Employee Ownership Companies on the Hunt
Acquisitions by ESOP Companies

By Martin Staubus

There was a time – a couple of decades ago - when employee stock ownership plan (ESOP) companies were assumed by many to be weak businesses, with uncertain futures.

This image was an outgrowth of press coverage afforded to a relatively modest number of employee-driven (and often union-led) buyout efforts launched during the 1980s, typically as an effort to preserve jobs in the face of a threatened plant closure. The realistic goal in these cases was that employee ownership would succeed in keeping the damaged company afloat long enough, and repair enough of the damage, that a healthy suitor would eventually buy the firm, preserving the jobs for the long term. The employee buyout of Weirton Steel Corporation may have been the best-known of these cases.

But that was then – and what have we now? My, how things have turned. With ESOPs now formed almost entirely at very healthy companies – and many of those enjoying the unique cash flow benefits of operating as ESOP-owned S corporations – a growing number of these companies have become the predators of the M&A jungle.

A company that operates as an S corporation pays no taxes (at the corporate level) on its income. And, if the sole legal shareholder is an ESOP, no income taxes are paid by that shareholder either. The effective boost to after-tax income from this arrangement can be as high as 70 percent, depending on the otherwise applicable state income tax rate. Increasingly, these big cash profits are being put to use by these companies as financing for the acquisition of other firms.

Take Environmental Science Associates, Inc. (ESA), a San Francisco-based environmental planning and consulting firm with operations along the West Coast from Seattle to San Diego. The firm has had an ESOP in place since the early 1990s, but only achieved 100 percent ESOP

ownership in 2004. Just two years later, it was ready to make its first significant acquisition, striking a deal to acquire Adolfson Associates, a 40-person Seattle-based environmental consulting firm for a purchase price of $2.2 million – a price representing about 20 percent of ESA's assets at that time.

The unique income tax-exempt status that ESA enjoyed as a 100 percent ESOP-owned S corporation was certainly a big advantage in terms of the firm's ability to generate disposable cash. But that unique status had drawbacks, too. First and foremost is that it effectively eliminated ESA's ability to consummate acquisitions through the issuance of their own stock as payment. After all, if a selling owner took stock as payment for his company, ESA would no longer be 100 percent ESOP-owned, a result that would cost it those unique tax benefits associated with 100 percent ESOP ownership. While there is a legal structure that in theory would permit an ESOP company to issue stock to a seller and then have the ESOP purchase that stock (this may even make the seller eligible for the special capital gains tax deferral under section 1042 of the tax code), this is a complex path, requiring a genuinely interested and motivated seller, among other requirements. "Most deals are difficult enough to close without the added complexity and cost of this type of transaction structure," said Greg Thornton, ESA's chief financial officer." As a practical matter, 100 percent ESOP-owned S corporations like ours are limited to cash and debt to pay for an acquisition." In short, it's a good thing that 100 percent ESOP-owned S corporations enjoy special cash generation benefits, since cash will be the only currency it can use to effect acquisitions.

In 2010, ESA completed a second major acquisition, agreeing to pay a $3.3 million purchase price for Philip Williams & Associates, Ltd. (PWA), with roughly half that sum paid in cash at closing and the balance in notes payable over the next couple of years. The terms of the deal also provided for an earn-out provision that would increase the payment to the selling shareholders if specified business performance goals were reached.

Of course, while the post-tax profit boost of the ESOP-owned S corporation may make acquisitions more achievable, nothing about that status should relax the rigorous strategic analysis that should be undertaken to confirm that an acquisition actually makes sense. Thus, in the case of the 2006 acquisition of Adolfson, ESA had spent several years working on the question of how to successfully expand their California-based operations to the Pacific Northwest. It was only after their assessment concluded that acquisition would be the best path that they made the decision to go forward with an acquisition. In the case of the 2010 acquisition of PWA, the supporting strategic analysis was not based on geographic expansion, but on a breadth-of-services expansion. PWA was the leading niche expert in the field of environmental hydrology, a skill set that ESA lacked, forcing them to subcontract with other firms (including PWA) in order to win work that required that expertise.

Unlike the acquisition of Adolfson, where ownership was concentrated in the founder and a small number of senior employees, ownership of PWA was more broadly distributed among a large portion of its employees (not through an ESOP, but through an employee purchase program). The enthusiasm of PWA's employee shareholders for the proposed sale of their company, then – and particularly their enthusiasm (or lack thereof) for the idea of ESA becoming

their employer – was a significant factor.

Indeed, ESOP companies attempting to complete an acquisition may potentially benefit from the fact that employees of the target company may be more sanguine about the idea of being acquired by a company that shares its stock with its employees, as compared with being acquired by a large, impersonal, corporate behemoth. This may be especially significant for professional services companies (like ESA) where senior employees are often shareholders and thus have real say in whether to accept an acquisition offer.

Not that this was an easy sell for ESA. Indeed, for the Adolfson acquisition, ESA had to work to overcome some negative perceptions on the part of some employees who had worked for a large area firm that had fared poorly with an ESOP. While these challenges did not surface in the 2010 acquisition of PWA, ESA nevertheless found that they had to work hard to explain the benefits of being part of an ESOP company. They communicated regularly on this, stressing that the target company employees would receive ESA stock without having to pay anything for it; that all employee shareholders would share in the wealth that would be generated by ESA's future growth; and that being an employee owner would give them a greater voice in the future direction of the company. Still, says CFO Thornton, "our assessment was that in the pre-merger discussions, the existence of the ESOP was not helpful in attracting the target."

But, while the target employees may not immediately appreciate the special value of being part of an employee-owned company, that doesn't mean that the human resources aspect of ESOPs plays no role in the successful completion of corporate acquisitions. Significantly, studies of corporate acquisitions generally have consistently found that the majority of all such acquisitions ultimately fail, in terms of their impact on the financial performance of the acquiring company.

Given this reality, ESA's experience may highlight what may prove to be the biggest benefit of ESOP ownership when it comes to corporate acquisitions – the power of employee ownership to bring people together with a common sense of identity and purpose as co-owners of a company. Says Greg Thornton, "The perception of ESOP ownership by the acquired staff has become very positive as time has gone by and they have seen the financial benefits of ESOP participation. Over all, it has had a unifying role in the company's culture."

###