

Morgan Lewis

ESOPs and Government Contractors

Michael Holzman: Morgan, Lewis & Bockius LLP

Scott Levine: Stout Risius Ross

Robert Massengill: SES Advisors

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Agenda

- Overview of the M&A and ESOP market for government contractors
- Change in Control issues
- Financing ESOP buyouts
- 8(a) status and ESOP transactions
- Contributions, Cost reimbursements and overhead
- Structuring management equity incentives in ESOPs

General M&A Overview

- Number of deals continues to increase
- Relative valuations also continue to increase
- Debt multiples increased as a result of increased liquidity from a variety of financing sources. There is more uncertainty recently due to current credit market conditions
- Lower return expectations are resulting in more narrow valuation multiples between strategic and financial buyers

ESOP M&A Overview

- **Factors to Consider with Change in Control Transactions**
 - **New SBA Recertification Rules could affect M&A market for strategic buyers**
 - **After-tax proceeds in an ESOP transaction are often equal to or can exceed offers from other third party buyers**
 - **Government contractors are good ESOP candidates because of business stability and strong cash flow (especially when costs are reimbursed)**
 - **Consideration of marketability discount and premium for control is a factor in ESOP transactions**
 - **Financing v. valuation**
 - **Pricing multiples vary based on type of work, customers and employees**
 - **S Corp. ESOP benefit is increasingly used to facilitate transactions**
 - **More sophisticated transaction structuring makes ESOP transactions yield more benefits for all stakeholders (sellers, ESOP, management, etc.)**

ESOP M&A Overview (continued)

- **Factors to Consider in Minority Ownership Transactions**
 - **Assists with business succession planning**
 - **Flexibility in transferring ownership**
 - **Lower valuations due to a lack of control discount**
 - **With appropriate planning, valuation discounts can be offset**
 - **Maintain operation and control for the business owner**
 - **Participation in future capital appreciation for the selling shareholder**
 - **Transactions are easier to finance**

New SBA Recertification Regulations

- Effective June 30, 2007, any M&A transaction (including asset deals requiring novation, as before, as well as stock purchases and reverse mergers) will require either (1) a recertification, or (2) notification to the customer if the size standards are exceeded
- The new regulations are applicable to all contracts with durations of more than five years
- These new rules are expected to impact M&A activity of government contractors

ESOP as a Buyer of Company Stock: Valuation Definitions

- Adequate Consideration: fair market value as determined by the ESOP trustee
- Fair Market Value: a value, expressed in cash or its equivalent, at which a willing seller and a willing buyer, both being informed of the relevant facts about the business, could reasonably conduct a transaction, neither person acting under compulsion to do so
- Financial Fairness: the ESOP company may not pay more than fair market value to acquire another company taking into account all of the terms and conditions of the sale
- Strategic Value v. Fair Market Value: accounting for premium for control and discount for lack of marketability

Financing ESOP Buyouts

- ESOPs are typically leveraged and financed with a combination of bank debt, subordinated debt and seller notes
- Bank debt is the cheapest capital, but is the most restrictive
- Subordinated debt is more expensive, but less restrictive
- A given cash flow can only support so much debt
- ESOP buyout debt is financed PRE-TAX so the equity cushion is effectively built in

Bank Debt

- Banks will first evaluate cash flow to determine the maximum senior debt capacity
- It will then evaluate the collateral base and lend at the “lesser of the two”
- Government receivables are typically excluded from a company’s borrowing base
- However, they CAN be used if properly assigned
 - This is done through an Assignment of Claims process
 - This helps increase the collateral capacity and therefore the borrowing amount

Assignment of Claims Act

- The Assignment of Claims Act (1940) allows a contractor to assign monies due if certain conditions are met
 - Contract specifies payments in excess of \$1,000
 - The assignment is made to a bank or trust company
 - The contract does not prohibit assignment
 - It is only assigned to one party and the assignee sends written notice of assignment to certain parties
- These assignments can be used as collateral for bank debt

Balance Sheet

(\$000)

Cash	\$ 300	Line of Credit	\$ 950
A/R	1,000	CP. LTD	200
Inventory	1,590	A/P	1,300
Prepaid Expenses	<u>400</u>	Accruals	<u>600</u>
Current Assets	3,290	Current Liab.	3,050
PP&E	4,000	Long-term Debt	1,040
Less: Accum. Dep.	<u>1,200</u>	Owners' Equity	<u>2,000</u>
PP&E, Net	2,800	Total Liabs + Eq.	\$6,090
Total Assets	\$6,090		

