



VALUATION

OBSERVATIONS



ESOPs: A Savvy Succession Planning Alternative for Family Businesses

Family-owned businesses are the backbone of the U.S. economy, accounting for over one-half of our country's GDP, employment, and job creation. Yet, virtually all family businesses eventually encounter difficulty in transitioning to the next generation, which can have a tremendous and lasting impact on the family, key management, employees, the company, and the communities where the company operates.

While there is no "silver bullet" when it comes to succession planning, we at GBQ believe that Employee Stock Ownership Plans ("ESOPs") may be ideal tools for transitioning ownership in family-owned businesses. ESOPs offer a unique combination of advantages that allow a family to maintain operational control of their business and preserve their company's culture and legacy, while achieving a successful and financially rewarding ownership transition for: (a) existing family shareholders, (b) family members who are active in the business, (c) family members who are not active in the business, and (d) non-family management and employees. The objective of this article is to discuss the following:

- How an ESOP Works
- ESOPs: A Unique Solution for Succession Planning Challenges of Family Businesses
- What Types of Family Businesses Should Consider ESOPs



ESOPs may be ideal tools for transitioning ownership in family-owned businesses.

How an ESOP Works

It is beyond the scope of this article to explain ESOPs in full detail, but a high-level overview is as follows, and please visit <https://gbq.com/about-esops/> for more information about ESOPs.

- An ESOP is a unique business succession and ownership transition tool that offers tremendous advantages to the selling shareholders, the company, and its management and employees.
 - An ESOP is a qualified retirement plan, similar to a 401(k), which allows the employees of a company to become owners of the stock of their employer.
 - As an employee benefit plan, ESOPs are governed by the U.S. Department of Labor
 - Several features make ESOPs unique as compared to other employee benefit plans, including: (a) only an ESOP is required by law to invest primarily in the securities of the sponsoring employer, and (b) an ESOP can borrow money
 - There are currently 6,000+ ESOP-owned companies in the U.S.



ESOPs: A Savvy Succession Planning Alternative for Family Businesses (continued)

- Business owners may sell some or all of their stock to employees via the ESOP in exchange for a combination of cash (from the company and/or a bank) and seller-financing (i.e., notes from the company).
- Selling shareholders receive fair market value over time plus a fair interest rate on seller financing; cash at closing would come from the bank or the company, with the sellers financing the remainder of the purchase price.
- Operational control and management of the company does not need to change after the sale to an ESOP. Selling shareholders usually remain in their current positions, and are typically eligible to participate in the ESOP for as long as they remain an employee.
- ESOP shares are allocated to all eligible employees over a relatively long period of time, often 10 to 40 years. Shares are typically allocated based on compensation, although tenure may be considered in some allocation formulas.
- Employee participants receive an annual statement detailing their number of ESOP shares, value per share, total value in their account, and vesting percentage. Participants are able to sell their vested ESOP shares for fair market value when they leave the company and receive cash if they are of retirement age, or roll the proceeds into an IRA if they are not.

ESOPs: A Unique Solution for Succession Planning Challenges of Family Businesses

According to *Businessweek.com*, only 40% of U.S. family-owned businesses successfully transition to the second generation. Approximately 13% are passed to a third generation and only 3% successfully transition to a fourth generation or beyond. Given these scary statistics, it is clear that choosing the proper succession plan is perhaps the most important decision that family business leaders will make. The success or failure of a family business succession plan will have a lasting impact on the legacy of the company and the family.

Based on our experience working with thousands of family-owned businesses on succession planning, we see families struggle with the same challenges over and over. Here are some of the most common succession-related issues that family-owned businesses struggle with, and how an ESOP may be an ideal strategy to overcome these challenges.

→ Succession Planning Challenge #1: Preserving the Legacy of the Family Business

- **Succession Challenge:** Many family business owners are immensely proud of their companies. They have spent a lifetime building their businesses and developing a family-oriented culture, and there is often a strong desire to preserve this legacy. Also, many family leaders feel a commitment to their communities. There is often an unwillingness to sell to a larger acquirer or private equity investor due to fear that a new owner could jeopardize the company's culture, quality, reputation, or position in the local market. There are many unfortunate examples to justify this fear.
 - **ESOP Solution:** With ESOP ownership, family business owners can ensure that there are absolutely no required changes to leadership, operations, etc. after the sale. The name of the company remains intact. The culture does not have to change (although the empowerment of employee ownership often leads to an improved culture). There is no disruption for customers, suppliers, or key business partners. The company is not relocated. In short, nothing changes except the ownership with an ESOP.
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ESOPs: A Savvy Succession Planning Alternative for Family Businesses (continued)

