Alternative Financing Sources in ESOP Transactions

There are various alternative financing sources for transactions involving ESOP-owned companies. Transactions can be related to initial ESOP transactions, partial-to-full ESOP transactions, growth initiatives/acquisitions, or for a myriad of other purposes. The type of alternative capital chosen depends on many things including the amount of capital needed, the company's cash flow/collateral coverage, strategic objectives, and uses of the capital. There are also certain considerations for key stakeholders before seeking these alternatives.

Why is There a Need for Alternative Financing?

When pursuing an ESOP transaction (or any type of balance sheet recapitalization), alternative financing sources may need to be explored beyond traditional financing sources. This could be for a variety of means. First, a larger amount of capital or liquidity may be sought which could trigger the need to speak with alternative capital providers. Traditional capital providers may be willing to only provide a certain amount of capital for their perceived risk taking. Secondly, traditional sources of capital may not be available or willing to provide capital. A particular company's characteristics or dynamics may limit the willingness of traditional financing sources to provide capital. For example, a business may operate in an out of favor industry or the perceived riskiness of a business may be beyond a certain comfort level for providers. Further, macroeconomic conditions in the broader market environment may cause providers to be more cautious and unwilling to provide capital. This has clearly been seen during the Great Recession in the late 2000s and more recently with the COVID-19 pandemic. Finally, the Company may be seeking a more customized capital structure in order to meet specific goals or objectives in a transaction. For example, scenarios exist whereby a company is seeking a more mechanical / structured program for future capital borrowings. Traditional capital sources may not be willing to agree to this structure in advance. Alternative financing sources, on the other hand, can be more creative and customize credit or equity facilities to meet these objectives.

There are many reasons why alternative financing sources may be ideal for a company to pursue. The reasons and examples listed above are just a few that exist. The key takeaway is that if a traditional financing source is unwilling or unable to provide capital, one should not get discouraged as there are a myriad of alternative financing providers who stand ready to help companies achieve their goals and objectives.

What Alternative Financing Options Exist?

Many alternative financing options exist. This section is not meant to be all encompassing, and is focused on some of the typical, more common forms of alternative financing options available.

Mezzanine Debt

Mezzanine debt is the middle layer of capital that sits subordinated to senior debt and above equity on the balance sheet. This type of capital is usually not secured by assets and is lent based on a company's ability to repay with cash flows. This form of capital is a great way to "bridge the gap" between the company's cash needs and what traditional lenders are willing to provide. This is often described as more "patient" capital. Mezzanine debt does not require any principal payments and simply has a balloon payment at the end of its term. This debt typically matures six months or more after any senior debt on the balance sheet. Because this debt sits lower on the balance sheet, it is deemed to be riskier than senior debt and requires higher interest rates. As such, it is common for interest rates for this type of debt to be double digits and to have a component of it be "payment in kind" or PIK. This means that the interest is not paid in cash but added to the principal balance of the mezzanine debt instrument. Some benefits of

mezzanine debt include: no amortization, longer maturity, and provides additional liquidity/capital without diluting existing owners. Some considerations include higher interest costs, prepayment penalties if one desires to repay the debt sooner than required, stricter financial covenants, and in some cases, board of directors observation rights / seats. Sources for mezzanine capital include traditional commercial banks, nonbank lending institutions, insurance companies, and some private equity firms.

Structured / Preferred Equity

Structured equity or preferred equity represents flexible capital that has debt and equity like characteristics. This capital sits below debt and above common equity on the balance sheet. It is often labeled as "structured" equity since it is not common equity and usually has incremental features compared to common equity. For example, this type of capital may have a principal component and accruing dividend component (like debt). It may even have a required return component. Further, this capital may have an equity participation component, such as conversion into common equity. In these instances, the accrued dividends may be eliminated, and only common equity is held, or the common equity may be incremental to the dividends. The capital is placed on the balance sheet with call and put features. A call right is the company's ability to buy back the equity. A put right is the equity holder's ability to force the company to buy back the equity. The time periods for the call and put features, as well as determining the fair market value of the equity, are subject to negotiations with the capital provider. This capital provides incremental liquidity or capital beyond bank and mezzanine debt. However, structured equity is dilutive to the existing equity holders of the business. This form of capital will also typically require observation rights or actual seats on the company's board of directors. The other terms and conditions of the structured equity are subject to market conditions and negotiations. Common negotiated terms include reporting requirements, anti-dilutive provisions, and conversion features, among others. Sources of structured equity include nonbank lending institutions, insurance companies, and private equity.

Common Equity

Common equity or common stock represents the most basic form of ownership in a company. Investors in this scenario are holding the exact same class of stock as the ESOP. All characteristics of their investment mirror the stock held by the ESOP. Common equity investors participate in the performance of the company, the value of which will move up and down. Common equity investors benefit from dividends and equity value growth. Common stock is subordinate to all other capital (debt through preferred equity). Common stock is the riskiest form of investment and provides the holder unlimited upside. Common stock is dilutive to the existing owners of the company and typically comes with a requirement for seats on the company's board of directors. Common equity investors will be entitled to receive information and vote its shares as directed in a company's bylaws. Some common equity investors can be vocal and attempt to sway strategic directions of the company; other investors will be more passive in nature. Sources of common equity are typically private equity firms.

What Are Considerations When Choosing Alternative Financing Options?