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Balance Sheet Collateral Capacity

	<u>Balance Sheet Amount</u>	<u>Effective Advance Rate</u>	<u>Asset Availability</u>
Cash	300	0%	-
A/R	1,000	80%	800
Inventory	1,590	60%	954
Prepaid Expenses	400	0%	-
Net PP&E	2,800	<u>50%</u>	<u>1,400</u>
Gross Balance Sheet Capacity			3,154
Less: Outstanding Debt			<u>(2,190)</u>
Marginal Balance Sheet Borrowing Capacity			<u>\$964</u>

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Sample Income Statement

(\$000)

Income Statement	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>
Net sales	\$ 8,145	\$ 8,574	\$ 9,025	\$ 9,500	\$ 10,000
Cost of Goods Sold	<u>5,702</u>	<u>6,002</u>	<u>6,318</u>	<u>6,650</u>	<u>7,000</u>
Gross profit	2,444	2,572	2,708	2,850	3,000
Operating Exps/SG&A	<u>1,772</u>	<u>1,865</u>	<u>1,963</u>	<u>2,066</u>	<u>2,175</u>
Income from operations	672	707	745	784	825
Depreciation	<u>163</u>	<u>171</u>	<u>181</u>	<u>190</u>	<u>200</u>
EBITDA	<u>\$ 835</u>	<u>\$ 879</u>	<u>\$ 925</u>	<u>\$ 974</u>	<u>\$ 1,025</u>

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Cash Flow Borrowing Capacities

(\$000)

Average EBITDA	\$	975
Less: Interest on Existing Line of Credit		<u>(45)</u>
<u>Gross</u> Cash Flow Available for Debt Service	\$	930
Divide by: Cash Flow Coverage Ratio		<u>1.5</u>
<u>Net</u> Cash Flow Available for Debt Service	\$	650
Cash Flow Debt Capacity (\$650 pmt, 7%, 6 years)	\$	3,097
less: Existing Term Debt		<u>(1,240)</u>
Marginal Cash Flow Borrowing Capacity	\$	<u><u>1,857</u></u>
Debt Service as % of EBITDA		63%
Implied Coverage		1.58

Value of ESOP Financing

(without prepayments)

	Regular Debt	ESOP Debt
Gross principal payments	\$ 8,000,000	\$ 8,000,000
Value of principal deduction	<u>-</u>	<u>(3,200,000)</u>
Net after-tax principal paid	8,000,000	4,800,000
Interest expense	2,110,980	2,110,980
Value of interest deduction	<u>(844,392)</u>	<u>(844,392)</u>
Net Interest Expense	1,266,588	1,266,588
Net after-tax financing cost	\$ 9,266,588	\$ 6,066,588
Cash savings on financing costs		\$ 3,200,000

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Value of ESOP Financing

(with prepayments)

	Regular Debt	ESOP Debt
Gross principal payments	\$ 8,000,000	\$ 8,000,000
Value of principal deduction	-	(3,200,000)
Net after-tax principal paid	8,000,000	4,800,000
Interest expense	2,110,980	1,661,842
Value of interest deduction	(844,392)	(664,737)
Net Interest Expense	1,266,588	997,105
Net after-tax financing cost	\$ 9,266,588	\$ 5,797,105
Cash savings on financing costs		\$ 3,469,483

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Stand Alone Senior Debt Loan “Sizing”

- Balance sheet borrowing capacity \$964,000
- Cash flow borrowing capacity \$1,857,000
- Maximum “Stand Alone” senior debt is the smaller of the balance sheet borrowing capacity and the cash flow borrowing capacity but can be limited to an overall multiple of cash flow to senior debt (now about 4.0x’s)
- Company could borrow up to ~ \$960,000 on a senior “stand alone” basis for a 32% transaction
- Collateral shortfall is approximately \$900,000

Types of Contracts

- Fixed-Price Contracts
- Incentive Contracts
- Indefinite-Delivery Contracts
- Time and Materials, Labor-Hour, and Letter Contracts
- Basic agreements and ordering agreements

Types of Contracts (cont.)

