Succession Planning in a Closely Held Firm: Establishing an Employee Stock Ownership Plan

by

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Abstract

Planning for the succession of a business is especially difficult for family-owned companies. In this report, I will use a case study of a family-owned steel company to explore the potential for an Employee Stock Ownership Plan (ESOP) to benefit its owners in their succession planning. After a discussion of the difficulties faced by family-owned businesses, I will use the case study business to discuss the issues company owners should examine when considering the establishment of an ESOP. Following a thorough explanation of ESOPs, I will conclude with some issues particular to the case study business.

While this report focuses on one company, the process for exploring the feasibility of, and establishing an ESOP would be the same for any small business; therefore, this report acts as a blueprint for other companies considering an ESOP. Additionally, this report can be employed by city and county economic development agencies when working to retain jobs in their jurisdiction when a small business is otherwise at risk of being sold or closed due to the owner’s retirement.
Definition of an Employee Stock Ownership Plan

As defined by the National Center for Employee Ownership (NCEO), an Employee Stock Ownership Plan (ESOP) is “a type of employee benefit plan in the U.S. that buys and holds company stock for the benefit of a broad group of employees. ESOPs offer significant tax advantages and often are used in closely held (private) companies to buy part or all of the shares of existing owners, but they also are used in public companies (National Center for Employee Ownership, 2010).”

The Problem of Succession Planning for Family-Owned Businesses

According to Druex and Goodman (1997), a family business can be considered any pool of capital, generally in the form of an operating, economic entity, which is controlled, owned, and/or managed by some combination of members of a family. These businesses tend to originate within the family, and therefore generally operate with the same value system and morals as the founding family. Because of their value systems, family businesses do not always operate strictly in a mode of profit maximization, often incorporating other priorities into the business (i.e. religion or heritage) and commonly prioritizing the benefit to the entire family and their community. Similarly, corporate decisions are not always made in light of an arbitrary, brief time frame like a fiscal year. Instead decisions are considered in a generational context and with a stronger desire to perpetuate the business than is generally found in public ventures (Dreux IV & Goodman, 1997).
When combining this family-oriented value structure with a strong desire to perpetuate the business, planning for succession is a critical, yet often overlooked, aspect of family business planning. However, it is rarely considered until a crisis or decision point is reached. Following are several reasons that researchers postulate for this lack of planning.

In a 1988 survey of members of the Young Presidents’ Organization\(^1\), 39% of the respondents founded their business; this group overwhelmingly felt that they do not intend to retire or look forward to retiring, and do not think that age should limit their tenure as president. The 41% of respondents that were relatives of founders reported a very similar perspective. The survey also found that founders and family members of founders look for different qualities in successors than the non-family businesses, and feel it takes longer to properly train a successor (Sonnenfeld, 1988).

Succession planning can be emotionally difficult. Not only does the individual need to conceptualize their next phase of their life, but they also must let go of some or all control over the business they have built. Due to the magnitude of these decisions and all of their rippling effects on their family, taking the first steps towards exiting the business can be very intimidating.

Family business exit planning is more complicated than the decision to sell or go public in a more traditional corporation. A successful limited company can often sell as a going

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\(^1\) To be eligible for membership in the Young Presidents Organization, one must, by age 40, be the president of a firm with at least 50 employees and sales of $4 million. Approximately 40% of members manage family businesses (Sonnenfeld, 1988).
concern, however a family business has a much harder time with valuation and sale, especially when the value of the business is tied to the primary owner or owners’ goodwill in the form of institutional knowledge or long-term relationships with customers. (Butler, 2006).

Family businesses are most often closely held. In order to successfully plan for succession, the owners must begin to share information about the business that they have not shared before. In beginning to share responsibility for the company with others, the owners start to lose some of the control they have had over the business. This actual loss of control can be complicated by the owner’s perception of losing more control than they actually are. (Frisch R. A., 2001).

While some family business owners are experts in their field, they may not be savvy businesspeople. “[W]hen the subject matter turns to business succession planning, the number, complexity and interconnectivity of issues can appear overwhelming (Dreux IV & Goodman, 1997, p. 34).” This decision is likely to be the biggest and most far-reaching decision the owner(s) ever make about the business, and may involve employees and/or other family members. This process can also take much longer for family businesses because of the generational timeline perspective of the business owners and the reality that their time is occupied with running the business on a day-to-day basis.

