

ESOP Questions & Answers

Collateral Support

We often receive questions about the issue of collateral support in an ESOP transaction from prospective clients. The following question and answer series addresses some of the common questions posed to Dynasty Capital personnel.

Q: What is a collateral shortfall?

A: Seldom do we encounter a successful company with sufficient assets to fully collateralize a 100% buyout of its equity. Our Pre-Feasibility Study identifies the available assets on the balance sheet of the target company and estimates what collateral shortfall exists. We use book value for our estimate, although market value, which generally exceeds book value, will be taken into consideration as the transaction progresses. Typical lending advance rates are used to determine the amount of collateral available for the loan. The difference in the available collateral and the proposed loan amount often results in a collateral shortfall.

Q: Why do I need to assist with collateral support in an ESOP transaction?

A: Most lenders, even ESOP lenders, require full collateralization on their loans. Because ESOP transactions do not receive an equity infusion from an outside buyer, the only source of collateral support is from the seller. Even though the seller receives a check at closing for the full value of the stock as established by an independent valuation, the lender will typically propose that an amount, in the form of seller-owned investments from proceeds representing the collateral shortfall, be pledged to the loan for a period of time to cover the shortfall.

Q: Is this similar to a “hold back” of part of the seller’s proceeds?

A: No, the seller receives all of the proceeds in cash at closing and may deposit them in his bank account immediately. The portion that represents the collateral shortfall will be restricted from withdrawal until the pledge is released. The seller continues to receive any interest and dividends on these funds, as they are his funds.

Q: Why would I agree to this?

A: One of the main benefits to an ESOP transaction is the favorable tax treatment it affords the seller. By electing a tax deferral, the proceeds of sale are tax-deferred indefinitely. The rules require that the proceeds be invested within 12 months of the closing date into stocks and/or bonds of American companies. Some of these securities are then offered as collateral support to the buyout loan. Our lenders offer a 100% advance rate on the investment portfolio rather than a typical margin rate of 50% on stocks. When you consider the funds that are invested to obtain the tax-deferral are going to be untouched anyway (liquidating those investments would trigger a taxable event), there is no penalty to offer a portion of the investment portfolio to the lender for collateral support. Since the amount in question may be roughly equal to the taxes that would have otherwise been paid to the IRS on a third-party asset sale and discounts that may have been conceded to a third-party buyer, it makes sense to protect those (otherwise lost) funds and use them for collateral support.

Q: How long will my investments be pledged?

A: Typically, our lenders will release the pledge over the first three years of the ESOP loan. In cases where the collateral shortfall is substantial, the pledge may be released over five years. The releases are incremental per year as the loan is paid down. Other factors which can shorten the release schedule are the growth rate of the investment portfolio and growth in the value of the company and its assets.

Q: Isn't this similar to seller financing?

A: Yes, but it is much more favorable to the seller. In a typical third-party sale, the seller receives a note from the buyer who is normally a stranger to him, and the note is secured by a subordinated lien on the assets of the company. Meanwhile, the seller has lost control of the company on the day of closing to a stranger and now is at the mercy of the new owner for loan repayment. In the ESOP environment, the seller has the ability to remain in control of the company (if so desired) and continues to operate the company for as long as he chooses. His funds are already liquid and in the bank or in his investment account.

Q: This sounds like I am just borrowing money. Why wouldn't I just get a loan and keep my company?

A: The purpose of an ESOP transaction is to provide an exit strategy to the seller, usually for retirement. Eventually the seller will want to sell, and borrowing money will only delay the exit. Keep in mind, the entire loan payment for an ESOP is tax deductible for the company. So Uncle Sam is helping to repay about one third of the loan. This makes ESOP borrowing the least expensive source of funds for the company.

Q: What happens to my portfolio if the company goes under?

A: In a worst-case scenario, the portion that is pledged could be liquidated to repay the loan. However, this is a very rare event. Companies can experience hard times because of events beyond their control. Our lenders have always been willing to assist with such crises, as they did when some of our clients that were affected by Hurricane Katrina couldn't make their loan payments. Our banks graciously offered to suspend payments until the business got things under control. Further, because of the positive effect on the business with the debt being repaid with before tax dollars, the cash flow of the company is enhanced. This helps explain why ESOP loans have the lowest default rate of all commercial loans (less than 1%).

Q: What if I still don't want to pledge any of my proceeds because I have other plans for the money and I don't mind paying the taxes?

A: Dynasty Capital has emerged as a pioneer in the ESOP industry and has made a commitment to addressing the needs of its clients by providing innovative financing solutions. We have recently partnered with a large mezzanine fund to enable us to significantly reduce the pledge requirement for those companies that qualify. There may still be a small pledge, but it is likely not to exceed the taxes that you would pay anyway. This way, you can still get unencumbered cash for your business and recover the taxes that would have been paid on a third party sale.

Q: How does Dynasty Capital help me negotiate with the lender?

A: We have longstanding priority-level relationships with our lenders because of our past performance and dominant market presence. It is not uncommon for our lenders to agree to "airballs", which is a portion of the loan that is unsecured. This effectively reduces the amount of the pledge that is required. Since Dynasty Capital functions as a valuable advisor on your team, it is our obligation to negotiate terms with our lenders that favor your goals and objectives.

While we cannot know exactly what to expect from our lenders when we begin an engagement, the entire process of designing an ESOP is driven with our clients' objectives in mind. Hopefully the above questions and answers have helped to allay any fears sellers may have regarding collateral shortfall and collateral support issues. As we prepare the final ESOP Feasibility Study, the transaction begins to take shape and our clients become more comfortable with the idea of being in control of a process with a predictable outcome.