- Cost-Reimbursement Contracts
- Cost Contracts
- Cost-sharing Contracts
- Cost-plus-incentive-fee Contracts
- Cost-plus-award-fee Contracts
- Cost-plus-fixed-fee Contracts

Cost Reimbursability (Historic Perspective)

- For ESOPs that meet the definition of a pension plan, the contractor measures, assigns, and allocates the costs in accordance with Cost Accounting Standard (“CAS”) 412
- For ESOPs that do not meet the definition of a pension plan, the contractor measures, assigns, and allocates the costs in accordance with CAS 415

Pension ESOPs

CAS 412

- Plan documents must offer the plan participants:
 - (1) benefit payments for life, or
 - (2) benefits that are payable for life at the option of the participants
- For pension type ESOPs, interest costs incurred by the ESOP are allowable provided the contractor's annual contribution to the ESOP meets general reasonableness criteria and does not exceed 25 percent of covered compensation
- Plans that provide future payments for current work, and that are not pensions, are deferred compensation ESOPs
- The Cost Accounting Standards Board has now concluded that all ESOP costs should be treated consistently as deferred compensation

Deferred Compensation ESOPs

CAS 415

- The contractor's cost for an ESOP shall be measured by the contractor's contribution, including interest and dividends, if applicable, to the ESOP
- Contributions made in company stock shall be based on the market value of the stock at the time of the contribution
- An ESOP contribution shall be assignable to the cost accounting period only to the extent that the contribution is awarded to the employees in the accounting period

Challenges of Cost Reimbursability

- Calibration of expected cost reimbursements with ESOP loan amortization
- Projecting reimbursable ESOP costs, assigning them to contracts, and keeping competitive rates
 - It is important to communicate with the agency's contracting officer about the ESOP

Service Contract Act

- ESOP benefits must qualify as “Bona Fide” fringe benefits
 - Applies to any contract in excess of \$2,500
 - Plan must contain a definite formula for determining the amount to be contributed by the contractor and a definite formula for determining the benefits for each of the employees in the Plan.
 - Timing of contributions for employees subject to the Service Contract Act

Maintaining 8(a) Status

- Disadvantaged owner must retain a 51% ownership interest in the company
- ESOP can acquire up to a 49% in the company and future ESOP stock sales can be planned as the company graduates from the 8(a) program
- 8(a) regulations offer an equity raising waiver that can apply to ESOP transactions

Change in Control Issues

- All contracts must be reviewed for Change in Control notice provisions
- Most contracts require that the agency's contracting officer be notified of any disposition of a controlling interest in the company
- Most agencies have no objection to an ownership change to an ESOP, but notice is still typically required
- Communication with the agency is important to assure continuity of business as expected

Overview of Equity Incentive Plans for ESOP Companies

- Management incentive plans are common in ESOP companies
- These incentive plans can meet a variety of goals
 - **Retention of key employees and contributors**
 - **Alignment of interests between management and shareholders**
 - **Provides performance incentives**
- Can and should be used in 100% ESOP-owned companies
- Management incentive plans can take numerous forms
 - **Profit sharing plans**
 - **Discretionary bonuses**
 - **Equity based compensation**
- Equity based compensation will be our focus

Typical Forms of Equity Based Compensation

- Stock Options
 - Can be either qualified or nonqualified
- Warrants
- Phantom Stock or Stock Equivalent Units
- Stock Appreciation Rights
- Restricted Stock

All of these programs are designed so that management participates in value creation at the company (i.e. improved stock performance)

Transaction Implications

- Typically, some form of management incentive plans are established as part of an initial ESOP transaction
 - ESOP is a financial buyer and relies upon the retention of a well-qualified team of executives to manage the company
- “Cost” of the incentive plans are analyzed by the trustee and its advisors
 - Measured in terms of dilution to the equity holders and ESOP (exemplified below)

	Fully Diluted Ownership	
	Pre <u>Transaction</u>	Post <u>Transaction</u>
Equity holders	100.0%	60.0%
ESOP	0.0%	30.0%
Management	0.0%	10.0%