Unless constrained by a bank loan, or some form of bonding, closely-held businesses are not required to have an active business plan, set goals with corresponding measurements, or have the business valued. The added time and costs of creating or
conducting these assessments is a further deterrent to beginning the process of succession planning.

Conventional best practices for succession planning in family businesses suggest that this planning should begin many years ahead of when it may be needed, and that any plans made should be shared with both family and employees to alleviate confusion and allow time for clarification.

Long-term succession planning has also become more critical with the changes in inheritance tax laws. Butler warns, “the inheritance of any average family property could use up most of the tax-free allowance, leaving the inheritance of the family business liable to be taxed at 40% (2006, p. 383).”

Considering all of these factors, it is in the best interest of business owners to begin their succession planning as early as possible. To assist business owners in this process, this case study evaluates the desirability of establishing an Employee Stock Ownership Plan at a family-owned structural steel company, Raulli & Sons, Inc.

An ESOP will be most successful in a business that is already profitable and shows the potential for continued profit. To determine if an ESOP may be the best direction for Raulli & Sons, Inc., this report begins with a description of the business and a discussion of their business potential, including assessments of their regional economy, their industry and a financial evaluation of the company.
At age 29, Paolo Raulli moved from Tocco di Casauria, Italy after the First World War to join his brothers, Angelo and Augustino in Rome, NY. Without enough work to sustain the three brothers at the Raulli Brothers Bicycle and Wagon Repair shop, Paolo and his new bride, Rosina, moved to Syracuse, NY in 1928. After repairing washing machines and finding other miscellaneous jobs including working for the WPA during the Depression, Paolo started Raulli Iron Works as a sole proprietor, specializing in ornamental iron railings.

In 1954, his son Guido joined him in the business, followed shortly by Guido's younger brother, Hugo, who had just returned from military service. The three men formed a partnership under the same name.

At the urging of a close friend, Paulo invested his life savings in the purchase of a small lot on Burnet Avenue in Syracuse, NY, and the first family owned shop was constructed, measuring 165 square feet. The oldest brother, Joe, soon joined the business and a series of expansions ensued including buying the lots on either side of the original shop and several building additions.

In 1960, Paolo sold his interest in the business to his three sons and continued working at the shop, officially retiring in 1966. Despite several retirement parties, Paolo continued making daily appearances at the shop and was a welcome contributor to the governing of the business until 1980; he passed away in 1988 at age 96. Paolo was a
well-known folk artist in Syracuse, with several newspaper articles having been written about him and having had his art shown posthumously in the Everson Museum (Case, 1982) (Scobey, 1993) (Hahn, 1996).

On April 30, 1960, upon taking ownership of the company, the three eldest sons incorporated the business, with each owning one of three equal shares in the company, Raulli & Sons, Inc.

The youngest child of Paolo and Rosina, Richie, joined the business in 1966 after graduating from welding school. In 1972, the oldest brother, Joe, sold his share of the business to Richie and continued to work as an employee. At this point the company was owned by Guido with 2 shares, Hugo with 2 shares, and Richie with 1 share.

In 1972, Guido’s sons, Thomas and Paul, began working at the business after college. The shareholders agreed to a recapitalization plan for the company and revised the Certificate of Incorporation in 1981 to allow both Class A and Class B stock and to “fix the relative rights of each class in order to facilitate the expansion of management and the succession of stock ownership as the business of the Corporation increases and additional management personnel are developed (Raulli & Sons, Inc, 1981).” After the recapitalization plan, there were 12 shares of stock issued and outstanding: Guido (4), Hugo (4), Richie (2), Thomas (1), and Paul (1) (Raulli & Sons, Inc, 1988). Guido passed away in 1982, with some of his stock being inherited by his sons; Hugo retired in 1988, selling most of his shares back to the business and gifting a portion to his son, Robert, leaving 30% of the ownership of the company to each Richie, Thomas, and Paul and
10% to Robert. Robert left the company in 2006, selling back his shares, which leaves the company at its present ownership of three equal shares belonging to Richie, Thomas and Paul.

