Unlocking Growth and Competitive Edge: The Power of M&A Over ESOP

Mergers and Acquisitions (M&A) offer distinct advantages over Employee Stock Ownership Plans (ESOPs). M&A provides an avenue for rapid expansion and market penetration by leveraging the strengths of two companies. This strategic combination enables access to new markets, technologies, and customer bases that might not have been achievable through internal growth or an ESOP approach. M&A also brings the potential for synergies, such as cost savings from eliminating duplicate functions, enhanced operational efficiency, and shared expertise. These synergies can lead to improved financial performance and shareholder value, making M&A an attractive option for companies seeking accelerated growth and competitive advantage.

An ESOP is a very specialized type of IRS sanctioned qualified retirement plan. It is the only retirement plan that is permitted to own a concentrated amount of stock in its corporate sponsor. ESOPs have been specially designed so that employees can effectively own stock in their employer. The federal legislation establishing ESOPs was specifically designed to encourage employee ownership.

The company uses an ESOP to buy shares on behalf of the employees from the owner(s). The sale to an ESOP is financed with a loan. If 51% or more of the company is sold to the ESOP, the owners no longer have operating control of the company. If 50% or less of the company is sold, the owner retains majority control of the company. The bank loan is repaid by the ESOP through contributions to the ESOP plan by the employer (which are limited to 15% of payroll). Employees are the beneficial owners of the shares but not the legal owners. The shares are owned by the retirement plan and the plan is managed by a fiduciary/trustee. Employees are entitled to receive the cash value of their allocated percentage of ESOP value when they retire. ESOPs are highly regulated – they must follow tax regulations as well as Department of Labor rules.

Characteristic	M&A	ESOP
Liquidity	100% cash received at close	• Cash rolled into equity investment (illiquid) • 7-10 years before full payout (if minority share sold)
Valuation	Fair Market Value	Book Value (<FMV), no upside
Taxation	Long-term capital gains	• Tax deferred when rolled to equity • Capital gains on equity appreciation
Operating Control	New owner assumes risk and daily operating responsibility	• 50% or less: Seller retains risk and ownership • 51% or more: trustee assumes operational duties (govern by “comittee”)
Employee Equity Incentive	Receives cash proceeds for their share of equity granted by seller at closing.	Receives cash value of ESOP upon retirement.
Regulations & Cost	Only incurred at exit, small percentage of overall proceeds	Extensive on-going costs of compliance for entire life of the ESOP: legal. tax, DOL, admin.
Source of Funds	External parties (with additional resources/capital for growth)	Company-financed debt (limits] cash flow for growth)

While ESOPs have certain benefits, they are not the most ideal structure for the exit of a business or to receive market value for their equity. They are best suited for situations where owners want to retain most of the company but want to create a retirement investment vehicle for the benefit of employees. For owners looking for meaningful liquidity, M&A is the best route to maximize value and structure

© 2023 Align Business Advisory Services. All rights reserved.