Best Practices Discussion

Employee Stock Ownership Plan Financial Feasibility Analysis: Financial Considerations for Shareholders

Robert F. Reilly, CPA

The owners of a private company who are looking for an exit strategy may consider the sale of all (or part) of that company to an employee stock ownership plan ("ESOP"). Such an exit strategy may be particularly attractive to baby boomer private company owners who are seeking retirement and liquidity and who would prefer to see their loyal employees retain a stake in the company ownership. This discussion summarizes the factors that such private company owners should consider—and the feasibility analysis that their financial advisers should perform—to assess whether a sale of the private company stock to an ESOP makes sense as an ownership transition strategy.

Introduction

When it is time for the owners of a private company to consider an ownership transition (i.e., a sale of the company on the path to retirement), a sale to the company employees may be one option to consider. This particular ownership transition exit strategy is often implemented through the formation of an employee stock ownership plan ("ESOP").

The private company sponsors (i.e., arranges) the formation of the ESOP. And, the ESOP trust buys the private company stock, often through a leveraged stock acquisition transaction. As discussed below, the selling stockholders may or may not provide seller financing to make the stock acquisition transaction more attractive to the employees.

Through the ESOP's acquisition of the company stock, the selling stockholders receive liquidity—usually in a tax-advanced structure. The selling stockholders achieve the ownership transition objective that they are seeking. And, the loyal employees enjoy a stake in the ownership of the employer company on a going-forward basis.

Obviously, an ESOP formation and a leveraged stock acquisition is not the appropriate ownership transition strategy to satisfy every private company owner's exit plan. This discussion summarizes the financial factors that the current company shareholders should consider before the company sponsors an ESOP formation.

In addition, this discussion describes the ESOP financial feasibility analysis (and the other issues) that the company financial advisers should consider before the current owners implement a sale of the private company to an ESOP.

Before a private company proceeds with the formation of an ESOP, the company owners should participate in an ESOP formation feasibility analysis. The purpose of a feasibility analysis is to give both the selling shareholder(s) and the private company management/directors the information they will need to determine whether to move forward:

1. with the ESOP formation and
2. with the ESOP's purchase of the company stock.

The results of the feasibility analysis should enable the private company, the trustee of the to-be-formed ESOP, the selling shareholder(s), and the legal counsel to all parties to structure a transaction that is beneficial to all of the such parties.

Of course, in order to comply with the applicable federal laws, such a stock purchase transaction must be fair to the to-be-formed ESOP from a financial point of view.

This discussion summarizes the process of the ESOP financial feasibility analysis. And, this discussion summarizes how the parties to the ESOP formation may use the information developed in the financial feasibility analysis to decide if—and how—to structure the ownership transition transaction.

In the decision to implement an ESOP purchase of the private company stock, the selling shareholders have to consider whether (and at what price) to sell their company shares to the ESOP. The selling shareholders also have to decide whether they are willing to give up ownership control of the private company to a new owner—that is, to the ESOP.

This transfer of ownership control consideration is also relevant in an ESOP formation where the private company itself (and not the current shareholders) sells treasury shares to the ESOP.

The company managers and company directors have to consider whether the company can afford to finance the ESOP stock purchase transaction—particularly if the ESOP transaction is to be a leveraged stock purchase. The company managers and company directors also have to consider the other (nondebt service) ESOP-related costs—such as plan administration expenses, regulatory compliance expenses, and financial statement impact "costs."

The information developed during the ESOP financial feasibility analysis allows these parties to decide whether or not an ESOP stock purchase transaction is an effective strategy for achieving the current shareholders' ownership transition and liquidity objectives. Each ESOP feasibility analysis will be different—depending on each private company's situation.

However, most ESOP feasibility analyses include certain basic considerations in order to:

1. provide meaningful information to all of the parties involved in the ESOP formation and the private company sale decision and
2. avoid costly mistakes that could impair the long-term success of the ESOP (and of the private company itself).

The Employee Stock Ownership Plan

An ESOP is an employee benefit plan that provides employees with an equity ownership interest in the sponsor company. An ESOP is an employee retirement plan that in some ways is similar to (and governed by) the same statutory authority and administrative regulations as a 401(k) plan.

Through the ESOP, the sponsor company creates a trust for the company employees. Either the sponsor company contributes cash to the ESOP to allow the trust to purchase the sponsor company stock shares or the ESOP trust borrows funds from a financial institution (or from the selling stockholders) to purchase the sponsor company stock shares. Alternatively, the sponsor company may contribute shares of stock (from the company treasury stock) directly to the ESOP. In any event, the company employees obtain ownership in the employer company through the ESOP trust.

The sponsor company's contributions to the ESOP (to allow the ESOP trust to buy the employer shares or to pay back the stock acquisition loan) are tax deductible to the sponsor company. However, the employees do not recognize an income tax liability for the sponsor company contributions until the employees actually receive the shares of stock. That receipt typically occurs either when the employee leaves the company or retires.

ESOPs were created by, and are regulated by, the Employee Retirement Income Security Act of 1974 ("ERISA"). In addition, an ESOP is an Internal Revenue Code ("Code") Section 401(a) qualified defined contribution plan that is either a stock bonus plan or a stock bonus/money purchase plan.

The ESOP must be designed to invest primarily (although not exclusively) in qualifying employer company securities—as defined by Code Section 4975(e)(8). In addition, the ESOP must meet other qualifying requirements of the Code and the Regulations.

The Internal Revenue Service and the U.S. Department of Labor both have regulatory jurisdiction over ESOPs and ESOP sponsor companies.

The ESOP Financial Feasibility Analysis

In general, an ESOP feasibility analysis should address the following transaction pricing and structuring questions:

- What parties will actually sell the private company shares to the to-be-formed ESOP?

- How will the to-be-formed ESOP finance the purchase of the private company stock?
- How will this new stock acquisition financing (if any) affect the cash flow of the private company?
- What is the best plan design for the company? For example, should the company merge the to-be-formed ESOP with its existing 401(k) plan?
- What are the ERISA and the Code (and state securities law) requirements with respect to an ESOP that the company management and the selling shareholder(s) should know about?
- What if the company actual future results of operations vary—positively or negatively—from any financial projections prepared at the time of the company stock purchase transaction?
- How does the selling shareholders' desired sale price for the private company stock compare to the range of company stock fair market values estimated by the independent financial adviser or valuation analyst (hereinafter, collectively, the "analyst") working for the to-be-formed ESOP trustee?

Initial Considerations

The initial considerations regarding the ESOP feasibility analysis may be assessed by the company's selling shareholder(s)—with the help of the company management. That is, the ESOP feasibility initial considerations may be determined without the need to retain an independent analyst or legal counsel.

