



BDO CAPITAL ADVISORS :

WHY EMPLOYEE STOCK OWNERSHIP PLANS (ESOPS) ARE BECOMING A FIRST OPTION

November 2024

Agenda for Today

- 1) About BDO Capital
- 2) Market Observations
- 3) BDO's ESOP
- 4) ESOP Overview
- 5) ESOP Structure & Benefits
- 6) Questions



About BDO Capital Advisors



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Justin Tu, CPA

Director, ESOP Advisory Services

EXPERIENCE

Justin has more than ten years of public accounting and investment banking experience, with a focus on executing ESOP transactions. He has advised middle-market companies and their shareholders on leveraged ESOP formations, acquisition financing, and management buyouts in a variety of industries. Prior to joining BDO Capital Advisors, Justin served as a tax senior manager in BDO USA's Global Employer Services practice where he consulted on leveraged ESOP transactions. He began his career in the assurance practice at BDO USA.

PROFESSIONAL AFFILIATIONS AND ACCREDITATIONS

American Institute of Certified Public Accountants
General Securities Representative (Series 63 and 79)
Georgia Association of Certified Public Accountants
National Center for Employee Ownership
The ESOP Association, Advisory Committee on Valuation

EDUCATIONAL BACKGROUND

M.Acc., Manderson Graduate School of Business, University of Alabama
B.S., Business, Culverhouse College of Business, University of Alabama

BDO Capital Advisors

WE PROVIDE A SUITE OF INVESTMENT BANKING SERVICES...



Sell-Side M&A

- ▶ Advise clients seeking a sale to a strategic buyer or private equity firm
- ▶ Reputation for maximizing value and delivering superior outcomes for our clients



ESOP Advisory

- ▶ Advise clients seeking to establish or unwind an ESOP
- ▶ Holistic offering from feasibility assessments to transaction execution



Capital Raising

- ▶ Advise clients seeking to raise private capital to fund growth and/or liquidity objectives
- ▶ Broad access to lenders and private equity sponsors



Board Advisory

- ▶ Advise clients on shareholder value maximization strategies
- ▶ Strategic alternative reviews, liquidity options, fairness opinions



Buy-Side M&A

- ▶ Advise clients seeking to acquire another company
- ▶ Quarterback the process from target identification and approach through to closing

Market Observations

Market Observations

- Larger companies are considering and executing ESOP transactions of recent
- Companies within industries that have traditionally faced difficulties in transferring substantial equity internally are now exploring Employee Stock Ownership Plans (ESOPs) as a viable solution
 - Professional Services Firms
 - Investment advisors, asset managers
- ESOP transactions are being looked at as an equal and viable alternative to other types of M&A transactions
 - Due to increased sophistication in deal structuring (warrants, longer internal loans, management incentive plans, etc.)
 - Institutional acceptance by senior and non-traditional lenders
 - Government support and subsidies
 - Tax advantages for seller and company
 - ESG considerations
- Projects are shifting from ESOP Feasibility Study to Review of Strategic Alternative Studies and ESOP Execution Transactions to Dual Track Transactions are becoming the “new normal” for our team as companies are looking to appropriately consider all strategic alternatives

Professional Services Firms

- Employee Stock Ownership Plans (ESOPs) have traditionally been viewed as acquisition vehicles for capital intensive businesses, such as manufacturing, (\$69bn¹ in plan assets), and construction firms (\$26bn¹)
- However, more often, ESOPs are being considered - and successfully used - for transition of Professional Services Firms (\$36bn¹) that are experiencing increases in capital calls for - investment in talent & technology; partner retirements in clusters
- Professional service firms uniquely match the common profile of an ideal ESOP candidate, which includes

Owner Profile	Company Profile	Employees Profile
Looking to exit and/or liquidity event	Tax advantages	Employee base of critical size
Motivated by tax advantages (IRC 1042)	Debt Capacity + Consistent, predictable cash flows	Sophisticated workforce
Limited universe of buyers	Capable next generation of leaders	Ownership mentality already in place

- Partner/ Owner Incentives**
- Creative compensation structure for potential partner-candidates
 - ESOPs are broad based
 - Additional stock-based compensation can be implemented in addition to ESOP share allocation

