

ESOP as an Acquisition Strategy

By Gregg Hamilton-Piercy, Senior Valuation Manager

Today the Commerce Department reported that the U.S. Economy grew at a 3.5 percent pace in the third quarter. This following four straight quarters of a contracting economy, a downward trend not seen in recorded history since 1947. With this news, many believe that the worst is behind us and that we can be cautiously optimistic about a return to prosperity.

One area of interest as a result of this news lies in the level of merger and acquisition activity that we can anticipate in the coming year. For those considering an acquisition in this environment, three major challenges come to mind; a) finding suitable acquisition targets willing to negotiate a fair price for their assets in this market environment, b) structuring a deal that mitigates the additional risk of market uncertainty, and c) finding sources of debt financing while banks continue their structural shift in corporate lending practices.

It is with these issues in mind that investors need to consider unique deal structures to help them overcome deal flow, preservation of capital and financing hurdles. One such structure takes a page out of the privatization of Tribune Company which was orchestrated by U.S. billionaire Samuel Zell in 2007. It is worth noting that Tribune's meteoric demise in the years that followed was more due to fundamental changes in the newspaper industry and less about Zell's novel privatization strategy.

The Tribune structure involved a strategy whereby an investor used a combination of debt, warrants and an Employee Stock Ownership Plan (ESOP). This structure allowed the investor to offer a higher purchase price, mitigate some investment risk through debt and helped obtain better access to debt.

In the case of Tribune, the company converted from a subchapter C Corporation to a subchapter S Corporation, established an ESOP that purchased 100 percent of the company's equity which was partially funded through debt from Zell, and sold Zell warrants giving him the right to purchase 40 percent of the company's equity.

The truly interesting feature of this transaction lies with the fact that although the newly created ESOP owns 100 percent of the company, Zell managed to secure a synthetic equity position through the issuance of warrants. In doing so, Zell is able to participate in all the financial benefits afforded to ESOP participants without having the heavy initial cash outlay associated with a direct equity ownership structure. Additionally, the money saved was invested as subordinate debt which helped to mitigate total investment risk by securing a priority claim on company cash flow.

Zell was able to capitalize on these benefits through a higher offering price which helped him outbid other would-be suitors. Additionally, the use of an ESOP made debt financing more readily available since an ESOP structure allows lenders to receive debt payments using pre-tax dollars. In essence, lenders are paid before the government in an ESOP structure, which makes lending to ESOP companies much more appealing.

This acquisition strategy can potentially equip the investor with better price negotiation strength, lower total investment risk and better access to debt financing. For more information on how an ESOP might help with your investment strategy contact Gregg Hamilton-Piercy at 781-547-8800, x3266 or e-mail at ghamilton-piercy@kahnlitwin.com.