In general, private companies that are reasonable candidates to successfully implement an ESOP formation—and to sponsor a sustainable ESOP—have the following characteristics:

- Be a private U.S. company
- Employ more than 25 full-time employees
- Have an established track record of consistent profitability and earnings growth
- Have at least 10 years of company operating history
- Report at least $10 in company annual revenue
- Have one or more company owners who are interested in investment liquidity and in a diversification of their personal wealth
- Have one or more company owners who are interested in ownership/management succession planning and in the transition of the company ownership to the employees
- Have one or more company owners who would consider accepting a reasonably conservative stock value (i.e., a price that is at the lower end of the range of corporate acquirer transaction prices)
- Have a senior management team that supports the concept of an ESOP formation (and of the employee ownership of the private company)

The controlling shareholder(s) should assess the company relative to these benchmark characteristics in order to determine if the company is a reasonable candidate for an ESOP formation. This initial feasibility analysis may be performed internally within the private company—that is, without the company having to spend large amounts of time and money.

That is, if the private company, the selling shareholders, and the company management do not "pass" these threshold characteristic "tests," then the company may not be a particularly good candidate for an ESOP formation. The company stockholders and the company management do not need to proceed to the financial, valuation, or administrative "tests" associated with an ESOP formation.

The next procedure of the feasibility analysis is for the company shareholders and company management to become more familiar with the ESOP installation process. This procedure should include developing a familiarity with the financial, legal, administrative, and regulatory aspects of an ESOP formation. The ESOP Association and the National Center for Employee Ownership are useful resources for this type of information.

This "process familiarity" procedure should allow the parties in interest to address questions such as the following:

- Can the differing goals and objectives of the various company shareholders—and of the other parties to the proposed stock sale transaction (e.g., the management team, employees, nonselling shareholders, etc.)—be achieved through the formation of an ESOP?
- Would a company merger or a sale to a strategic corporate acquirer—or some other type of company liquidity event—be better suited to achieve the objectives of the company shareholders, management, and other parties?
- What percentage of the private company stock will the to-be-formed ESOP own after the stock purchase transaction? And, which shareholders will sell or redeem their shares as part of the ESOP's stock purchase transaction?
- How will the current company management—and the current controlling shareholder(s)—react to the inevitable changes in voting/control rights and in corporate governance?
- How will the company's current management succession planning be addressed in relation to the stock ownership change transaction? How long will the selling shareholders (assuming they are also company managers or directors) remain in their current management roles? How will the successors to the current executive management or board of directors be identified and transitioned in order to maintain operational management continuity on a going-forward basis?
- Is it desirable for the private company to merge the to-be-formed ESOP with the company's existing 401(k)—or other employee benefit—plan?
- What happens to any existing management incentive (compensation) plans? Will a new management compensation plan be introduced at the same time as the ESOP stock purchase transaction?
- Which of the company's employees will (and will not) be eligible to participate in the to-be-formed ESOP?

Consideration of these questions may help to clarify the strategic objectives (and the personal objectives) of all interested parties to the private company ownership transition. In order for the ESOP formation to be successful, the means of achieving these strategic objectives (and these personal objectives) should be evaluated as part of the ESOP feasibility analysis.

If these initial procedures indicate that financing an ESOP stock purchase transaction is a reasonable alternative for achieving the objectives of most of the interested parties, then it may be time for the company to retain experienced ESOP advisers.

These ESOP advisers will address some of the more technical (and complex) ESOP formation feasibility issues. These ESOP advisers typically include a trustee, legal counsel, an independent financial adviser/analyst, and perhaps others.

Typical Components of an ESOP Financial Feasibility Analysis

A comprehensive ESOP feasibility analysis typically includes several transaction planning, pricing, structuring, administrative, and legal considerations. These considerations typically include the following:

- A preliminary valuation of the private company stock to estimate the approximate fair market value price that the to-be-formed ESOP could or may pay
- A quality of earnings (or sometimes called a stockholders' equity) analysis to determine how the to-be-formed ESOP would affect (1) the existing company shareholders and (2) the company's future financial performance
- A plan design study to determine the most beneficial stock ownership transition transaction structure and which plan features to incorporate in the to-be-formed ESOP
- A liquidity study to assess the future demands that the ESOP stock repurchase obligation may eventually make on the private company

A Preliminary Valuation Analysis

A preliminary valuation analysis of the company stock is an important component of the ESOP financial feasibility analysis. It is one of the procedures that should be performed early in the process. Accordingly, this preliminary valuation analysis may be performed by an analyst without undertaking a comprehensive due diligence investigation.

Therefore, the analyst typically cannot provide a final opinion of the fair market value of the private company stock. Rather, the analyst provides an opinion of a reasonable—but not final—range of fair market value indications for the private company stock.

The estimation of the company stock value is a complex process—and it is important to the ESOP formation decision. Accordingly, the parties usually retain an analyst who is experienced in ESOP—and ERISA-related—stock valuations.

In fact, typically the selling shareholders (and/or the company) and the trustee to the to-be-formed ESOP typically each retain their own independent analyst at this stage of the feasibility analysis. Regardless of whether the analyst is retained by the company's selling shareholders or by the to-be-formed ESOP trustee, the analyst's preliminary value conclusion is typically expressed as a range of fair market values for the private company stock.

At this stage of the feasibility analysis, an analyst experienced in ESOP—or ERISA-related—stock valuations will typically estimate a reasonable range of stock values without preparing a narrative valuation report. Consequently, the expense associated with this preliminary valuation analysis is usually less than the expense associated with the analyst's final stock valuation analysis (and the preparation of a written narrative valuation report).

The estimation of the preliminary range of company stock fair market values is often considered on the "critical path" of the ESOP formation process. It is important for all of the parties to find out early if:

1. the preliminary stock value range is less than the per-share stock price desired by the company's selling stockholders and
2. transaction structuring alternatives, such as earn-outs or warrants, cannot be used to encourage the company's selling stockholders to accept the preliminary stock price.

In such an instance, other strategies may have to be considered to increase the ownership transition attractiveness to the company's selling shareholders. Such "other" strategies may include waiting until the company's financial performance improves, reducing company operating expenses, and the like. In other words, what can the selling shareholders do to increase the value (i.e., the selling price) of the private company?

If the company's principal shareholders are not willing to sell their stock to the ESOP, or to permit the company to issue new shares of stock at a price within the preliminary range of fair market values estimated by the analyst, then the ESOP formation process may be abandoned.

"The estimation of the preliminary range of company stock fair market values is often considered on the "critical path" of the ESOP formation process."

Therefore, the preliminary range of fair market values for the company stock should be concluded as early as possible in the ESOP feasibility process. That way, the selling shareholders can change direction and evaluate other liquidity alternatives—while still minimizing the expense incurred to pursue an ESOP formation strategy that will ultimately be unsuccessful.

The Quality of Earnings Analysis

Often, the following components of the financial feasibility analysis can all be performed concurrently:

1. The quality of earnings analysis (which includes what is often called a stockholders' equity analysis)
2. The company liquidity (or cash flow test) study
3. The ESOP plan design study

In fact, these financial and administrative analyses can be performed at the same time that the preliminary stock valuation analysis is being performed.