Regulations around ownership need revisiting

- Certain states require professional service firms to adhere to licensing and ownership requirements, including:
 - Engineering, Architecture, Law Firms under ABA Model Rules of Professional Conduct Rule 5.4, and CPA Firms
 - *North Carolina, for example, requires 2/3 of the engineering PC or PLLC to be owned by licensed professionals*
- Ownership requirements are determined by type of license/certificate, and at the state-level
 - For example, some states require the “licensed professional” to be the ESOP Trustee, Board level, or employee-level as beneficial owners
 - Some A&E firms have multiple types of licenses in various states
 - In certain cases, a Management Service Organization may be needed to achieve owner’s goals
 - Structure must contemplate future growth plans
- For professional services firms that must adhere to state licenses requirements, BDO Capital recommends the Company engage an attorney for a “legal feasibility”, coupled with BDO Capital ESOP Feasibility analysis

A Transformational Moment For BDO

Building a New Model for Our Firm of the Future

Accounting/Advisory Industry Landscape

- ▶ Talent and technology are critical for growth
- ▶ Deployment of private equity investment to capitalize on a highly-fragmented, transformative industry poised for growth

Effective August 31, 2023, BDO established an Employee Stock Ownership Plan ("ESOP"), providing broad-based ownership, and a new model for the firm's continued investment in *People First*.

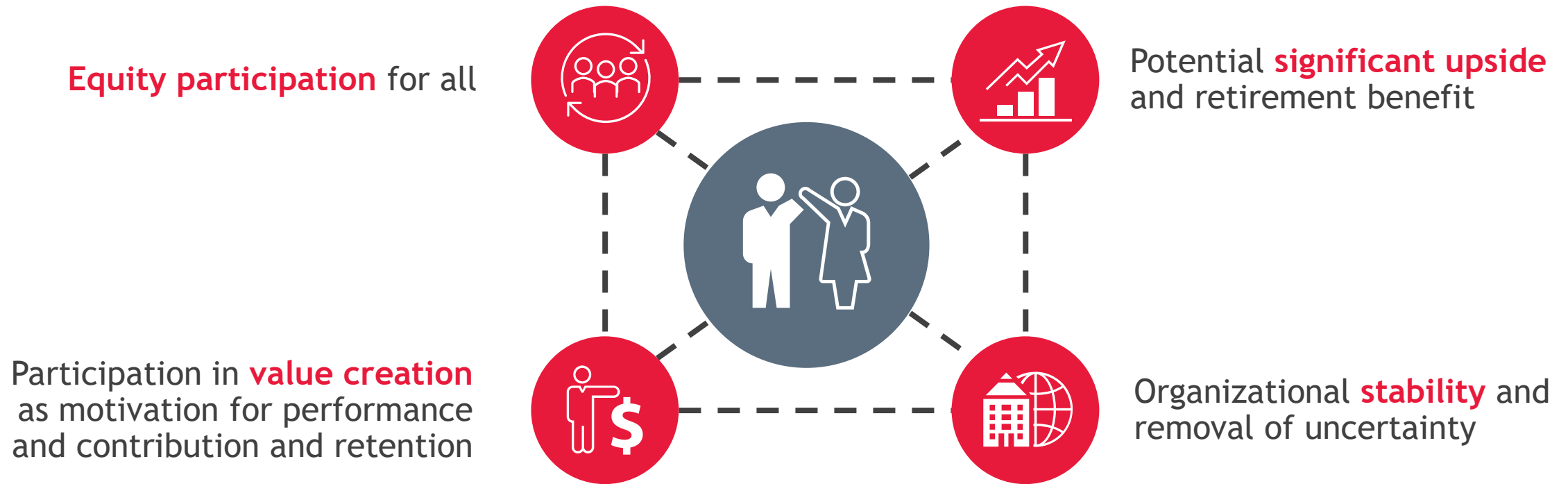
Opportunities in the Changing Landscape of Our Profession

“Amid the changing landscape of our profession, the ESOP unlocks the value of our firm today and embodies our strategy to sustain a strong, caring and resilient business for tomorrow.”

Wayne Berson, CEO, BDO USA

Together We Thrive

BENEFITS TO OUR PROFESSIONALS



ESOP Overview

What is an ESOP?

An **E**mployee **S**tock **O**wnership **P**lan (ESOP) is a qualified, defined contribution employee benefit plan, much like a 401(k), that invests primarily in the sponsoring employer's stock.

