u>	<u>ESOP</u>
▶ Fair Rate of Return	Yes	No
▶ Diversification	Yes	No
▶ Liquidity	Yes	No
▶ Fair Market Value Appraisal	Yes	Yes

Repurchase Obligation

	<u>Stock Redemption</u>	<u>ESOP</u>
Timing	All at Once upon death or retirement of owner	Spread Over Lives of Many Plan Participants
Cost	Nondeductible	Deductible

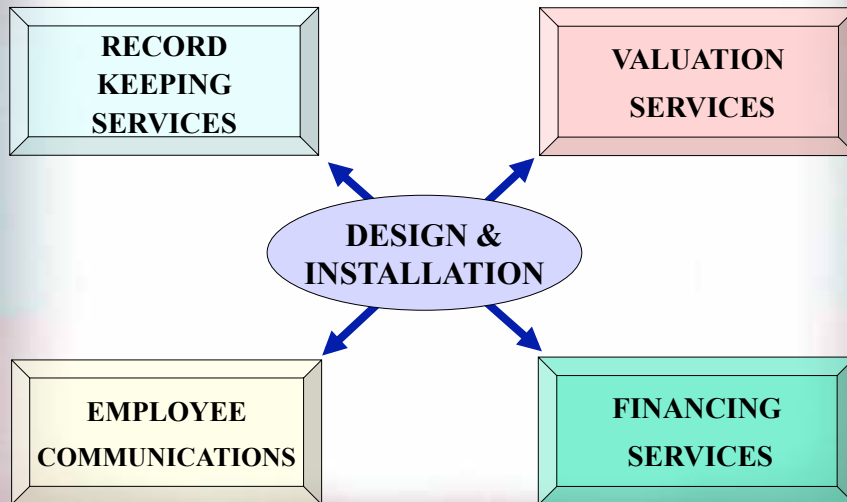
105

What If I Change My Mind?

- ▶ ESOP does not prevent sale of Company
- ▶ Terminate ESOP and distribute
- ▶ Freeze ESOP and convert to profit sharing/ 401(k)
- ▶ Gradual phase-out

106

Menke & Associates Total ESOP Servicing



Design & Installation Services

- ▶ Stock Valuation
- ▶ Financial Consulting
- ▶ Drafting of Legal Documents
- ▶ Obtaining of IRS Approval
- ▶ Employee Communications
 - Booklets
 - PowerPoint Presentation
- ▶ Accounting System & Administrative Forms

108

Annual Services

- ▶ Annual Recordkeeping
 - Continuing Consulting
 - Preparation & Filing of Tax Return
 - Preparation of Participant Benefit Statements
- ▶ Annual Update of Stock Valuation

109

Why it is Important to Use an ESOP Specialist

- ▶ Extensive Expertise
- ▶ Better Coordination
- ▶ Lower Cost
- ▶ Fewer Errors

Menke & Associates, Inc. has designed
over 2,500 ESOPs since 1974

110

Menke & Associates Offices



111


ESOP Valuation Offices



112

Menke's ESOP Process

- ▶ Complete Feasibility Questionnaire
- ▶ Analyze ESOP Feasibility
- ▶ Propose Alternative ESOP Structures
- ▶ Engage Menke & Associates, Inc.
- ▶ Close Transaction



MENKE & ASSOCIATES, INC.

**Confidential
ESOP
Questionnaire**

For a free ESOP analysis, mail or fax this information to:

255 California Street, 18th Floor
San Francisco, CA 94111
Phone: 415-362-5200
Fax: 415-398-2260

Over 2,500 ESOPs ESTABLISHED SINCE 1974

113

The ABCs of ESOPs

Questions and Answers

**A copy of this web seminar will be available on our
website within 24 hours.**

www.menke.com

114

The End

Thank You For Attending



MENKE & ASSOCIATES, INC.
ESOP ADVISORS AND INVESTMENT BANKERS

www.menke.com

115