These three owners have reached an age at which they need to begin their retirement planning, but as in many family businesses, this involves a complicated set of factors. The owners have a very strong desire to see the business grow and prosper, however, their net worth is largely wrapped up in the business and they need to be able to realize some of this capital for their retirement. The options for doing this are few.

One option is to sell the company outright. It could be sold as an ongoing concern, potentially achieving the highest value on the open market. The company is frequently courted by businesses from Japan and Italy, so they know a market exists for the business. Venture capital firms have also shown interest, with a likely outcome that they would break up the company and sell off the pieces for a profit. While the relative ease of an outright sale and the possibility of achieving the highest profit are attractive, these options do not satisfy goals of the company president, who is not yet ready to retire and talks of phasing out the business over several years. He also speaks of keeping some control over the business in the hands of the current owners, ensuring its productivity and reputation for quality, and the ability to reward the employees who, in his word, “deserve” the business if there are not family members able to buy in.

The ideal option would be to have family members buy the owners out of the company. Even if this takes a decade or more to do, the owners would prefer this. There are two
family members currently working at the business who would be eligible to buy in according to the By-Laws, Dennis Raulli and Mark Raulli, but this option is complicated by the high value of the shares.

Richie bought into the company in the early seventies with a deduction from his weekly payroll to cover the share purchase roughly equal to the pay raise he received for becoming part owner. The process worked similarly for Thomas and Paul to buy in during the eighties. Since then, however, the value of the company has grown significantly through the normal trends of a successful business. Operational efficiencies, technological improvements, productivity increases, as well as the friendly purchase of an ailing steel company in Rome, NY and the friendly purchase of a controlling interest in a steel company in Buffalo, NY have all contributed to the company’s rapid growth over the last several decades.

The value of the company stock has increased commensurately, making the purchase of any meaningful amount of stock impossible for any individual employee\(^2\). An additional complication converting Raulli & Sons, Inc. into an ESOP is the inclusion of Dennis & Mark in the plan. The Anti-Abuse Laws that govern S Corporations and the IRS Regulations that govern the 1042 rollover prevent most family members from participating in the ESOP, making their involvement especially tricky.

\(^2\) One of the non-shareholder family member employees is a direct descendent of a current owner who, according to the By-Laws, may gift his son up to 10% of the business.
Business Potential for Raulli & Sons, Inc.

To determine the future viability of the business, this report now turns to a discussion of both the regional economy and the industry that Raulli & Sons, Inc. operates as a part of. The outlook of the regional economy and the industry make the case for any business remaining viable in their location and industry. In order to evaluate the potential of a specific business, this report continues with an assessment of Raulli & Sons, Inc.’s current financial status and a calculation of the future value of the business.

Outlook of the Greater Syracuse Economy

The Federal Reserve’s Second District is managed by the Federal Reserve Bank of New York and covers all of New York State. A significant difficulty with economic forecasting for this region is the disparity between the economy of the New York City area and the metropolitan areas of upstate New York, including Syracuse. Still, the Federal Reserve’s January 2010 report, The Beige Book, can be used to start gaining a sense of the current economic climate and near-term trends for the region:

“The Second District’s economy has shown further signs of improvement since the last report [December 2009], with indications of a modest pickup in the labor market; prices remain relatively stable. Business contacts, in general, report some expansion in activity, with
manufacturing contacts also indicating that they are adding workers
(Federal Reserve Bank of New York, 2010, January).”

The Beige Book report continues to say that there is already some increase in employment, further plans to increase employment in manufacturing firms as the number of contracts increases, and that manufacturers remain optimistic. A review of the last year’s reports shows slowing and contracting activity before steadying in July 2009, then slightly increasing activity and employment beginning with the September report. The manufacturers remain steadily optimistic about the short-term outlook throughout all reports (Federal Reserve Bank of New York, 2009, July) (Federal Reserve Bank of New York, 2009, September).

The Federal Reserve Bank of New York also published the latest “Current Issues in Economics and Finance” report in September 2009. This report monitors more localized economic activity, and to this end, has created indexes of ‘coincident economic indicators’ (CEIs) for New York State and New York City. While they do not track upstate New York separately, it possible to approximate upstate trends by subtracting out the trends attributed to New York City (Bram, Orr, Rich, Rosen, & Song, 2009).