ESOP Basics:

- ▶ An ESOP is a powerful corporate finance tool as it is the only qualified benefit plan that can borrow money
- ▶ Subject to ERISA (Employee Retirement Income Security Act of 1974), which protects plan participants
- ▶ Participants are beneficial owners of the stock, but the ESOP Trust owns the stock on your behalf (liability protection)
- ▶ ESOP employees share in the future success of their companies
- ▶ ESOP companies have payout levels that are 3x to 7x greater than 401(k) plans, on average

ESOP Quick Facts



Approximately 6,250 ESOPs in place in the U.S. covering 14 million+ employees



Many ESOP companies have other retirement plans to supplement their ESOP



Total assets owned by U.S. ESOPs are estimated to be over \$1.8 trillion as of 2023



About 580 ESOPs are sponsored by publicly traded companies

Benefits of an ESOP



SELLER

- ▶ Receive fair market value
- ▶ Favorable tax treatment on sale (\$1042 Capital Gain Deferral - C corporation)
- ▶ Flexibility; can sell any percent of company
- ▶ Preserve legacy as independent company
- ▶ Retain operating control
- ▶ Reward management and employees who helped grow the business



COMPANY

- ▶ Tax-advantaged financing
- ▶ Potential for income tax-free entity (100% ESOP-owned S corporation)
- ▶ Repay debt more quickly with enhanced cash flow
- ▶ Potential for productivity gains and reduced turnover

