Selling company? Employees can buy it

BY RENEE MCGAW
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When Gerald H. Phipps died in 1993, he left behind a will that gifted his Denver-based general contracting company to its employees. Today, 102 employees of Gerald H. Phipps Inc. all own a piece of the company through an employee stock ownership plan, or ESOP.

Phipps' foresight is rare. In coming years, a slew of private Colorado companies likely will change hands, as post-World War II entrepreneurs retire or die. Unless the business owner has an heir willing to run the business, most will be sold to an individual or another company.

Ron Lint, CEO of ATI Capital Group of Colorado, an Estes Park-based business consulting firm, said most companies are overlooking a third choice: ESOPs.

"Colorado is an under-ESOP'ed state," Lint said. "Most companies, at $25 million and under, are too small to attract M&A interest. So how do you transition?"

He's assembling a team to offer what he said is the state's first turnkey approach to ESOPs. The groups he's working with include three Colorado law firms, including Davis & Associates; two CPA firms; and three banks, including Vectra Bank Colorado. Other potential participants either declined to be named, citing the early nature of the project, or couldn't be reached.

The start-to-finish service will handle all aspects of the deal for a single fee, disclosed up front, based on the complexity of the transaction. Lint said his team-based approach can slash the entire process to roughly 90 days; it typically takes about a year.

Lint sees a large untapped market. There are only 12 ESOPs operating in Colorado, out of about 11,000 nationwide, according to the Washington, D.C.-based ESOP Association. Besides Phipps, they include Denver-based architectural and engineering consultant SA Miro, Inc.; Westminster-based Alpine Lumber Co.; Hazen Research, a metallurgical and mining research company in Golden; New Belgium Brewing Co. in Fort Collins; and others.

But Lint estimated about 2,000 Front Range businesses would qualify for an ESOP, based on their size, profitability and other factors.

"Business succession is a big problem in the United States," he said. "There are so few ways to do it effectively."

ESOPs are what Lint, who has been doing them for the past 20 years, calls "the ultimate exit strategy" for private business owners.

"The company can deduct 100 percent of the principal and interest on the loan to purchase the stock," Lint said. "That creates almost enough cash flow to pay the bank back for the money you borrowed to do it."

A leveraged ESOP works like this: The company establishes an ESOP. A bank or other lender lends money to the ESOP, which buys company stock from the selling owner. The company makes annual tax-deductible contributions to the ESOP, which repays the loan.

The seller, meanwhile, can legally defer capital gains tax under Section 1042 of the Internal Revenue Code of 1986, which allows sellers to ESOPs to roll over the proceeds tax-free as long as they invest them in qualified U.S. stocks. Capital gains tax then would be deferred until those stocks were sold — but Lint said that with a properly structured plan, capital gains tax can be avoided permanently.

But many companies, wary of the complexity, avoid leveraged ESOPs. And they do have some downsides. For one thing, the tax benefit is wasted if the company isn't profitable, because an unprofitable company wouldn't pay income tax in any case.

