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IPOs and ESOPs as exit strategies: Prepare for the complexities

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After several years of very active deal-making in the private equity industry, fund managers may find they need to begin considering some alternative strategies for exiting their portfolio companies. If plans call for a nontraditional strategy, such as taking a company public via an initial public offering (IPO) or selling it to an employee stock ownership plan (ESOP), early preparation is essential.

When private equity fund managers approach the end of a deal cycle and start considering how best to capitalize on their investment, they often discover that a traditional third-party sale to a strategic acquirer or a secondary buyout by another investment group might not be the most lucrative exit strategy. Alternative strategies could potentially produce a more favorable return.

For example, taking the company public through an IPO could provide a more accurate true market value for the portfolio company. On the other hand, selling to an ESOP could produce a more favorable return as a result of potential tax treatment for ESOP companies and their investors.

Despite the potential advantages, such strategies also are likely to complicate the company's regulatory environment, increasing both risk and compliance costs. If fund managers believe an IPO or ESOP might be a viable strategy, they should begin evaluating these options early to allow time to prepare for and execute the deal while enabling and maintaining regulatory compliance.

The IPO landscape – increased regulatory and public oversight

To realize value from an IPO, timing is absolutely critical. Deciding to take a company public triggers a variety of accounting, financial reporting, and regulatory requirements, which almost invariably take more time and effort than expected.

In addition to meeting various corporate governance, financial statement, and disclosure requirements mandated by the Securities and Exchange Commission (SEC) and the exchange where the stock is to be listed, public companies also must comply with the testing and documentation requirements spelled out in Section 404 of the Sarbanes-Oxley Act of 2002 (SOX 404). SOX 404 requires that all publicly traded companies establish internal controls and procedures for financial reporting. It also requires them to document, test, and maintain those controls and procedures and to issue a statement attesting to the effectiveness of internal control over financial reporting.

Companies going public are exempt from this requirement for the first year, but they must certify compliance by the time they issue their second Form 10-K. This means they have a maximum of 24 months, but often considerably less time, to achieve SOX 404 compliance. Many companies underestimate the scope of the evaluation, testing, and documentation efforts involved, as well as the staffing and technology capabilities that will be needed to meet this objective.

A closely related challenge for newly formed public companies is meeting the requirements of a recognized internal control framework for their annual assessments and reporting of internal control. The vast majority of publicly traded companies use the Committee of Sponsoring Organizations of the Treadway Commission (COSO) "Internal Control – Integrated Framework," which was updated in 2013 and is commonly referred to as COSO 2013. As a result, the investor community is virtually unanimous in expecting an IPO to meet the requirements of COSO 2013.

In addition to these internal control measures, other financial reporting standards and regulatory requirements also have grown more complex in recent years. Two recent updates by the Financial Accounting Standards Board (FASB) deserve mention in this regard.

Accounting Standards Update (ASU) No. 2014-09, "Revenue From Contracts With Customers," spells out detailed guidance on the amount and timing of revenue recognition for financial reporting purposes. Publicly traded companies must adopt this new standard for annual reporting periods beginning after Dec. 15, 2017.

A more recent update, ASU 2016-02, "Leases (Topic 842)," applies to all organizations that lease assets such as real estate, vehicles, or equipment – a description that encompasses most businesses these days. For public companies, this ASU will be effective for fiscal years beginning after Dec. 15, 2018.

With the implementation dates of these two new standards rapidly approaching, any strategy for taking a portfolio company public must include a plan for compliance.

Preparing for an IPO

Private equity groups (PEGs) assume significant reputational and other risks if their portfolio companies do not have sound internal controls over financial reporting prior to going public. Beyond resulting in potential legal and regulatory consequences stemming from noncompliance, weak internal controls also increase the likelihood that a company's financial statements and registration statement might include inaccurate data.

Questions about the accuracy of financial statements invariably cause problems with the SEC, which can seriously affect the market's interest and the demand for investment. Acknowledgment of a material weakness in a company's internal control over financial reporting may produce a drop in share value. When such a disclosure occurs within a short time of an IPO the reactions can be particularly volatile.

In addition to avoiding such negative consequences, strong internal controls and sound corporate governance also can offer positive benefits. These include better risk management, reassured stakeholders, and reduced cost of capital. Because strong corporate governance also can help attract new investors, PEGs should require their portfolio management teams to establish strong governance and compliance initiatives well before an IPO is launched.