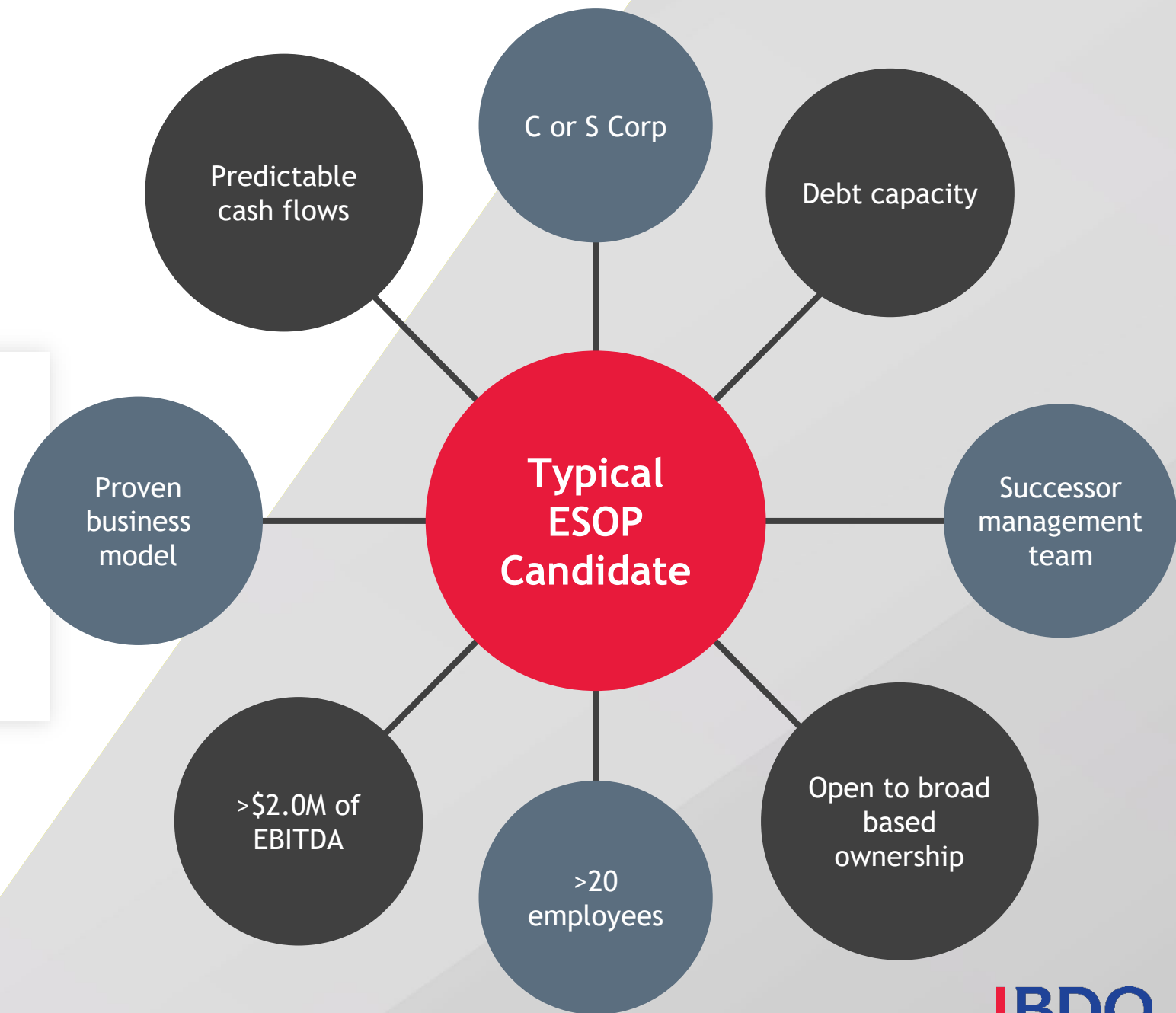


EMPLOYEES

- ▶ Valuable retirement benefit
- ▶ Ability to participate in value they help create
- ▶ Ensure continued employment
- ▶ Incentive for management through Management Incentive Plans

ESOP Candidate Characteristics

Although views differ on what exactly makes a good ESOP candidate, several characteristics reveal themselves as essential qualifiers. Our list of ESOP candidate characteristics is not exclusive but can be used as a guideline.



ESOP Structure & Benefits

S Corporation vs. C Corporation Considerations

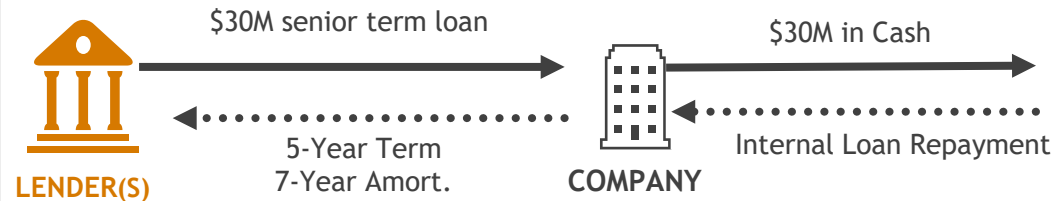
A company must sell stock to an ESOP, therefore, the company must be a corporation prior to the transaction (i.e., LLC must be converted to corporation). The company and selling shareholders have flexibility to choose which structure meets their goals.

OWNER CONSIDERATION	C CORPORATION	S CORPORATION	COMMENTS:
Valuation	Fair Market Value	Fair Market Value	Either option will provide Fair Market Value
Owner's Tax on Proceeds	Capital gain deferral (assuming IRC 1042 election); 3.8% NIIT applies	Capital Gains rate (Installment Method) - 453A sting tax	Capital gain deferral is only allowable under C-Corp structure
Hold or Exit Period	Longer due to C-Corp taxes (If company has been a C-Corp for at least five years, conversion to S-Corp is available after close of transaction)	Shorter due to more cash available for debt service	The S-Corp structure allows the Company to repay debt more rapidly using pre-tax dollars
Income Taxes Paid by Company	21% federal rate plus state tax rate	The ESOP shareholder is exempt from federal and most state income tax, thus no tax distributions are needed for the ESOP's share of income	S-Corp transactions generally favor the Company, while C-Corp transactions generally favor the selling shareholders

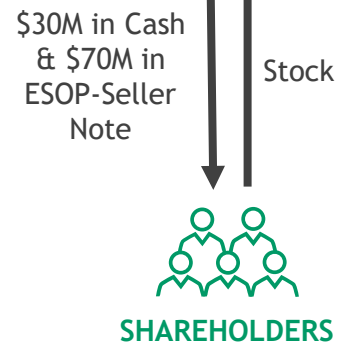
Common 100% ESOP Structure

\$100M EXAMPLE

Step 1 - Financing (Optional)



Step 2 - Loan to ESOP

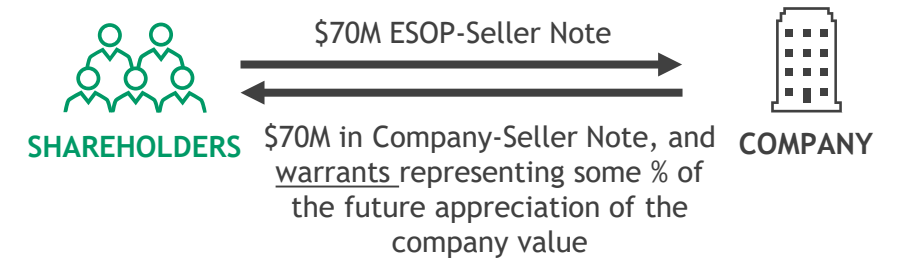


Shareholders sell \$100 million equity value for \$30 million provided by lender & \$70 million ESOP-seller notes.