The quality of earnings analyses should address several of the important questions that are typically asked by the company's principal shareholders. These principal shareholders are typically interested in the following considerations, particularly for the time period during which the ESOP stock purchase loan will be outstanding:

- How will the ESOP affect the fair market value of their (retained) stock ownership?
- How will the ESOP affect the company's expected cash flow and the company's expected profitability?
- What dilution effect will the ESOP-owned shares have on the fair market value of the company stock?

If the private company already has an existing pension and/or profit-sharing plan, the quality of earnings analysis may also compare:

1. the effects of the ESOP stock ownership on the company's benefit plans—in contrast to
2. the effects of the current stock ownership (without the ESOP formation) on the company's existing plans.

The quality of earnings analysis typically applies management-prepared financial projections—projections with alternative growth and profitability assumptions and other ESOP transaction variables—to create several alternative scenarios.

The analyst typically performs this scenario analysis to illustrate the resulting impact of the to-be-formed ESOP on:

1. the private company cash flow and
2. the private company stock value.

The cash flow component of the quality of earnings analysis can also be used as a structuring tool to help evaluate a mixture of stock purchase financing options. The alternative ESOP stock purchase financing options may include varying levels of bank debt financing versus seller note financing—as well as the assorted terms and conditions of the proposed financing structure.

In the quality of earnings analysis, some of the analysis variables that may be typically adjusted (or "stress tested") in order to construct alternative scenarios include the following:

- Company revenue growth rates
- Company operating profit margins
- The amounts of the company's current operations-related bank financing
- The amounts of—and the terms of—the ESOP stock purchase bank financing
- The ESOP stock purchase bank financing terms (e.g., interest rates, covenants, maturity, required prepayments, guarantees, etc.)
- The amounts of any selling stockholder-provided financing
- The terms of any selling stockholder subordinated debt (e.g., interest rates, maturity, required prepayments, warrants, etc.)
- The refinancing of the company's existing bank debt
- Any expected future capital expenditure investment requirements
- Any expected future working capital investment requirements

Often, the analyst applies the management-prepared financial projections as a "base case" scenario in the quality of earnings analysis. The analyst then adjusts (or "stress tests") the revenue, expense, investment, and income projection variables in order to create alternative financial projected scenarios. These alternative scenarios may include financial projections that reflect prospective operations under optimistic, pessimistic, and zero growth conditions.

These alternative scenarios typically hold all of the other company operational variables constant across the various sets of conditions. The goal of stress testing the operational variables in these alternative scenarios is to analyze how the private company could fare under alternative future operating circumstances.

The Liquidity Analysis

The liquidity analysis component of the ESOP feasibility analysis is intended to estimate the amount of the ESOP stock repurchase obligation that the company may incur over the next, say, 10 to 15 years. This ESOP stock repurchase obligation results from the employees' expected future terminations of service due to death, disability, retirement, and so forth.

The liquidity analysis typically does not address the source of funding for the ESOP stock repurchase obligation. Nonetheless, this liquidity analysis is a valuable tool that can help the private company management to estimate the timing of—and the amount of—the funding that may be needed in the future for repurchasing the allocated shares from any departing employees.

This information allows the private company management to make the appropriate financing, insurance, or other liquidity plans.

The Plan Design Study

The greater the flexibility included into the design of the ESOP documents themselves, the more effectively the ESOP will be able to accomplish its objectives.

The ESOP plan design study will typically address the following issues:

- Plan participant eligibility
- Employee vesting schedules
- The timing of the benefit distributions
- Forfeitures of the departing employees
- Company contribution levels
- Employee account allocation formulas
- Past service credit
- Early retirement policies
- A corporate charter or bylaw provision that restricts the stock ownership to the employee group

The use of one or more special classes of stock (e.g., nonvoting stock, preferred or convertible preferred stock, etc.) may also be addressed in the ESOP plan design study.

Some of the other questions that may need to be considered in the ESOP plan design study include the following:

- Who will (and who will not) be able to participate in the to-be-formed ESOP?
- Must the private company distribute the shares of stock to employees at retirement—or at other required distribution dates—if the employees demand it, or can the company just limit the form of the distributions to cash?
- What company divisions or subsidiaries may be excluded from the plan?
- Who will (and who will not) be able to vote the shares of the ESOP-owned private company stock—and under what circumstances?
- Should the private company combine other benefit plans, such as a 401(k) plan, with the ESOP?
- What will happen to the company's existing pension or profit-sharing plan?
- Is the existing company pension plan overfunded, underfunded, or adequately funded?
- What about the selection of the ESOP fiduciary/trustee, and of any possible administrative and/or advisory committee(s)?

The consideration of income tax issues should also be part of the plan design phase of an ESOP feasibility analysis. The relevant income-tax-related issues may include the tax implications of ESOP-related legislation, regulations and administrative rulings, and judicial precedent.

> **"The greater the flexibility included into the design of the ESOP documents themselves, the more effectively the ESOP will be able to accomplish its objectives."**

In addition, all of the interested parties should consider the implications of the following issues:

1. The "tax-deferred reinvestment" or "tax-free rollover" election available for the selling shareholders with regard to the sale proceeds of the private company stock to an ESOP
2. The tax deductibility to the employer company of dividend payments if paid to the ESOP participants or used to repay the ESOP stock purchase loan
3. Compliance considerations for an S corporation company that will be owned by an ESOP
4. Any new or currently proposed tax regulations or tax legislation

If a deferred profit sharing or money purchase pension plan already exists at the private company, it is normally "frozen." The assets of the existing benefit plan will typically remain invested in a diversified portfolio of publicly traded securities.

However, the employees can be given the option to invest a portion—or all—of their assets from a profit sharing, money purchase, or 401(k) plan into either (1) the company stock or (2) part of the ESOP stock purchase transaction.

Almost all ESOP sponsor companies either maintain or establish a diversified 401(k) plan that is not invested in the company stock. However, in some cases, the company may decide to merge its existing 401(k) plan with the newly formed ESOP.

In these situations, employees who are invested in the company's 401(k) plan are given the opportunity to invest their money into the ESOP. These funds are considered part of the stock purchase transaction financing. These funds are used to purchase the company's shares from the selling shareholder(s).

All federal and state securities laws should be complied with, and "full disclosure" should be provided to the company employees. Full disclosure can be a fairly burdensome requirement for a private company.

As mentioned above, there are both expenses and risks associated with a new ESOP formation. For example, the private company that forms an ESOP will be required to create a disclosure memorandum.

The disclosure memorandum typically describes the following:

1. The nature of the company's business operations
2. The company's historical financial performance
3. Company management's expectations regarding the company's future financial performance
4. The risks associated with investing in the company stock
5. Other information that an investor may require in order to make an informed investment decision

The disclosure memorandum is then distributed to the company employees. The employees are typically given 20 to 30 days to make their decisions about investing in the company stock. The distribution of this disclosure memorandum may be considered a risk to the ESOP formation process. This is because, often, the company employees may not have the financial sophistication—or the desire—to evaluate all of the information provided in the disclosure memorandum.