→ Succession Planning Challenge #2: Maintaining Family Control/Influence

- **Succession Challenge:** Most owners of family businesses want their company to remain a family business. Maintaining family control of the business and passing the reigns to the next generation is often the primary goal of current owners.
- **ESOP Solution:** A critical and often misunderstood advantage of ESOPs is that while ESOPs allow current owners to transition ownership, the family can (and typically does) remain in full operational and strategic control of the company after the sale to an ESOP, even when 100% of the shares are sold to an ESOP. Typically, a family will remain in control of the Board of Directors and management. Family members who remain employees can earn ESOP shares, and those who are managers can earn additional incentives (which often provide “equity-like” upside). As such, all strategic, operational, and managerial decisions continue to be made by the family (and other existing leaders in the family business). Simply put, the family-controlled business remains a family-controlled business after the sale to an ESOP.

→ Succession Planning Challenge #3: Financial Feasibility for Existing Owners

- **Succession Challenge:** Since the family business is typically the largest asset the current owners of family businesses hold, it is often challenging to balance the current owners’ needs to monetize the family-owned business with the desire to pass the business on to children or others, who often cannot afford to buy ownership or are unwilling to assume the debt required to buy-in.
- **ESOP Solution:** An ESOP is a unique vehicle that allows family business owners to exchange their ownership for fair market value, yet remain active in (and in charge of) company operations. Owners typically receive fair market value in the form of (a) a cash down payment (often from a bank or using excess company cash) and (b) an attractive payment stream from a note for the balance of the price (often with an attractive interest rate and/or warrants to provide upside). On top of that, there is favorable tax treatment for shareholders who sell to an ESOP. In short, ESOPs offer the gradual transition that many family business owners desire, while allowing the selling shareholder(s) to monetize their investment and diversify their wealth as they transition toward retirement.

Succession Planning Challenges Solved by ESOPs

#1:
Preserving the Legacy of the Family Business

#2:
Maintaining Family Control/Influence

#3:
Financial Feasibility for Existing Owners

#4:
Active vs. Non-active Family Members

#5:
Estate Planning with Family Business

#6:
Lack of NextGen Family Leadership

#7:
Proper Treatment of Non-Family Employees

#8:
Success of the Company Comes First



ESOPs: A Savvy Succession Planning Alternative for Family Businesses (continued)

→ Succession Planning Challenge #4: Active vs. Non-active Family Members

- **Succession Challenge:** As the number of family members increases, the potential for conflict increases as well. There is often conflict between the family members who are involved in the business and those who are not. For example, non-active family members often desire dividends or distributions on their ownership, while active family members may be more concerned with the long-term growth and profitability of the business. There is also often conflict between family members who are leaders of the business relative to other family members who play more modest roles at the company. Lastly, conflict between generations is common. These issues become more acute with multi-generational businesses when cousins, spouses, nieces, nephews, etc. become involved. These types of conflicts are often a key element family business owners must navigate when transitioning ownership and/or management of the family business.
- **ESOP Solution:** Simply put, disputes with non-active family owners stop with an ESOP. Since the ownership of the company is sold to the ESOP and effectively converted to cash and/or a fixed payment stream, non-active family members no longer have a vested interest in the company. As such, there are no more conflicts over ownership, how to operate the company, dividends/distributions vs. keeping profit in the business, etc. Family members who are active with the business (especially those in leadership roles) no longer need to balance the needs of various family members; rather, their sole focus will be on growing the company and making decisions that are in the best interest of the company. Finally, the family shareholders who sell their ownership to an ESOP will enjoy much more simple estate/inheritance planning for all family members (both active and non-active) since it is much easier to plan with cash and investments versus an illiquid family business.

→ Succession Planning Challenge #5: Estate Planning with the Family Business

- **Succession Challenge:** When it comes to estate planning, most owners of family businesses have two primary goals: (a) equalize the inheritances of all family members, including both those who are active in the business as well as those who are not, and (b) ensure that family members with business leadership potential have the opportunity to run/control the family business. The most common challenge is that since the family business is typically the largest asset in a family's estate, it is difficult (if not impossible) to transfer ownership control to one or a few key children while keeping inheritances equal for children who are not active with the family business.
 - **ESOP Solution:** An ESOP is an outstanding solution for this problem. By converting an illiquid asset (i.e., ownership in the family business) into cash (and a payment stream that quickly turns into cash), estate planning is much easier. All inheritances can easily be equalized using the proceeds from the sale of the business, and there will be no conflicts over how to manage a large illiquid asset such as the family business. Furthermore, those family members who are active in the business, and perhaps in leadership roles, can maintain those roles and continue to run the business, making all key operational and strategic decisions. Additionally, these leaders will continue to enjoy equity upside through the ESOP and other equity-like incentives (e.g., stock appreciation rights, or "SARs"). The key is that in the case of an ESOP, ownership can be decoupled from control. So, family business owners can "have their cake and eat it too" by monetizing their investment, equalizing inheritances for all children, yet maintain control of the business and pass on that control to the next generation when appropriate.
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ESOPs: A Savvy Succession Planning Alternative for Family Businesses (continued)