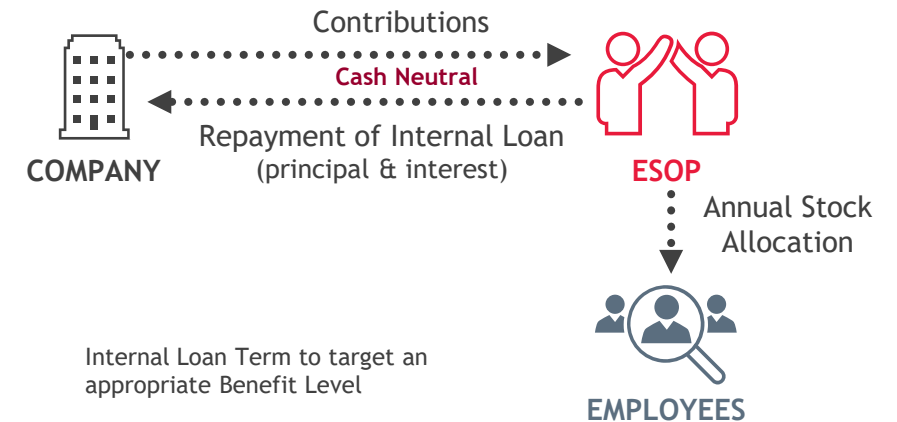
MANAGEMENT INCENTIVE PLAN
Synthetic Equity
(i.e. "Stock Appreciation Rights")