Therefore, some employees may simply elect not to invest in the private company stock. As a result, the company may not receive the level of employee participation that was expected for the ESOP formation.

In some cases, the company may make financial advisers available at no cost to the employees. These financial advisers may be provided in an effort to give the company employees the resources they need to make an informed investment decision. However, due to the expense associated with giving employees the option to invest their 401(k) or profit-sharing assets in the company stock, the company management should carefully weigh the risks versus the probability of success before pursuing this option.

If the company management determines that this option will be pursued, then a temporary "floor price" may be attached to the private company stock acquired with assets from other benefit plans. This temporary floor price often remains in effect until the ESOP's stock purchase loan is completely repaid.

In most cases, this "floor price" is calculated as the fair market value of the company stock without taking into account the impact of the ESOP's stock purchase loan.

The ESOP plan design features should also allow for factors that will positively influence employee motivation. For example, an accelerated vesting schedule may serve to motivate employee participation in the ESOP. However, as a means to prevent vested employees from terminating their employment prematurely in order to receive large account balances, the ESOP sponsor company may postpone the distribution of accounts to terminated employees for a certain time period.

The transfer of voting rights is also a concern for many shareholders of a private company. However, this issue has not actually resulted in a problem for ESOP-owned sponsor companies. The requirement to "pass through" voting rights to employees of private sponsor companies is a function of state law.

However, the voting rights "pass through" is usually only required for major corporate issues such as mergers, consolidations, recapitalizations, sale of the business, liquidation, dissolutions, and similar types of transactions.

When a trusted, experienced management team has a proven track record of successfully operating the business to achieve growth and profitability, the employees are generally content to not be involved in the management of the ESOP sponsor company.

Illustrative ESOP Financial Feasibility Quality of Earnings Analyses

This discussion section presents certain components of a quality of earnings analysis for two hypothetical private company ESOP formations:

1. The illustrative Alpha Widget Manufacturing Company
2. The illustrative Beta Professional Services Company

In the first illustrative example, let's assume that the principal stockholders of the hypothetical Alpha Widget Manufacturing Company ("Alpha") are considering an ESOP formation with the ultimate objective of achieving an ownership transition.

Exhibit 1 presents an illustrative "base case" operating scenario for Alpha. This "base case" scenario applies the illustrative financial projections provided to the analyst by Alpha management.

Exhibit 1
Alpha Widget Manufacturing Company
ESOP Formation Financial Feasibility Analysis
Prospective Financial Results of Operations
(Management-Prepared Financial Projections of the "Base Case" Scenario)
As of January 1, 2019

Years Ended:	Projected 12/31/19 $000s	Projected 12/31/20 $000s	Projected 12/31/21 $000s	Projected 12/31/22 $000s	Projected 12/31/23 $000s	Projected 12/31/19 %	Projected 12/31/20 %	Projected 12/31/21 %	Projected 12/31/22 %	Projected 12/31/23 %	5-Year Average %
Company Revenue	9,000	9,900	10,692	11,227	11,788	100.0	100.0	100.0	100.0	100.0	100.0
Revenue Growth Rate		10%	8%	5%	5%						
Cost of Goods Sold	6,120	6,732	7,305	7,706	8,128	68.0	68.0	68.3	68.6	69.0	68.4
Gross Profit	2,880	3,168	3,387	3,521	3,660	32.0	32.0	31.7	31.4	31.0	31.6
Operating Expenses	(2,121)	(2,086)	(2,027)	(1,915)	(1,810)	(23.6)	(21.1)	(19.0)	(17.1)	(15.4)	(19.2)
Operating Income (EBIT)	759	1,082	1,360	1,606	1,851	8.4	10.9	12.7	14.3	15.7	12.4
Interest Expense	(90)	(60)	-	(1)	(2)	(1.0)	(0.6)	-	(0.0)	(0.0)	(0.3)
Other Income (Expense)	518	-	-	-	-	5.8	-	-	-	-	1.2
Pretax Income	1,187	1,022	1,360	1,605	1,849	13.2	10.3	12.7	14.3	15.7	13.2
Cash Flow Projection:											
Earnings before Interest and Taxes	759	1,082	1,360	1,606	1,851	8.4	10.9	12.7	14.3	15.7	12.4
+ Depreciation and Amortization Expense	2,974	3,004	3,064	3,063	3,061	33.0	30.3	28.7	27.3	26.0	29.1
= EBITDA	3,733	4,086	4,424	4,669	4,912	41.5	41.3	41.4	41.6	41.7	41.5

Exhibit 1 presents the Alpha prospective results of operations for the next five-year period.

Exhibit 2 presents the illustrative proposed financing of the Alpha ESOP purchase of the private company stock. This analysis considers the deal financing structure, the debt interest rates, the debt maturities, and the resulting (post-ESOP) sponsor company cash flow and covenant compliance.

In this illustrative example, the Alpha ESOP will pay $13 million for the purchase of the private company common stock. In this illustrative example, the Alpha ESOP will borrow $13 million in total, arranged as follows: (1) $10 million in a bank term loan and (2) $3 million in subordinated financing from the selling stockholders.

In particular, Exhibit 2 tests whether Alpha will be in compliance with all of its debt financing covenants—based on both (1) the terms of the ESOP stock acquisition debt and (2) the "base case" financial projections.

Exhibit 3 illustrates the impact of decreasing management's revenue projections on the Alpha expected profitability and expected cash flow. Exhibit 3 presents the management-prepared "downside case" scenario financial projections.

Exhibit 4 illustrates how the "downside case" scenario decrease in the Alpha profitability affects the expected Alpha cash flow—and the expected ESOP stock acquisition debt covenant compliance.

In particular, Exhibit 4 tests whether Alpha will still be in compliance with all of the financing covenants—given the impact of the "downside case" scenario financial projections on the Alpha cash flow.

From this illustrative quality of earnings analysis, the interested parties to the proposed ESOP leveraged stock purchase transaction can assess the impact that a decrease in the company's expected revenue/profitability would have on the company's expected cash flow. The interested parties can then develop a plan of action—or alter the proposed ESOP leveraged stock purchase deal structure.

The purpose of such strategic plan changes—or transaction structure alterations—is to ensure that the sponsor company (i.e., the hypothetical Alpha) has adequate capital in the event that the "base case" financial projections are not achieved.

In this hypothetical situation, Alpha management may make the stock purchase lender (i.e., the term loan financial institution) aware of the amount of stress that the sponsor company could expect during the first year of the loan—should the Alpha projected revenue decrease by 15 percent.