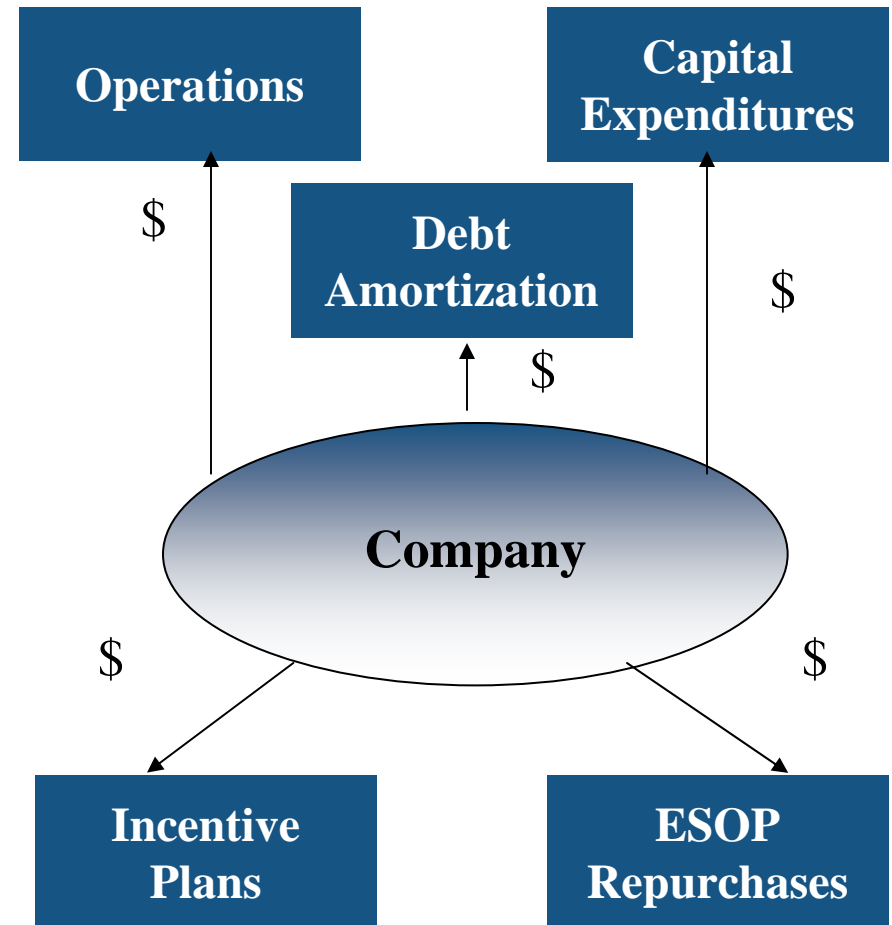
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Cash Flow and Valuation Impacts

- The dilution from the management incentive plans are incorporated into the annual ESOP administrative valuations (i.e., management's "claim" to value)
- Consideration also needs to be given to the cash flow impacts of management exercising the units that they own
 - Cash is typically required to fund the obligation unless stock is issued (100% S Corp considerations)
- Important because it impacts the amount of cash available to the company to fund its operations and grow its business
- In this way, it is similar to ESOP repurchase obligations



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Analysis of the Management Incentive Plan

- In analyzing a transaction that involves an equity based compensation plan, the ESOP trustee will review, among other things:
 - **Existing management incentive plans**
 - **The extent to which the plan is designed to meet identified objectives**
 - **Whether the plan is comparable to the “market”**
 - **The “depth” of plan coverage (who in management will participate)**
 - **The strike price of the equity instruments (fair market value)**
 - **The expiry of the awarded units**
 - **The method and time period for awarding and vesting the units**
 - **Is it tied to performance?**

ESOP Evaluation Process

- **Characteristics of an Ideal ESOP Candidate**
 - **A Profitable Company with a value of at least \$5M or more**
 - **A Company which employs at least 15 or more employees**
 - **A Company with Business Owners looking to incentivize employees**
 - **A closely held corporation with Shareholders looking for an exit strategy**
 - **A Company that has Shareholders who desire to sell their stock and leave the Company.**
 - **A Company with Shareholders desiring to realize maximum value on the sale of the Company**
 - **A Company with Shareholder-employees who want to plan for retirement**

ESOP Evaluation Process

- Discuss shareholder objectives to determine if the ESOP is the right tool for the job
- Complete ESOP Feasibility Questionnaire and discuss preliminary observations
- Conduct detailed feasibility & transaction analysis
- Assemble deal team including ESOP advisor, attorney, appraiser
- Raise money, complete appraisal, negotiate price, close deal

Presenters

- Michael Holzman: Morgan, Lewis & Bockius LLP
 - [202.739.5685](tel:202.739.5685)
 - mholzman@morganlewis.com
- Scott Levine: Stout Risius Ross
 - [703.245.6612](tel:703.245.6612)
 - slevine@srr.com
- Bob Massengill: SES Advisors
 - [973.540.9200](tel:973.540.9200) (ext. 103)
 - rmassengill@sesadvisors.com

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