Key Trends For ESOPS and Family Businesses Considering Acquisitions

In the world of private business advisory, where I have spent my 30-year career, M&A and transactions almost always means selling a partial or entire equity stake in the private business to an employee stock ownership plan (an "ESOP"), another company, or a private equity firm.

That said, many private businesses want to maintain their independence and continue their success. For these businesses, every reason exists to think about growing as private equity and public companies often do – by buying other businesses. M&A can be an effective way to acquire talent, gain new capabilities, and drive revenue growth beyond organic growth opportunities.

In recent years, we have seen a dramatic uptick in conversations with ESOP and private businesses considering acquisitions as awareness of the benefits of M&A has increased. There are four major trends companies actively acquiring, and those considering becoming an acquirer, should be aware of in the market today.

- Growth of the holding company structure.
- Increasing use of earn outs and other forms of contingent consideration
- Rise of unitranche debt and mezzanine capital, to fund the transaction.
- New appreciation by sellers of the strong culture and stability associated with private company and ESOP ownership.

While there are many ways to structure a transaction and the go-forward combined business, forming a holding company, or Holdco, has grown in popularity recently as companies look to diversify following the market and economic disruptions of the last several years. This structure permits both the original and acquired business to operate relatively independently while rolling them into the overarching holding company, which can be partially or wholly owned by an ESOP. In the case of an ESOP, the Holdco can be an attractive buyer of businesses that find ESOP benefits appealing, but struggle with creating their own. Hurdles can include the need for a seller's note or the costs of forming an ESOP. Selling to a Holdco lets the exiting owner feel the transaction is like an

outright sale while also delivering the go-forward benefits of being an ESOP.

Given the material swings in performance many businesses have experienced over the last few years, contingent consideration is increasingly part of the acquisition structure and financing mix. Contingent consideration addresses the age-old challenge of smoothing out steep macroeconomic swings and short-term variations in performance when pricing a business.

After peaks, buyers expect the business will return to a lower normal and are reluctant to pay for a possible temporary peak. In valleys, buyers hesitate to trust a projected return to growth, even if they understand what changed.

Thus, contingent consideration proves an effective way to bridge these risks and reduce bid-ask spreads that have widened since the pandemic. And while there are a number of structures to choose from such as earn outs or even rollover equity, the effect is to make the business easier for the purchaser to acquire while tying some portion of the seller's return to the success of the business post-sale.

The financing markets continue to evolve with unitranche structures becoming increasingly common. A hybrid loan structure, it combines senior and subordinated debt into one debt instrument. The borrower pays a blended interest rate that falls between the rate of the senior debt and subordinated debt. This makes debt-financing terms flexible and increases access to capital for companies.

Mezzanine debt is another commonly used feature. It bridges the gap between debt and equity financing in the funding structure and is subordinate to pure debt but senior to pure equity. It incorporates equity-based options, such as warrants, with lower-priority debt. This provides flexible long-term capital for use in buyouts or growth financings. Frequently unsecured, mezzanine debt usually bears interest at a higher rate than secured loans and often gives the lender a stake in the equity of the company.

Though ESOPs and other private companies have not historically been significant buyers in the M&A market, the data is promising that they can

be very successful acquirers and awareness of their advantages is increasing in the market. Studies show ESOPs have greater stability, better business performance through the cycle, and structural flexibility. Anecdotal reports from ESOPs that have pursued acquisitions offer that sellers are often drawn to ESOPs as buyers for their culture, the way the target's employees will be valued going forward, and the ability to continue to participate in equity growth if an owner chooses.

Considering the significant acceleration a sound acquisition can make to a company's growth plan, well-managed and high-performing ESOPs and family businesses should evaluate whether becoming an acquiror belongs in their strategic plan. Inorganic expansion is a time-tested way public companies and PE firms accomplish their goals. I encourage ESOPs and family businesses to explore adding M&A to the arrows in their growth quiver.