→ Succession Planning Challenge #6: Lack of NextGen Family Leadership

- **Succession Challenge:** Oftentimes, family business owners are ready and willing to transition leadership, but no family members are willing or able to step into a leadership role. Since maintaining the success, profitability, and growth of the family business is typically priority #1, the lack of capable NextGen leadership is often the beginning of the end of a family business.
- **ESOP Solution:** For reasons previously discussed, ESOPs are a perfect solution in this scenario. Existing family owners (as well as existing non-family managers) can maintain strategic and operational control of the business, while achieving liquidity for their ownership in the business. The ESOP is an ideal gradual transition tool, as existing owners can slowly phase out of leadership but maintain control for as long as they wish.

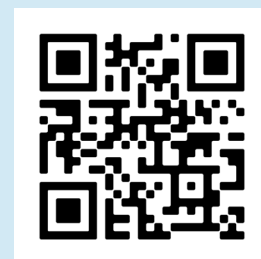
→ Succession Planning Challenge #7: Proper Treatment of Non-Family Employees

- **Succession Challenge:** In family businesses, the perception is sometimes “you are either family or you are not”. There are countless examples of exceptional company leaders leaving a family business because ownership and control are turned over to the NextGen of family owners instead of non-family business leaders. Oftentimes, non-family members are the best individuals to manage a family business. Furthermore, many family businesses have long-tenured key managers and employees who are viewed as “extended family” due to their many contributions to the family business. Doing right by these non-family employees is often a key concern during the succession planning process for family business owners.
- **ESOP Solution:** ESOPs are often a perfect solution to this dilemma. Rather than having to choose between transitioning ownership to family (who may not be the best successors to the business) and non-family employees (who may not have the ability or wherewithal to buy out the family), transitioning ownership to an ESOP is a great alternative. ESOPs provide the opportunity for all employees to own a piece of the company they work for. There are many examples of employees accumulating significant wealth they otherwise would not have access to due to their ESOP ownership. In addition, ESOPs are especially rewarding to key management. The eligibility, allocation, and vesting rules of ESOPs favor employees with longer tenure and higher compensation, which often tend to be key leadership and other management-level employees. In our experience, virtually all key management becomes very excited at the prospect of a family business transitioning to an ESOP ownership model.

Transitioning from Family-Owned to ESOP-Owned: The Automatic Handling Systems Success Story



Headquartered in Erie, Michigan, Automatic Handling Systems, Inc. (“AHI”) has a 40-year proud and rich history as a family-owned business. But in 2020, AHI and its founding family (the Pienta family) found itself at the same crossroads that many family businesses eventually reach...how to transition ownership to the next generation.



Scan to learn how transitioning ownership to an ESOP was the perfect solution for the Pienta family, the company, management, employees, and the community.



ESOPs: A Savvy Succession Planning Alternative for Family Businesses (continued)

→ Succession Planning Challenge #8: Success of the Company Comes First

- **Succession Challenge:** As presented throughout this article, owners of family businesses encounter countless challenges in succession planning for the family business. How can owners balance all of these competing requirements and desires? Which goals are prioritized over others? These are challenging questions. But one tenant that is common among many family business owners is this: the company always comes first. In short, when there are conflicting views or approaches, the overarching principal is that the family must make the best decision for the company, because without the continued growth, profitability, and success of the family business, it may be impossible to achieve other objectives.
 - **ESOP Solution:** Studies show that 95% of all leaders of ESOP-owned companies report that installing an ESOP was a good business decision that helped the company. That statistic is compelling, but how is it possible to have so much consensus about the advantages of ESOPs? The answer is simple: there is no question that companies benefit from ESOPs.
 - Key ways in which ESOPs actually help facilitate and improve the growth and profitability of a company:
 - **Creates an Income Tax-Free Entity:** ESOPs offer tremendous tax benefits for companies. In what is clearly the greatest tax advantage of them all, ESOPs make it possible to create a business that is completely free of federal income tax, and oftentimes free of state and local income tax. S-corporations don't pay tax at the corporate level, so the income tax liability is passed through to the shareholders...but in the case of a 100% ESOP-owned S-corporation, the sole shareholder is a tax-exempt trust, so there is no need to make distributions of S-corporation income to cover pass-through tax. Hence, the income tax-free company is a reality. No federal income tax. Period. With enhanced cash flow from the elimination of income tax, companies can more aggressively invest in equipment, locations, acquisitions, personnel, or other growth initiatives. Barring a highly unlikely change in the tax law, 100% ESOP-owned family businesses will have a permanent advantage over their tax-paying competitors. Also, this advantage will be highly attractive to growth-minded company leadership (both family and non-family).
 - **Engaged and Motivated Workforce:** An engaged and committed workforce that has a vested interest in the success of a family business makes a difference. Numerous studies show that employee-owned companies outperform conventionally-owned companies. ESOP-owned companies routinely demonstrate: (a) faster growth, (b) stronger profitability, (c) lower employee turnover, (d) greater financial security/retirement benefits for employees, and (e) a stronger image in the market among potential and existing customers
 - **Enhanced Attractiveness from Customers & Employees:** Numerous studies indicate that customers prefer to do business with employee-owned companies. Additionally, ESOPs are effective in attracting new management and employees, as studies also indicate that employees prefer to work in employee-owned environments. Obviously, customers and employees are two keys to success for any business.
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ESOPs: A Savvy Succession Planning Alternative for Family Businesses (continued)