Even as they work to address these increased accounting, financial reporting, and regulatory oversight requirements, most companies' management teams will still want to maintain an entrepreneurial spirit and a nimble, responsive corporate culture. To achieve the right balance, senior management should set an appropriate tone from the top early in the process.

Communications from the C-suite emphasizing the importance of the compliance program can help smooth the transition to successful internal controls and risk management. The effort also should include a strong emphasis on training to help those affected recognize the need for and purpose of the new controls. Empowered and trained employees can help create better and more effective controls, often using simplified and efficient control structures and frameworks that have yielded prior success.

As noted, all these steps will take time and effort. Management should begin establishing corporate governance and compliance programs for a portfolio company at least 18 months before it will be required to file its second SEC Form 10-K, and it should manage the transition proactively to see that adequate resources are allocated.

ESOP – another nontraditional alternative

Although they are used far less frequently than IPOs, secondary buyouts, or recapitalizations, ESOPs can offer some attractive advantages as an alternative strategy for exiting a portfolio company. In many instances, the ESOP structure could provide a potentially more favorable return compared to a dividend recap or even a traditional leveraged buyout (LBO), due to the structural and tax efficiencies an ESOP can offer.

ESOPs were established by the Employee Retirement Income Security Act of 1974 (ERISA) as a type of qualified retirement plan. They were created in order to give owners a way to transition out of a business by selling shares to a tax-exempt trust, in which employees can earn a vested interest. In fact, ESOPs could rightly be characterized as the original form of LBO, because the trust specifically is allowed to fund its stock purchase by using debt.

Much of the appeal of using an ESOP to recapitalize a portfolio company is due to the potential tax benefits it can offer. Like a 401(k) or other qualified retirement plan, an ESOP is tax-exempt. So if the company being sold converts to an S corporation, and the ESOP owns 100 percent of its stock, the company's federal income tax obligation effectively is eliminated.

Moreover, when a private equity firm sells to an ESOP, the sellers often finance all or part of the sale by taking back a note plus a warrant or stock option with an appropriate strike price. With the additional free cash flow provided by the ESOP's tax-exempt status, debt can be paid down more quickly, which further increases the equity value of the company. The warrant gives the private equity investor the potential of an additional and significant economic upside, which is an appropriate and market-based incentive for the investor given the continued investment of capital.

What's more, if certain requirements are met, selling or recapitalizing into an ESOP structure could allow the seller to receive the proceeds free of capital gains tax under Section 1042 of the Internal Revenue Code. As one might expect, those requirements are quite detailed, specific, and complex, so qualified tax counsel should be consulted in every instance.

ESOP factors that must be considered

An ESOP is subject to specific U.S. Department of Labor and IRS laws and regulations, including ERISA and the Internal Revenue Code. While the preparatory phases of an ESOP sale are generally somewhat shorter than those involved in an IPO, the process does require adequate planning. The PEG will need to engage experienced sell-side professionals for accounting and legal support.

Then, as the deal matures, an independent third-party trustee should be engaged to act as the ESOP's fiduciary. In addition, an independent financial adviser and attorney must be hired. It is necessary that the ESOP be represented by these independent third parties for purposes of negotiating an arms-length transaction that reflects fair market value; the ESOP always must act for the primary benefit of the employee beneficiaries.

An investor group contemplating a sale to an ESOP should prepare economic models that compare the potential returns of all viable exit strategies. There could be situations in which the tax advantages of an ESOP sale at fair market value might be outweighed by the equity value offered by other exit strategies. Broadly speaking, an ESOP is most likely to be advantageous for an entity with a moderate growth rate, stable earnings, a relatively high effective tax rate, and a corporate environment where employee incentives are valued.

Exploring alternatives

The various regulatory and compliance issues associated with nontraditional exit strategies undoubtedly will continue to grow in complexity over the coming years. As they do, it becomes increasingly important that management teams get an early start on preparing for an exit. These early steps should include a complete determination of scope and risk assessment to identify, evaluate, and prioritize any vulnerabilities that could affect the choice of strategy.

Early intervention and a strong, positive tone from the top not only can help reduce wasted effort in pursuit of a nonviable strategy, they also can help launch the chosen strategy more effectively, setting the stage for future performance and ultimately helping investors maximize their potential return.

Learn more

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