Certain components of a second illustrative quality of earnings analysis are presented in Exhibits 5 and 6. This illustrative quality of earnings analysis estimates the fair market value of the stock of the hypothetical Beta Professional Services Company ("Beta"). This illustrative quality of earnings analysis is based on the company financial projections prepared by Beta management and presented in Exhibit 6.

In this hypothetical ESOP formation and ESOP stock purchase transaction, the transaction is

Exhibit 2
Alpha Widget Manufacturing Company
ESOP Formation Financial Feasibility Analysis
ESOP Stock Purchase Debt Service Projections
(Management-Prepared Financial Projections of the "Base Case" Scenario)
As of January 1, 2019

Years Ended December 31:		2019 $000s	2020 $000s	2021 $000s	2022 $000s	2023 $000s	2024 $000s	2025 $000s	2026 $000s
Stock Purchase Term Loan:									
Loan Principal Amount ($000s)	10,000								
Loan Interest Rate	4.65%								
Loan Amortization Period (years)	7								
Loan Term (years)	3								
Beginning Principal Balance		10,000	7,356	5,955	4,080	2,916	1,655	289	-
Principal Payments		2,644	1,401	1,874	1,165	1,261	1,366	289	-
Interest Payments		380	312	379	284	188	83	3	-
Total Loan Payment		3,025	1,713	2,253	1,449	1,449	1,449	292	-
Ending Principal Balance		7,356	5,955	4,080	2,916	1,655	289	-	-
Total Principal Payments		2,644	1,401	1,874	1,165	1,261	-	-	-
Total Interest Payments		380	312	379	284	188	-	-	-
Total Transaction Debt Service		3,025	1,713	2,253	1,449	1,449	-	-	-
Cash Flow Available for Debt Service		3,452	3,757	3,998	4,207	4,418	4,638	4,870	5,114
Senior Debt Service Coverage (Deficit)		427	2,044	1,745	2,758	2,969	4,638	4,870	5,114
Selling Shareholder Subordinated Note 1:									
Seller Note Principal Amount ($000s)	3,000								
Note Interest Rate	10.00%								
Note Term (years)	3								
Beginning Principal Balance		3,000	3,000	3,000	3,000	3,000	3,000	3,000	3,000
Principal Payments		-	-	-	-	-	-	-	-
Interest Payments		300	300	300	300	300	300	300	300
Total Loan Payment		300	300	300	300	300	300	300	300
Ending Principal Balance		3,000	3,000	3,000	3,000	3,000	3,000	3,000	3,000
Cash Flow for Debt Service		427	2,044	1,745	2,758	2,969	4,638	4,870	5,114
Subordinated Note Payment		300	300	300	300	300	300	300	300
Debt Service Coverage (Deficit)		127	1,744	1,445	2,458	2,669	4,338	4,570	4,814
Excess Cash Flow Amount:									
EBITDA		4,086	4,424	4,669	4,912	5,157	5,415	5,686	5,970
Less: Cash Interest Expense		680	612	679	584	488	300	300	300
Cash Income Taxes (if any)		-	-	-	-	-	-	-	-
Required and Voluntary Debt Payments (principal)		2,644	1,401	1,874	1,165	1,261	-	-	-
Unfinanced Capital Expenditures		495	545	588	617	648	648	648	648
Dividend Distributions		194	258	305	351	369	387	407	427
Treasury Stock Purchases		-	-	-	-	-	-	-	-
		72	1,609	1,223	2,194	2,391	4,079	4,331	4,595
Mandatory Prepayment		(36)	(804)	-	-	-	-	-	-
Adjusted Cash Flow		36	804	1,223	2,194	2,391	4,079	4,331	4,595
Beginning Cash		1,348	1,384	2,189	3,412	5,606	7,997	12,076	16,407
Ending Cash		1,384	2,189	3,412	5,606	7,997	12,076	16,407	21,002
Selling Shareholder Personal Loan Guarantee		2,500	2,500	2,500	2,500	-	-	-	-
Debt Covenant Compliance:									
Letter of Credit		-	-	-	-	-	-	-	-
Capital Expenditures Loan		-	-	-	-	-	-	-	-
Stock Purchase Term Loan		7,356	5,955	4,080	2,916	1,655	289	-	-
Seller Subordinated Note 1		3,000	3,000	3,000	3,000	3,000	3,000	3,000	3,000
Seller Subordinated Note 2		-	-	-	-	-	-	-	-
Seller Personal Guarantee		2,500	2,500	2,500	2,500	-	-	-	-
Total Funded Debt		12,856	11,455	9,580	8,416	4,655	3,289	3,000	3,000
EBITDA		4,086	4,424	4,669	4,912	5,157	5,415	5,686	5,970
ESOP Contribution Expense		-	-	-	-	-	-	-	-
EBITDAE		4,086	4,424	4,669	4,912	5,157	5,415	5,686	5,970
Total Leverage Ratio		3.15x	2.59x	2.05x	1.71x	0.90x	0.61x	0.53x	0.50x
Maximum Leverage Ratio Allowed		3.25x	3.25x	3.25x	3.25x	3.25x	3.25x	3.25x	3.25x
Is the Sponsor Company in Compliance?		Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes

Exhibit 3
Alpha Widget Manufacturing Company
ESOP Formation Financial Feasibility Analysis
Prospective Financial Results of Operations
(Illustrating a Decreased Revenue Projection in the "Downside Case" Scenario)
As of January 1, 2019

Years Ended:	Projected 12/31/19 $000s	Projected 12/31/20 $000s	Projected 12/31/21 $000s	Projected 12/31/22 $000s	Projected 12/31/23 $000s	Projected 12/31/19 %	Projected 12/31/20 %	Projected 12/31/21 %	Projected 12/31/22 %	Projected 12/31/23 %	5-Year Average %
Company Revenue	9,000	7,650	6,503	5,527	4,698	100.0	100.0	100.0	100.0	100.0	100.0
Revenue Growth Rate		-15%	-15%	-15%	-15%						
Cost of Goods Sold	6,120	5,202	4,443	3,794	3,239	68.0	68.0	68.3	68.6	69.0	68.4
Gross Profit	2,880	2,448	2,060	1,733	1,459	32.0	32.0	31.7	31.4	31.0	31.6
Operating Expenses	(2,121)	(1,612)	(1,233)	(943)	(721)	(23.6)	(21.1)	(19.0)	(17.1)	(15.4)	(19.2)
Operating Income (EBIT)	759	836	827	791	738	8.4	10.9	12.7	14.3	15.7	12.4
Interest Expense	(90)	(60)	-	(1)	(2)	(1.0)	(0.8)	-	(0.0)	(0.0)	(0.4)
Other Income (Expense)	518	-	-	-	-	5.8	-	-	-	-	1.2
Pretax Income	1,187	776	827	790	736	13.2	10.1	12.7	14.3	15.7	13.2
Cash Flow Projection:											
Earnings before Interest and Taxes	759	836	827	791	738	8.4	10.9	12.7	14.3	15.7	12.4
+ Depreciation and Amortization Expense	2,974	3,004	3,064	3,063	3,061	33.0	39.3	47.1	55.4	65.2	48.0
= EBITDA	3,733	3,840	3,891	3,854	3,799	41.5	50.2	59.8	69.7	80.9	60.4

financed by seller financing (i.e., the company selling stockholders provide the stock acquisition financing). In partial compensation for this seller financing, the selling shareholders will receive warrants to buy some of the Beta stock at a future date, as indicated in Exhibit 6.