Initial Transaction Flows →
Annual Flows→

Step 3 - Note Exchange

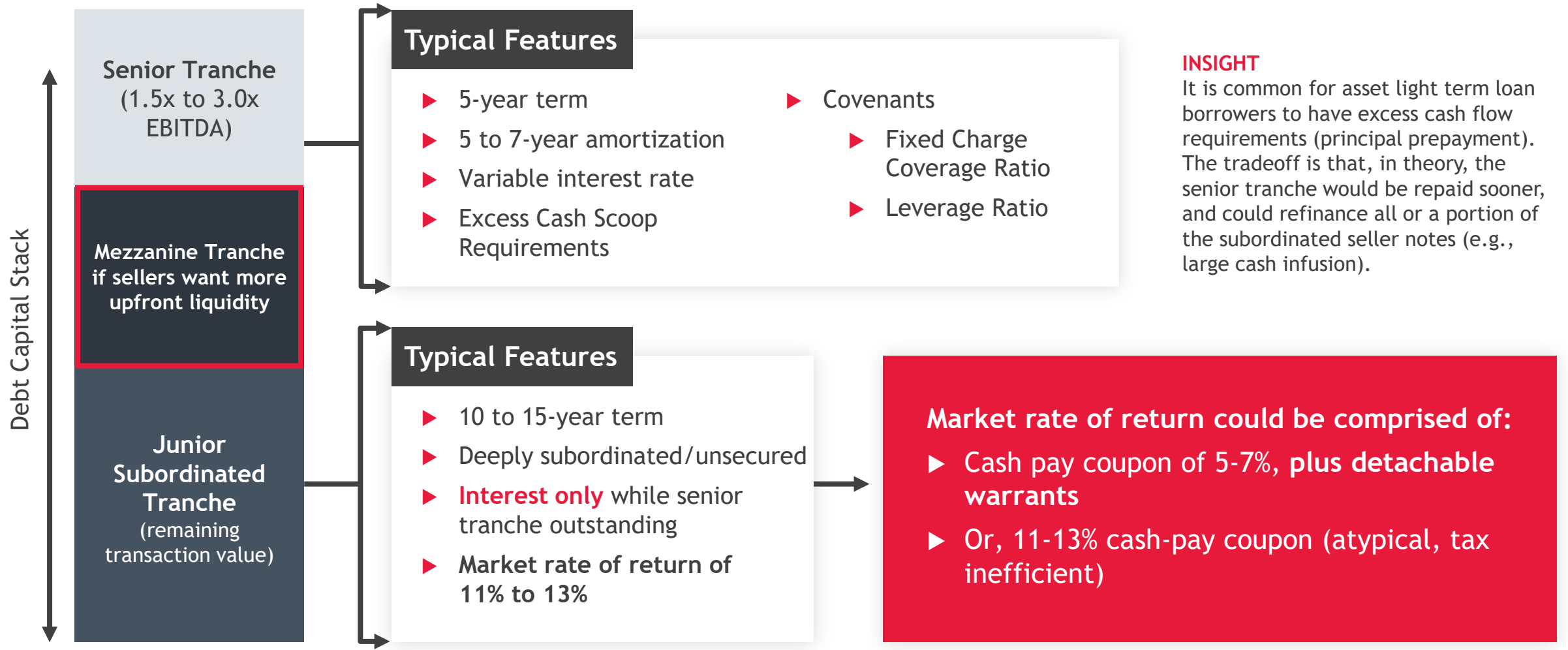


Step 4 - Annual Stock Allocations



OPTION TO 100% SELLER FINANCE: If the shareholder would prefer to seller finance the entire transaction, the above references to Lender(s) and Cash will not exist, and corresponding notes will be increased as such.

Typical ESOP Financing Structure



Warrant Overview

Warrants are financial instruments that grant the holder the right to purchase the Company's shares at a pre-determined price within a specified time range, subject to negotiations with the Trustee. Warrants are useful in improving the internal rate of return for sellers without creating an increased interest expense burden for the Company, along with incentivizing shareholders by offering the potential to benefit from the Company's growth.

Warrant Basics:

- ▶ Overall warrant size is negotiated with ESOP trustee.
- ▶ Warrants are issued at closing to the seller note participants.
- ▶ Warrants are assigned a set exercise price upon issuance.
- ▶ Warrant valuation is tied directly to the company's valuation, performed annually.
- ▶ Typical exercise period of 15 years, tied to terms on Seller Note.
- ▶ Put and Call rights are common, and the timing of each is negotiated with the trustee.
 - Put rights give the warrant holder the right to exercise the warrants which are typically settled in cash and subject to bank subordination.
 - Call rights, give the Company the right to exercise the warrants.

Benefits to Stakeholders



BENEFITS: The Company (Borrower)

- ▶ Lower annual cash debt service on the seller notes
- ▶ Aligns warrant holders' long-term interest with ESOP participants and company performance



BENEFITS: Warrant Holder (Seller)

- ▶ "Second bite of the apple" with uncapped upside potential
- ▶ All-in seller note return akin to mezzanine/subordinated capital
- ▶ Capital gains treatment
- ▶ Great gift and estate planning tool

Management Incentive Plans (MIPs)

How Do MIPs Work

- ▶ The MIP is structured outside of the ESOP and therefore can be discriminatory
- ▶ The size and composition of the MIP will be negotiated with the ESOP Trustee as part of the overall deal.
- ▶ Post-closing, the Board of Directors and Compensation Committee have discretion of implementing the MIP.
- ▶ Typically Stock Appreciation Rights (SARs) or Full-Value Awards
- ▶ Stock Appreciation Rights (SARs) have a strike price and exercise price similar to a stock option.
- ▶ Typical 3-year cliff vesting with either lump sum payment or graded payment over 3 years.
- ▶ Taxed as ordinary income at the time of receipt.



BENEFITS: MIP Unit Holder

- ▶ Medium-term cash incentive (typical 3-year vesting)
- ▶ MIP awards are recycled into the plan for future regranting. Plan term subject to negotiation with ESOP trustee



BENEFITS: The Company (Issuer)

- ▶ Great tool to attract and retain key talent
- ▶ Board discretion over recipient/s and amount of incentive
- ▶ Way to further align the financial goals of both company/ESOP and company leadership. ESOP and MIP both use same yearly valuation.
- ▶ Provides medium-term benefit to balance out long-term benefit of the ESOP

ESOP Share Allocations Explained

- ▶ Companies have options on how they wish to allocate ESOP shares annually to participants (subject to ND testing)
 - Compensation method (safe harbor) with IRS limits (\$345K in 2024)
 - Years of Service
 - Hybrid
- ▶ As the ESOP pays its current year principal and interest (Internal Loan), company stock is released from suspense and allocated to participants accounts (beneficial ownership). Vesting provisions then apply.
- ▶ Internal Loan's amortization period (in years) determines the minimum share allocation each year
 - EXAMPLE: a 10-year amortization equates to 10% of total stock allocated each year
 - Shorter amortization period provides a higher benefit level. Potential impacts are:
 - Run on the bank scenario
 - Case of the “have’s and have not’s” - future employees will not realize a meaningful ESOP benefit each year
- ▶ Employee accounts value grows each year due to 1) new share allocations each year, 2) an increase in share price and 3) share forfeitures due to unvested account balances.



Questions?





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