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PERFORMANCE GROUP

ESOP
Weapon or Entitlement?

Employee Stock Option Plan is a very attractive tool for exit planning when it is used properly. The tool alone will not get the ultimate outcome in most cases. The only time the tool is a complete success alone, is if the owner sells and leaves immediately with the right corporate structure.

If an owner sells a portion or all of the company to an ESOP and stays in the business, it will take a very proactive and purposeful strategy to maximize the benefits. If none of these things are done, the risk could be the demise of the business.

We believe an ESOP can be a weapon to differentiate and grow a business. However, when ESOPs are not managed properly, they become another entitlement program that can destroy a company.

ESOP WEAPON

- Employees "feel" like owners because of education on ESOPs – Great ESOP companies will do things for the employees to help them understand what it means to be a shareholder in the company. Even though it is purely a financial investor through a qualified plan, the employee feels like they are now an owner. The company provides training on how to make the company more profitable, how an employee can impact the profit growth, and gives them frequent feedback on how the stock is performing.
- Employee expectations are to "act like owners" – We change the expectations to help them realize we have "responsible owners" vs "entitled owners" in our company. Anyone employed in the firm will be asked to be a responsible owner. The definition of a responsible owner is someone who increases the value of everyone else's stock. Entitled owners are people who want everyone else to increase the value of their ownership.
- Frequent communication – Annual reports are not good enough. It doesn't keep the ownership mindset alive and active. Monthly communications that touch on ownership of the business must be purposefully delivered.
- Value proposition to clients – Building in the messaging to prospects and clients that EVERY employee in the firm cares about our clients because they are owners in the business, is a valuable weapon. Business owners know how it feels to be an owner and they believe it is different than just being an employee. Sending the message that every employee understands what it is like to own the business and do the right things, is a valuable weapon.
- Attracting talent – It is attractive to future employees to know they are going to get a piece of the success if they work in your firm. The brand needs to be clear and the expectations should be discussed in the hiring process that we expect

our owners to contribute to our success. We can elevate the feeling of working for our firm with this message.

- Defined element of culture – When we speak about our culture, we must have clarity of the "beliefs and behaviors" of an owner. We must monitor those behaviors and give honest feedback on how people perform as owners of the business.
- Language – Language is the most powerful tool in creating and driving a culture. Leadership must be given clear communication strategies on how they will keep the ESOP language (Responsible owner) alive daily in the business. This can include recognition programs, tying messaging to the ESOP, making the ESOP ownership and its profit a connection point in how we run the business.
- Acquisition tool – Depending on the corporate structure of a prospective acquisition and your strategic design on who will purchase a future company (the ESOP or other shareholders), an acquisition can become more attractive to the seller if you are an ESOP. It has tax advantages as well as being very attractive to future employees.
- Tax favored corporate financing – Financing the funding of the exiting partners (or portions of the ownership) can be financed with principal and interest payments being deductible beyond the normal 25% maximum, can be very attractive. Lower tax liability allows for more investment and profit in the company.
- Make dividends deductible at the corporate level – Dividends of a C Corporation can be deductible. Dividends paid on qualifying employer securities help by an ESOP can be deducted to the extent the dividends are pain in cash, paid to the plan and distributed in cash to the participants within 90 days after the end of the plan year, used to pay principal or interest on the exempt loan used to purchase the securities, or at the election of the participants when reinvested in qualifying employer securities. Bottom line, another weapon of increased cash through reduced tax liability for the owners.
- Clarity of Company Performance – We can make it clear how the ESOP works and why it is necessary to grow. Growth is what funds the ESOP debt payment and the retirement plan. Without growth, we can't fund the ESOP successfully. Giving growth targets annually for meeting the ESOP requirements should be part of annual communications.

ESOP ENTITLEMENT

- When employees get a retirement check in the end – Some companies just give the check at the end as a nice reward to the employee. The employee never understood how it worked or why they are receiving the check. They appreciate it, but they don't have any idea how it came to be. They feel like it is owned to them because it is a company benefit.
- Employees get annual statements – Companies who just communicate how the ESOP is doing annually will eventually have people upset based on a bad year or on potential flat performance. They will also look at the ESOP as no different than a fancy 401k that only invests in your company. They will misunderstand it and will come to conclusions that the ESOP is only a benefit to the company.
- Employees are told they are "owners or shareholder" but expectations are not to act like owners. – This happens when we don't treat employees with respect, don't expect them to look and act like they are owners, and/or we talk down to

them, etc. We may have to change some personnel if we don't have the right people for an ESOP. If we dumb down expectations (vs taking the opportunity to raise expectations), they will never feel like they are responsible for making the company worth more money.

- ESOP is "lorded" over employees – The ESOP is used as a threat, constantly used in negative examples of why they should perform better, is told to be something ownership is "giving" to them vs something they are earning.
- ESOP is treated like another qualified plan – The messaging is just like what we would do for a 401k or other qualified retirement plan. If it is just communicated at the new employee orientation and in annual reports, it won't influence behavior.
- It is a one time event – When we first start an ESOP we will have great excitement. If that is the end of the action and excitement, the ESOP will never create value for the firm outside of the financial structure for tax.

An ESOP can be a weapon to increase employee performance and reach elite growth strategies.

A recent Canadian study on ESOP companies showed the following statistics:

- Five year profit growth was 123% higher in ESOP companies.
- Net profit margin was 95% higher than non-ESOP companies.
- Productivity measured by revenue per employee was 24% higher.
- Return on average total equity was 92.3% higher.
- Return on capital was 65.5% higher

A US study (Rutgers) showed that ESOP companies had 2.4% increase in sales per employee.

Another US study showed US ESOPs had 5.5% higher return on assets, 10.3% higher net profit, 5.6% higher return on equity, and .8% higher growth.