



ESOP Financing

By The ESOP Association

A broad overview of the unique characteristics and advantages of ESOP financing as compared with conventional debt financing.

Using an ESOP in conjunction with debt financing has so many unique characteristics that it is called “ESOP financing.” In this issue brief, some of the basic characteristics of ESOP financing are discussed and compared with conventional debt financing. In many financing situations, ESOPs have very desirable advantages.

An ESOP qualified under Sections 401(a) and 4975(e) (7) of the Internal Revenue Code is the only type of employee benefit plan which may be used to borrow money, provided that the loan is primarily for the benefit of the participants, the interest rate is reasonable and the only collateral the ESOP offers is the qualifying employer securities purchased with the loan proceeds.

The General Outline

The general outline is simple: the ESOP borrows money and purchases an agreed upon number of shares at their fair market value from the employer or existing shareholders. The shares purchased with the borrowed funds are placed in a suspense account, and may be used as collateral for the loan. As the loan is repaid, the shares in the suspense account must be released from pledge, and allocated to individual employee accounts on a pro rata basis.

Leveraged ESOP Structures

In the basic leveraged ESOP three different structures are possible. In the first case, the ESOP simply gives a note to the lender. This note is usually accompanied by a guarantee from the employer that it will make contributions to the ESOP sufficient to enable it to amortize the loan, and may be secured by a pledge of the ESOP’s newly acquired shares, or, if the lender requires it, a pledge of the corporation’s assets .

Second, if the lender prefers, the loan may be made directly to the corporation, and the corporation may then make a “substantially similar” loan to the ESOP. This may reassure some lenders who are uncomfortable about lending directly to ESOPs.

A third alternative involves the company making the loan, but instead of re-lending it to an ESOP, the company simply sets up a non-leveraged ESOP and makes contributions of stock to it over the years of loan repayment which equal the amount of the loan payment.

This allows the company to receive the cash flow benefits of ESOP financing below and also results, in a company with a rising value in the ESOP, holding a smaller percentage of the company at the end of the loan repayment than in the first two cases.

All three of these alternatives share the cash flow benefits of ESOP financing which are described below.

The Cash Flow Benefits of ESOP Financing

The most fundamental characteristic of ESOP financing is that it increases the total cost of borrowing but significantly decreases the cash cost of borrowing. This results from the fact that principal payments as well as interest payments are deductible when repaying an ESOP loan and that ESOP financing involves transferring employer stock to the ESOP.

A brief example will serve to illustrate the cash flow benefits of ESOP financing. Suppose a company, taxed at the 35 percent rate, wants to borrow one million dollars. The firm arranges conventional financing at 10 percent interest and makes annual equal principal payments over five years. In exchange for \$1 million, the corporation assumes debt repayment obligations, which look like this:

Assumed tax rate 35%
 Assumed loan interest rate 10%
 Amount borrowed 1,000,000

Conventional Debt Case: W/O ESOP

Year	1 Principle	2 Interest	3 Deduction	(1+2+3) After Tax Cash Cost
1	200,000	100,000	(35,000)	265,000
2	200,000	80,000	(28,000)	252,000
3	200,000	60,000	(21,000)	239,000
4	200,000	40,000	(14,000)	226,000
5	200,000	20,000	(7,000)	213,000
Total	1,000,000	300,000	(105,000)	1,195,000

In contrast, if the company had used a leveraged ESOP to accomplish the same purpose, its repayment obligations would look like this:

ESOP Financing Case

Year	1 Principal	2 Interest	3 Deduction	(1+2+3) After Tax Cash Cost
1	200,000	100,000	(105,000)	195,000
2	200,000	80,000	(98,000)	182,000
3	200,000	60,000	(91,000)	169,000
4	200,000	40,000	(84,000)	156,000
5	200,000	20,000	(77,000)	143,000
Total	1,000,000	300,000	(455,000)	845,000

What is not shown in the chart above is in the ESOP financing case the ESOP ends up with \$1 million in stock. Thus) the total after-tax cost of the ESOP financing is \$1,845,000 as opposed to \$1,195,000 for the conventional debt, but the after tax cash cost of the ESOP financing case is only \$845,000, less than the face value of the loan.

From a lender's perspective that is \$350,000 pre-tax dollars the company does not have to repay the loan. In other words, ESOP financing makes a company better risk for a lender, because the loan is amortized entirely with pre-tax dollars, which enhances the company's ability to repay the debt considerably.

Conclusion

ESOP debt will lower net earnings and net profits during the period of loan amortization because the cost of interest plus principal plus ESOP contribution exceeds the interest and principal payments of conventional financing. Cash flow, however, is greater than it would have been with conventional debt financing; thus an ESOP loan enhances a company's debt servicing ability.