Understanding that there are alternative financing sources is helpful. However, choosing which alternative financing source is most appropriate gets more complicated. The key stakeholders in a company or transaction must explore the various considerations to identify the best form of capital. The discussion herein will focus on three key stakeholders: the company, the owner/seller, and the ESOP trustee. The intent of this section is to provide thought provoking questions and color as one considers taking on alternative forms of capital.

Company Considerations

Will the contemplated capital structure enable the company to execute its strategy? Said another way, does this capital help the company achieve its strategic goals and objectives as an organization? For example, if the Company's goal is to acquire smaller competitors, the capital placed in the transaction should be supportive of acquiring future targets. A common equity investor, for instance, may have more appetite to fund these acquisitions in the future than a traditional commercial bank.

Will cash flow be available to reinvest in the business? Can the company support debt servicing? It is important to choose a capital structure that is not so onerous that the Company cannot meet its debt servicing obligations. Not only must a company be able to meet its debt obligations, but there should be enough cash flow to execute on corporate strategies as well. If a company can barely meet any debt servicing obligations from a selected capital structure, the company may way to reconsider the contemplated structure.

Will leadership be forced to sell the company in the future in order to pay back the capital provider? There may be a balloon payment for mezzanine debt or required repayment of an equity investor in the future. The company must be able to afford these obligations through cash generated or through a refinancing with other debt providers. A company should know going into an alternative financing transaction exactly how it plans to repay the debt or equity obligations when due. Selling the company may be the only option in the future, and this may conflict with the company's strategic plan.

What financial covenants / reporting are required? As previously mentioned, certain types of debt and or equity provide benefits, but also come with financial covenants and reporting requirements. Is the Company prepared to provide monthly reporting to a mezzanine debt provider? Is a company prepared to offer a board seat to an equity investor?

Does decision making and control change? By taking on alternative capital, there could be changes to the decision makers in an organization. In some instances, the individuals may be the same, but servicing debt obligations may now be a top priority. In situations where there is a legal change in control, is the strategic direction the same of the new owners compared to the previous?

Owner/Seller Considerations

Will the capital structure provide sufficient cash at close? Many owners have a liquidity goal when transacting. In some instances, there needs to be sufficient liquidity at close to owners to justify selling or recapitalizing a business. A traditional provider of capital may not provide the desired levels. As previously discussed, several forms of alternative capital can increase liquidity at close and effectively meet this objective.

How involved will the seller be post-transaction? A seller may be looking for maximum liquidity and be willing to "take a back seat" of running the business. If this is the case, he/she may be willing to give up legal control. If the seller will be very involved post-closing, he/she may not want the reporting or financial covenants associated with certain types of alternative capital providers. He/she may fear that these requirements will divert management's attention from operational objectives.

Do investment returns and creditor/equity rights match risk? Owners will be "giving up" something for the increased capital/liquidity. In some instances, it is increased borrowing costs in the form of interest expense on mezzanine debt. In other instances, it is an ownership interest in the operations to a preferred or common equity provider. A seller or business owner needs to ask him/herself if "what I am receiving outweighs what I am giving up?"

Does decision making and control change? Will there be a new board member or observer voicing his/her concern or guidance for the operations? If so, does the owner have a pre-existing relationship with this person or firm? Will there be friction at the Board level? Conversely, what positive attributes can this individual bring? A new board member may have experience in the industry or have previously been a part of transactions of this type.

Trustee Considerations

Does the capital structure create an insolvency risk? A trustee is a fiduciary of plan assets, which holds the equity of a company. If the capital structure will put the equity at risk, a trustee may not be okay with the transaction.

Is the debt or equity priced at market rates and terms? A trustee will want to ensure that any capital utilized in the transaction is not dilutive to the ESOP. If it is dilutive, is the ESOP receiving a benefit in the transaction?

Does decision making and control change? If an equity capital provider is coming into the capital structure and taking control, the ESOP must receive adequate consideration.

How are employees long-term value impacted? ESOP Trustees will view capital structure decisions as a fiduciary. If employees' value will be harmed from a capital markets transaction, an ESOP trustee will need to understand the rationale.

Each stakeholder will have its own set of considerations to weigh prior to transacting with alternative sources of capital. In some instances, interests will be aligned, and, in some instances, interests may conflict. For a successful outcome, full transparency of considerations is encouraged among all parties.

Tips for Successful Alternative Financing Transactions

As previously mentioned, there are several alternative capital providers and the form/structure of capital can vary. Though no transaction is identical, a company and management team can take certain measures to ensure a successful outcome regardless of the capital and structure selected.

First, as discussed in the previous section, all stakeholders should fully understand the goals and objectives and ask itself if this transaction is helping to achieve or hurt the objectives. These objectives should be identified before starting any transaction and communicated to all parties involved. For example, a capital provider who understands the uses of capital may better structure a solution to meet the intended objectives. Second, a company should hire experienced advisors to lead the transaction. Advisors should have knowledge of the various capital providers and structuring solutions. In addition, advisors should have relevant experience in the same industry in which the company operates and executed upon similar types of transactions. Finally, a company needs to be fully prepared for what a transaction process entails. Preparation items can include, but are not limited to: (i) preparing a five-year business plan forecast, (ii) reviewing the Company's state of accounting records and financial control systems, and (iii) preparing to market the company as one would its own products and services to prospective customers. Further, these types of transactions take time and a company should plan for and allow adequate time to explore the financing alternatives.

Alternative financing providers are not new to the ESOP marketplace. Companies should consider this source of capital if it helps achieve the goals and objectives. However, like any corporate or strategic decision, proper education, exploration, and preparation is necessary to ensure a successful outcome.

About the Author

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