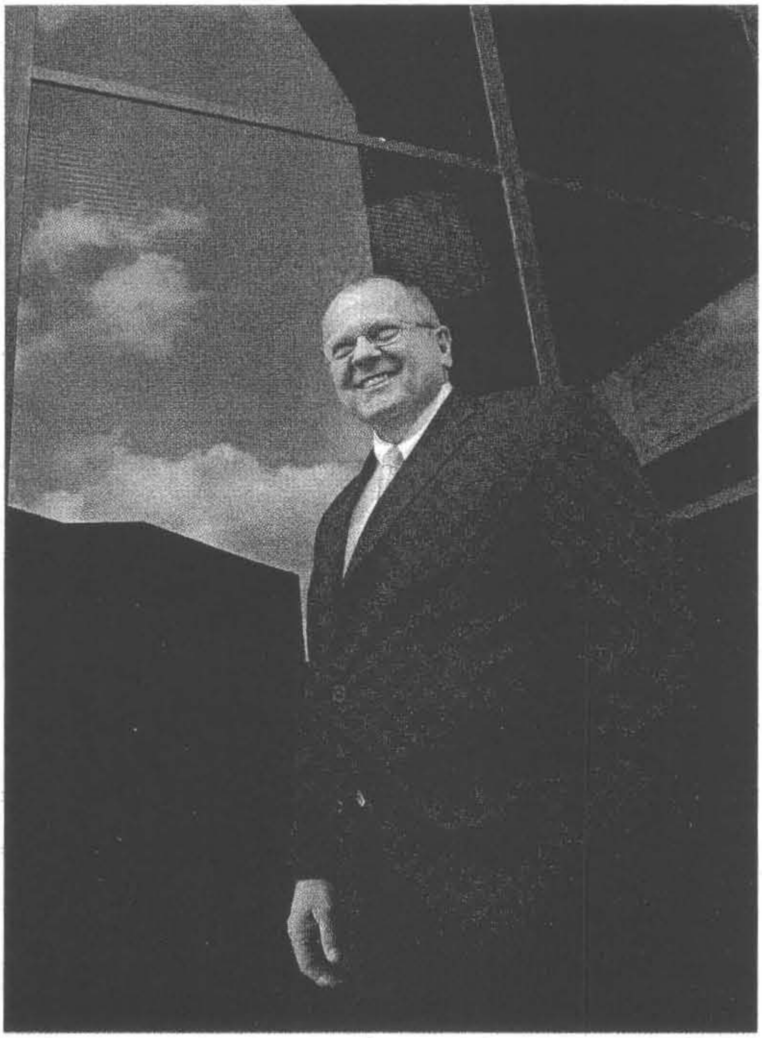
The employee stake also leaves the company with "repurchase liability" — that is, the company is obligated to buy back an employee's stock when he or she leaves the company or dies, a financial hit that can come unexpectedly. Lint said this can be managed by funding a repurchase liability account for eventual stock buybacks.

A leveraged ESOP also creates a perceived decrease in the company's value, at least until the ESOP loan is repaid. To balance this, Lint said it's useful to build relationships with banks ahead of time, educating them about the accounting peculiarities of ESOPs.

The increased debt load can be a problem in a sudden economic downturn, as well, though Lint said a leveraged M&A deal carries the same risk.

Adolphe Cyr, a financial services professional at MassMutual Financial Group who's working with Lint, said most ESOPs are created by attorneys, who may have little experience in them and are unable to provide a comprehensive approach.

"There's no one to herd the cats," Cyr said.



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Ron Lint, CEO of ATI Capital Group of Colorado in Estes Park, advocates for employee stock ownership plans.

Lint moved to Colorado about two years ago from Dallas, where he worked as a business appraiser and financial consultant. Although he says he's handled about 200 ESOPs around the country, he's never done one in Colorado.

Among his previous clients is Locke Supply Co., an Oklahoma City, Okla.-based wholesale supplier of plumbing, heating, air conditioning and electrical equipment. The 800-employee company went to an ESOP in 2000, after founder Don Locke died.

"We were able to talk his wife into allowing us to go out and secure the financing to buy 67 percent of the company from her for about $23.5 million," said Jack Anderson, the company's chief financial officer.

The tax benefits were one factor in deciding to go to an ESOP, but "it wasn't the primary factor," Anderson said. "We felt that with Don's death there would be a lot of people coming to Mrs. Locke and wanting her to sell stock to them. ... We felt it was in the best interest of Locke Supply to keep the management intact. The tax benefits

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allowed us to do what we did to finance the 67 percent. If we had had to buy the 67 percent and then pay income tax on that, I don't know if we would have been able to do it."

Although leveraged ESOPs can be complicated, "it was easier, probably, with Ron's expertise and with the team he had assembled, to get it done," Anderson said. "I had been in public accounting for 20 years, but I had never really been exposed to an ESOP company, so it helped me to have his expertise."

Anderson's advice for companies considering an ESOP: Plan ahead for the repurchase liability.

"The main thing is you've got to provide for the repurchase liability later on, after people start retiring," Anderson said. "You can't wait until people start retiring to think about that; you've got to do it on an ongoing basis."

Kurt Klandrud, a senior vice president at Gerald H. Phipps — whose ESOP wasn't handled by Lint — agreed.

"That's one of the things that our board and trustees is very mindful of," Klandrud said. "We obviously have the repurchase obligation. We have funded our plan every year since 1993. We haven't had to borrow or leverage the company to pay any of the retirees."

He knows his company's smooth transition is rare.

"There was a lot of foresight" in Phipps' setting up an ESOP transition plan in 1977, years before his death. "It's a huge benefit to the people who are involved in it now," Klandrud said.

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