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Divestitures and ESOPs

The Efficient and Effective Use of an ESOP to Divest a Division or Subsidiary

Twenty years ago we structured an ESOP divestiture, the sale of a U.S. government-contractor subsidiary of PerkinElmer. While other ESOP divestitures have been structured over the last twenty years by our firm and others, this ESOP application is essentially "off the radar screen." The ESOP divestiture holds great potential for developing new ESOP business and can be a win-win for both the selling company and the spun-off division or subsidiary.

More Supply, Less Demand

While the need for publicly-traded and large, private companies to divest operations in the future will continue, the market is less than robust. Divestitures will continue to be driven for the variety of reasons they have always been driven in the past. These reasons include a lack of "fit" with the parent organization, change of the strategic direction of the parent, or need for cash by the parent. It is the last reason that we see accelerating substantially. Lenders will be counseling their customers to improve their liquidity, and selling a profitable division or subsidiary may be the only way to accomplish it.

Profitable, not Problematic

It is important to emphasis that in the divestitures we have managed what we expect to see are profitable, well-managed divisions or subsidiaries. We are <u>not</u> talking about a "rescue" or "crises" ESOP that is the buyer of last resort, attempting to save a troubled operation. We are suggesting the ESOP be the buyer of *first* resort, or at least a buyer that is seriously considered while proposals are being solicited from traditional buyers.

The ESOP Advantage

The reasons the ESOP may be the best option to facilitate the divestiture are the unique tax benefits <u>available only to the ESOP</u>. Principal payments on all ESOP-related debt are tax deductible to the corporation. If the newly formed company (newco) that is divested elects S corporation status, (there are a number of ways to structure this) then income attributable to the percentage of stock owned by the ESOP is not subject to federal income tax. Most states mirror this provision. In other words, a 100% ESOP-owned S corporation formed as the result of a divestiture operates as a <u>tax-free</u> entity—not a non-profit, but a tax-free entity. As a result, it can repay approximately twice as much debt as a conventional corporation. In addition, in today's environment, the ESOP should be price competitive with any financial buyer.

Key Considerations

1. Strong proven management team and strong company.

2. Willingness of seller to hold a minority percentage of the transaction price as debt or equity.

3. Guarantee of a revenue stream for a limited period of time for product and/or services provided to the parent.

4. Willingness to listen to ideas presented in problem solving ways, i.e., the ESOP Alternative.