The Beta management-prepared financial projections will typically present the company's prospective results of operations projected out to at least the year that all of the seller financing matures.

In this illustrative analysis, the company's expected future market value of invested capital ("MVIC") is estimated by applying illustrative market-derived valuation pricing multiples for each future period. These illustrative market-derived valuation pricing multiples include valuation pricing multiples applied to both (1) revenue and (2) EBITDA (earnings before interest, taxes, depreciation, and amortization). The two value indications are then averaged in order to arrive at a single MVIC valuation synthesis and conclusion for Beta.

Next, both the sponsor company operations-related long-term debt and the ESOP stock acquisition debt are subtracted from the Beta MVIC. And, an illustrative discount for lack of marketability is applied in order to arrive at the estimated fair market value of the sponsor company total equity—on a nonmarketable, noncontrolling ownership interest basis) for each year in the projection period.

In the illustrative example presented in Exhibit 5, warrants are attached to the selling shareholder debt. Let's assume that these warrants provide the selling shareholder with the right to purchase 700,000 shares of stock at 90 percent of the December 31, 2018, fair market value of equity per share. Let's assume that the warrants are available in tranches that are exercisable based on the sponsor company achieving certain EBIT (earnings before interest and taxes) profit targets.

Exhibit 6 presents the cash flow implications of the additional debt arising from the selling shareholders' exercise of the Beta warrants. This component of the illustrative quality of earnings analysis may help to facilitate the discussions between the Beta selling shareholder(s), the legal counsel, and the ESOP financial advisers with regard to the following issues:

1. The total return on the debt and the warrants to be received by the Beta selling shareholder(s)
2. The resulting dilutive impact of the selling shareholder warrants on the sponsor company stock fair market value
3. The cash flow implications of the timing and the magnitude of the warrant cash out payments

Summary and Conclusion

Upon the completion of the ESOP financial feasibility analysis, the analyst typically presents the findings to the private company's board of directors or

Exhibit 4
Alpha Widget Manufacturing Company
Stock Purchase Debt Service Projections
Prospective Financial Results of Operations
(Illustrating a Decreased Revenue Projection in the "Downside Case" Scenario)
As of January 1, 2019

Year Ended December 31:		2019 $000s	2020 $000s	2021 $000s	2022 $000s	2023 $000s	2024 $000s	2025 $000s	2026 $000s
Stock Purchase Term Loan:									
Loan Principal Amount ($000s)	10,000								
Loan Interest Rate	4.65%								
Loan Amortization Period (years)	7								
Loan Term (years)	3								
Beginning Principal Balance		10,000	7,356	6,059	4,279	3,104	1,833	455	-
Principal Payments		2,644	1,297	1,780	1,174	1,272	1,377	455	-
Interest Payments		380	316	394	300	202	97	7	-
Total Loan Payment		3,025	1,613	2,174	1,474	1,474	1,474	463	-
Ending Principal Balance		7,356	6,059	4,279	3,104	1,833	455	-	-
Total Principal Payments		2,644	1,297	1,780	1,174	1,272	-	-	-
Total Interest Payments		380	316	394	300	202	-	-	-
Total Transaction Debt Service		3,025	1,613	2,174	1,474	1,474	-	-	-
Cash Flow for Debt Service		3,555	3,648	3,647	3,623	3,804	3,994	4,194	4,404
Senior Debt Service Coverage (Deficit)		530	2,035	1,473	2,149	2,330	3,994	4,194	4,404
Selling Shareholder Subordinated Note 1:									
Seller Note Principal Amount ($000s)	3,000								
Note Interest Rate	10.00%								
Note Term (years)	3								
Beginning Principal Balance		3,000	3,000	3,000	3,000	3,000	3,000	3,000	3,000
Principal Payments		-	-	-	-	-	-	-	-
Interest Payments		300	300	300	300	300	300	300	300
Total Loan Payment		300	300	300	300	300	300	300	300
Ending Principal Balance		3,000	3,000	3,000	3,000	3,000	3,000	3,000	3,000
Cash Flow for Debt Service		530	2,035	1,473	2,149	2,330	3,994	4,194	4,404
Subordinated Note Payment		300	300	300	300	300	300	300	300
Debt Service Coverage (Deficit)		230	1,735	1,173	1,849	2,030	3,694	3,894	4,104
Excess Cash Flow Amount:									
EBITDA		3,840	3,891	3,854	3,799	3,988	4,188	4,397	4,617
Less: Cash Interest Expense		680	616	694	600	502	300	300	300
Cash Income Taxes (if any)		-	-	-	-	-	-	-	-
Required and Voluntary Debt Payments (principal)		2,644	1,297	1,780	1,174	1,272	-	-	-
Unfinanced Capital Expenditures		495	421	358	304	258	258	258	258
Dividend Distributions		147	157	150	140	147	154	162	170
Treasury Stock Purchases		-	-	-	-	-	-	-	-
		(127)	1,400	872	1,581	1,809	3,475	3,677	3,889
Mandatory Prepayment		(63)	(700)	-	-	-	-	-	-
Adjusted Cash Flow		(190)	700	872	1,581	1,809	3,475	3,677	3,889
Beginning Cash		1,348	1,158	1,858	2,730	4,311	6,120	9,595	13,272
Ending Cash		1,158	1,858	2,730	4,311	6,120	9,595	13,272	17,161
Selling Shareholder Personal Loan Guarantee		2,500	2,500	2,500	2,500	-	-	-	-
Debt Covenant Compliance:									
Letter of Credit		-	-	-	-	-	-	-	-
Capital Expenditures Loan		-	-	-	-	-	-	-	-
Stock Purchase Term Loan		7,356	6,059	4,279	3,104	1,833	455	-	-
Seller Subordinated Note 1		3,000	3,000	3,000	3,000	3,000	3,000	3,000	3,000
Seller Subordinated Note 2		-	-	-	-	-	-	-	-
Seller Personal Guarantee		2,500	2,500	2,500	2,500	-	-	-	-
Total Funded Debt		12,856	11,559	9,779	8,604	4,833	3,455	3,000	3,000
EBITDA		3,840	3,891	3,854	3,799	3,988	4,188	4,397	4,617
ESOP Contribution Expense		-	-	-	-	-	-	-	-
EBITDAE		3,840	3,891	3,854	3,799	3,988	4,188	4,397	4,617
Total Leverage Ratio		3.35x	2.97x	2.54x	2.27x	1.21x	0.83x	0.68x	0.65x
Maximum Leverage Ratio Allowed		3.25x	3.25x	3.25x	3.25x	3.25x	3.25x	3.25x	3.25x
Is the Sponsor Company in Compliance?		No	Yes	Yes	Yes	Yes	Yes	Yes	Yes