What Types of Family Businesses Should Consider ESOPs

In our opinion, companies that are strong candidates for an ESOP share many of these characteristics:

- **Value:** The most common size for an ESOP is approximately \$5 million to \$100 million in value (i.e., approximately \$2 million to \$20 million in pretax profit). Above \$100 million, private equity and strategic buyers become more likely alternatives. Below the \$5 million level, the cost of an ESOP may begin to outweigh the tax and business benefits. Additionally, there may be too few long-term employees to “make the math work” for an ESOP.
- **Employees:** To qualify for the most attractive tax benefits of an ESOP, the company must pass an anti-abuse test (i.e., IRC 409(p)), which ensures that ownership within the ESOP is broad and not overly concentrated with a few individuals. To pass this test comfortably, ideally, there would be approximately 20+ employees who are expected to be longer-term team members.
- **Strong Leadership:** Post-transaction, there should be a strong, deep, and stable leadership team capable of operating the company. Family-owned companies where a select few individuals control all aspects of operations are not ideal ESOP candidates, especially if those individuals are nearing retirement.
- **Consistent Performance:** ESOPs are ideal for healthy and resilient companies that demonstrate consistent profitability and growth. Underperforming or debt-laden companies are not good ESOP candidates. Also, companies with explosive growth plans and intense needs for reinvestment are likely better candidates for private equity investors rather than an ESOP.

Based on these criteria, many family-owned businesses are great ESOP candidates. Perhaps the most important characteristic, however, is a family that has a “company-first” mentality. If the family’s primary objective is the success of the company, then an ESOP is often a viable alternative.

Summary and Next Steps

Due to the unique financial and non-financial benefits of ESOPs, we at GBQ believe that ESOPs are ideal ownership transition alternatives for many family-owned businesses. We also believe that ESOPs offer a solution to some of the most common succession planning challenges that owners of family businesses face. If you are part of a family business and wish to learn more about ESOPs, GBQ offers a wealth of information, including our website, seminars/webinars, and articles. Better yet, feel free to contact a member of GBQ’s ESOP Advisory team for a complimentary discussion to assess whether an ESOP may be an option for your family-owned company.



Capital Advisors

About GBQ's ESOP Advisory Practice

GBQ is a nationally-recognized authority on ESOPs and a proud advocate of employee ownership through ESOPs. We work with 100+ ESOP companies annually, and our ESOP clients can be found across the country. GBQ specializes in ESOP feasibility studies, formations/implementations, transactions, and valuations. We have successfully guided many companies through the initial evaluation, design, and implementation of an ESOP. We are frequent speakers and authors for leading ESOP organizations including the ESOP Association, the National Center for Employee Ownership, and the Ohio Employee Ownership Center.

300+
VALUATIONS
ANNUALLY














100+
ESOP
PROJECTS
ANNUALLY

15+
VALUATION
PROFESSIONALS

ESOP SERVICES

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- Annual Valuations
- ESOP Consulting

Select ESOP Implementations

 <p>ESOP Valuation ESOP Transaction Advisory</p> 	 <p>ESOP Feasibility/ Company-Side Advisory</p> 	 <p>ESOP Valuation ESOP Transaction Advisory</p> 	 <p>ESOP Valuation ESOP Transaction Advisory</p> 	 <p>ESOP Transaction Advisory</p> 	 <p>ESOP Valuation ESOP Transaction Advisory</p> 
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