Exhibit 5
Beta Professional Services Company
ESOP Formation Financial Feasibility Analysis
Selling-Shareholder-Provided Financing Analysis
Total Selling Shareholder Rate of Return Calculation
As of January 1, 2019

Years Ended:	12/31/18 $000s	12/31/19 $000s	12/31/20 $000s	12/31/21 $000s	12/31/22 $000s	12/31/23 $000s	12/31/24 $000s	12/31/25 $000s	12/31/26 $000s	12/31/27 $000s	12/31/28 $000s	12/31/29 $000s	12/31/30 $000s	12/31/31 $000s	12/31/32 $000s	12/31/33 $000s	12/31/34 $000s	12/31/35 $000s	12/31/36 $000s
Projected Company Revenue		40,000	37,000	42,000	46,000	49,000	51,450	54,023	56,724	59,560	62,538	65,665	68,948	72,395	76,015	79,816	83,807	87,997	92,397
Revenue Growth Rate			-8%	14%	10%	7%	5%	5%	5%	5%	5%	5%	5%	5%	5%	5%	5%	5%	5%
EBITDA		1,500	2,373	4,471	5,999	7,500	7,875	8,269	8,682	9,116	9,572	10,051	10,553	11,081	11,635	12,217	12,828	13,469	14,142
EBITDA Growth Rate			58%	88%	34%	25%	5%	5%	5%	5%	5%	5%	5%	5%	5%	5%	5%	5%	5%
EBITDA Margin			6%	11%	13%	15%	15%	15%	15%	15%	15%	15%	15%	15%	15%	15%	15%	15%	15%
Projected EBIT		1,200	2,273	4,371	5,899	7,999	8,398	8,818	9,259	9,722	10,208	10,719	11,255	11,817	12,408	13,029	13,680	14,364	15,082
EBIT Growth Rate			89%	92%	35%	36%	5%	5%	5%	5%	5%	5%	5%	5%	5%	5%	5%	5%	5%
EBIT Margin			6%	10%	13%	16%	16%	16%	16%	16%	16%	16%	16%	16%	16%	16%	16%	16%	16%
Market Value of Invested Capital (MVIC) Analysis:																			
Projected MVIC Indication (based on market-derived revenue valuation pricing multiple)		28,000	25,900	25,200	27,600	29,400	30,870	32,414	34,034	35,736	37,523	39,399	41,369	43,437	45,609	47,890	50,284	52,798	55,438
Projected MVIC Indication (based on market-derived EBITDA valuation pricing multiple)		22,500	35,593	33,532	44,989	56,250	59,063	62,016	65,116	68,372	71,791	75,380	79,149	83,107	87,262	91,625	96,207	101,017	106,068
Projected MVIC Valuation Synthesis and Conclusion	35,000	25,250	30,746	29,366	36,295	42,825	44,966	47,215	49,575	52,054	54,657	57,390	60,259	63,272	66,436	69,757	73,245	76,908	80,753
Company Equity Value:																			
Projected MVIC Valuation Synthesis and Conclusion	35,000	25,250	30,746	29,366	36,295	42,825	44,966	47,215	49,575	52,054	54,657	57,390	60,259	63,272	66,436	69,757	73,245	76,908	80,753
- Long-Term Debt	11,943	3,030	3,690	2,000	1,500	1,200	1,200	1,200	1,200	1,200	1,200	1,200	1,201	1,202	1,203	1,204	1,205	1,205	1,205
+ Cash	1,176	800	740	840	920	980	1,029	1,080	1,134	1,191	1,251	1,313	1,379	1,448	1,520	1,596	1,676	1,760	1,760
- Seller Warrant Note 1	-	-	-	-	-	5,899	5,347	4,772	4,172	3,547	2,895	2,216	1,508	770	-	-	-	-	-
- Seller Warrant Note 2	-	-	-	-	-	-	4,985	4,519	4,033	3,526	2,998	2,447	1,873	1,275	651	-	-	-	-
- Seller Warrant Note 3	-	-	-	-	-	-	-	1,036	939	838	733	623	509	390	266	136	-	-	-
- Seller Warrant Note 4	-	-	-	-	-	-	-	-	623	565	504	441	375	306	234	159	81	-	-
- Seller Warrant Note 5	-	-	-	-	-	-	-	-	-	300	272	243	212	180	147	112	76	38	-
- ESOP Note	10,600	10,477	9,572	8,630	7,650	6,630	5,568	4,462	3,312	2,114	868	-	-	-	-	-	-	-	-
= Indicated Equity Value (rounded)	13,633	12,543	18,224	19,576	28,065	30,076	28,896	32,306	36,431	41,155	46,438	51,533	55,960	60,597	65,455	69,743	73,559	77,424	81,308
- Concluded Discount for Lack of Marketability -5%	(682)	(627)	(911)	(979)	(1,403)	(1,504)	(1,445)	(1,615)	(1,822)	(2,058)	(2,322)	(2,577)	(2,798)	(3,030)	(3,273)	(3,487)	(3,678)	(3,871)	(4,065)
= Concluded Total Fair Market Value of Equity (rounded) (on a nonmarketable, noncontrolling interest basis)	13,000	11,900	17,300	18,600	26,700	28,600	27,500	30,700	34,600	39,100	44,100	49,000	53,200	57,600	62,200	66,300	69,900	73,600	77,200
Number of ESOP Shares (000s)	700	700	700	700	700	700	700	700	700	700	700	700	700	700	700	700	700	700	700
Seller Warrant Shares Executed (000s)	-	-	-	-	-	300	225	50	25	10	-	-	-	-	-	-	-	-	-
Seller Warrant Price per Share ($)	18.57	17.00	24.71	26.57	38.14	40.86	39.29	43.86	49.43	55.86	63.00	70.00	76.00	82.29	88.86	94.71	99.86	105.14	110.29
Seller Warrant Shares Exercised (000s)		-	-	-	-	300	225	50	25	10	-	-	-	-	-	-	-	-	-
Market Value of the Warrant Exercised		-	-	-	-	11,443	9,193	1,964	1,096	494	-	-	-	-	-	-	-	-	-
Seller Warrant Exercise Price ($)	16.71	16.71	16.71	16.71	16.71	16.71	16.71	16.71	16.71	16.71	16.71	16.71	16.71	16.71	16.71	16.71	16.71	16.71	16.71
Total Warrant Exercise Value		-	-	-	-	5,014	3,761	836	418	167	-	-	-	-	-	-	-	-	-
Seller Warrant Cash-Out Value		-	-	-	-	6,429	5,432	1,129	679	327	-	-	-	-	-	-	-	-	-
Cumulative Warrant Value		-	-	-	-	6,429	11,861	12,989	13,668	13,995	13,995	13,995	13,995	13,995	13,995	13,995	13,995	13,995	13,995
Return to the Selling Shareholders		11,200	16,600	17,800	25,800	27,600	26,400	29,600	33,500	38,200	43,100	47,900	52,000	56,400	60,900	64,800	68,400	71,900	71,900
ESOP Note		16.00	23.71	25.43	36.86	39.43	37.71	42.29	47.86	54.57	61.57	68.43	74.29	80.57	87.00	92.57	97.71	102.71	102.71
Total Return to the Selling Shareholders:																			
ESOP Note	(10,600)	544	1,306	1,306	1,306	1,306	1,306	1,306	1,306	1,306	1,306	885	-	-	-	-	-	-	-
Seller Warrant Note 1	-	-	-	-	-	802	802	802	802	802	802	802	802	802	802	-	-	-	-
Seller Warrant Note 2	-	-	-	-	-	-	678	678	678	678	678	678	678	678	678	678	-	-	-
Seller Warrant Note 3	-	-	-	-	-	-	-	141	141	141	141	141	141	141	141	141	141	-	-
Seller Warrant Note 4	-	-	-	-	-	-	-	-	85	85	85	85	85	85	85	85	85	85	-
Seller Warrant Note 5	-	-	-	-	-	-	-	-	-	41	41	41	41	41	41	41	41	41	41
Total Return to the Selling Shareholders	(10,600)	544	1,306	1,306	1,306	2,108	2,787	2,927	3,012	3,053	3,053	2,632	1,747	1,747	1,747	945	266	126	41

Total Transaction Internal Rate of Return	15.0%
Transaction Internal Rate of Return with Mid-Period Discounting	16.3%

Exhibit 6
Beta Professional Services Company
ESOP Formation Financial Feasibility Analysis
Sponsor Company Cash Flow Analysis
As of January 1, 2019

Years Ended:	12/31/19 $000s	12/31/20 $000s	12/31/21 $000s	12/31/22 $000s	12/31/23 $000s	12/31/24 $000s	12/31/25 $000s	12/31/26 $000s	12/31/27 $000s	12/31/28 $000s	12/31/29 $000s	12/31/30 $000s	12/31/31 $000s	12/31/32 $000s	12/31/33 $000s	12/31/34 $000s	12/31/35 $000s	12/31/36 $000s
Company Revenue	40,000	37,000	42,000	46,000	49,000	51,450	54,023	56,724	59,560	62,538	65,665	68,948	72,395	76,015	79,816	83,807	87,997	92,397
EBITDA	1,500	2,373	4,471	5,999	7,500	7,875	8,269	8,682	9,116	9,572	10,051	10,553	11,081	11,635	12,217	12,828	13,469	14,142
Senior Bank Debt - Revolver	(120)	(111)	(126)	(138)	(147)	(154)	(162)	(170)	(179)	(188)	(197)	(207)	(217)	(228)	(239)	(251)	(264)	(277)
Cash Flow after Bank Debt Payments	1,380	2,262	4,345	5,861	7,353	7,721	8,107	8,512	8,938	9,384	9,854	10,346	10,864	11,407	11,977	12,576	13,205	13,865
Seller Subordinated Notes	(544)	(1,306)	(1,306)	(1,306)	(1,306)	(1,306)	(1,306)	(1,306)	(1,306)	(1,306)	(885)	-	-	-	-	-	-	-
Seller Warrant Note 1	-	-	-	-	(802)	(802)	(802)	(802)	(802)	(802)	(802)	(802)	(802)	(802)	-	-	-	-
Seller Warrant Note 2	-	-	-	-	-	(678)	(678)	(678)	(678)	(678)	(678)	(678)	(678)	(678)	(678)	-	-	-
Seller Warrant Note 3	-	-	-	-	-	-	(141)	(141)	(141)	(141)	(141)	(141)	(141)	(141)	(141)	(141)	-	-
Seller Warrant Note 4	-	-	-	-	-	-	-	(85)	(85)	(85)	(85)	(85)	(85)	(85)	(85)	(85)	(85)	-
Seller Warrant Note 5	-	-	-	-	-	-	-	-	(41)	(41)	(41)	(41)	(41)	(41)	(41)	(41)	(41)	(41)
Total Seller Subordinated Debt Service	(544)	(1,306)	(1,306)	(1,306)	(2,108)	(2,787)	(2,927)	(3,012)	(3,053)	(3,053)	(2,632)	(1,747)	(1,747)	(1,747)	(945)	(266)	(126)	(41)
Projected Capital Expenditures	(200)	(200)	(200)	(200)	(200)	(200)	(200)	(200)	(200)	(200)	(200)	(200)	(200)	(200)	(200)	(200)	(200)	(200)
Projected Working Capital Additions	4,983	270	(450)	(360)	(270)	(221)	(232)	(243)	(255)	(268)	(281)	(295)	(310)	(326)	(342)	(359)	(377)	(396)
Excess Cash Flow/(Deficit)	5,619	1,026	2,389	3,995	4,775	4,514	4,748	5,057	5,429	5,863	6,740	8,104	8,606	9,134	10,491	11,751	12,502	13,228

to an ESOP formation committee. That ESOP formation committee may include board, management, and employee representatives.

The professionals involved in conducting the ESOP financial feasibility analysis may include the analyst, an ESOP consultant, investment bankers, lenders, the senior management team, legal counsel, and the company's selling shareholders. It is important for all of these parties to (1) anticipate potential ESOP formation obstacles and (2) consider reasonable solutions to each of these obstacles.

Based on such anticipatory consideration, any last-minute obstacles or issues can be evaluated as part of the decision-making process (1) of the private company's board of directors and (2) of the ESOP formation committee.

Further, the evaluation of the ESOP feasibility is an ongoing part of the ESOP formation process. As valuation, structuring, and financing decisions are made, circumstances (both for the employer company and for the selling shareholders) may change. In such instances, various alternative ownership transition opportunities may be considered.

As the consideration of the company sale transactions progress, the different aspects and considerations of the ESOP financial feasibility analysis may be updated. This updated feasibility analysis should reflect the most current set of facts related to the private company—in order to confirm the continued financial feasibility of the ESOP formation.

Finally, the decision to enter into a transaction to buy the private company's shares and to pay a fair market value price for those company shares is made (on behalf of the to-be-formed ESOP participants) by the ESOP fiduciary.

For private company owners considering a sale of all (or part) of the company, an ESOP formation is one possible ownership transition structure. However, a comprehensive ESOP formation and financial feasibility analysis would be appropriate to assess whether the sale of the private company stock to the ESOP makes sense (1) to the selling shareholders, (2) to the to-be-formed ESOP employee participants, and (3) to the private company itself.

Robert Reilly is a managing director of the firm and is resident in our Chicago practice office. Robert can be reached at (773) 399-4318 or at rfreilly@willamette.com.