This report finds that the New York State entered a “pronounced downturn in 2008, a number of months after the onset of the national recession in December 2007 (Bram, Orr, Rich, Rosen, & Song, 2009, p. 2).” This indicates that the region had both more

3 These CEIs collect data from four data series: nonfarm payroll employment, real earnings, the unemployment rate, and average weekly hours worked in the manufacturing sector (Bram, J., Orr, J., Rich, R., Rosen, R., & Song, J., 2009, September).
momentum and showed more resilience than the national economy as the current recession began, and the indexes began to steady in July 2009, showing a great likelihood that “the worst is over for the region’s economy (Bram, Orr, Rich, Rosen, & Song, 2009, p. 2).” However, the recovery in New York State has begun later than the national recession’s recovery, as it has in past recessions. The authors posit this delay in recession commencement and recovery is due to region-specific factors such as building cycles and a mature economy that differs from rapid-growth economies, like those in the Southwest.

The sharpest drop in employment for the region has been in construction and manufacturing. This is an important factor for Raulli & Sons, Inc. as they are both involved in manufacturing (steel fabrication) and construction (steel erection). However, the job losses appear to have hit the New York City area more than they have upstate. In the 14-month period from April 2008 to June 2009, upstate metro areas (including Syracuse) employment rates dropped 1.7% or less, while the New York City metro employment rate dropped 2.9% (Bram, Orr, Rich, Rosen, & Song, 2009).

According to Gary Keith, an economist and vice president with M&T Bank who presents the annual economic outlook for the Greater Syracuse Chamber of Commerce, there is some good news for Syracuse: The unemployment rate is lower than the national average (8.2 in December 2009), housing prices are stable, and job growth continues in the education and healthcare sectors (Eisenstadt, 2010) (New York State Department of Labor, 2010). Much of Raulli & Sons, Inc.’s work is in building for local school systems and universities, so the job growth in education may translate to a quicker recovery for
their business than other construction companies.

These reports suggest that Syracuse’s mature labor market may be well positioned to recover from the downturn more rapidly than other regions of the state and country. However, the manufacturing and construction industries may lag behind other industries in the recovery. Raulli & Sons’ practice of returning profits to the company to keep in reserve should see them through the remainder of the downturn, and better position them for when the construction pipeline increases.

**Outlook of the US Steel Industry**

The American Institute of Steel Construction (AISC) published an overview of the industry in September 2009 predicting a 20% decrease in both revenue and employment nationally from their 2008 estimates (American Institute of Steel Construction, 2009).

The Steel Industry has been working hard for several years to position themselves as the premiere building material for the new “green” economy. Because of its high recycled content and high recyclability, steel construction has garnered favor with the Green Business Council’s LEED standards, and other measures of earth and people friendly buildings⁴. Perhaps partially due to this “green” positioning, the market share of structural steel has steadily increased in non-residential building to 58% as of the

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⁴ The modern steel mills of today produce steel containing an average of 93% recycled material, and the current reuse/recycle rate of structural steel is 98% (American Institute of Steel Construction, 2009).
second quarter of 2009. The following table shows market share values for all structural
framing materials (non-residential, based on square feet) (American Institute of Steel
Construction, 2009).

<table>
<thead>
<tr>
<th>Market Share by Construction Material</th>
</tr>
</thead>
<tbody>
<tr>
<td>Structural Steel</td>
</tr>
<tr>
<td>Pre-engineered Buildings (Steel)</td>
</tr>
<tr>
<td>Wood</td>
</tr>
<tr>
<td>Masonry</td>
</tr>
<tr>
<td>Reinforced Concrete</td>
</tr>
<tr>
<td>All Other</td>
</tr>
</tbody>
</table>

According to AISC, steel industry construction starts through the second quarter of
2009 were down by 45% compared to the same period last year. This dramatic
downturn is due to both the economic recession that began in late 2007 and the
tightening of the credit market as of late 2008. AISC fears that a substantial resumption
in construction starts will lag behind the recession recovery by approximately nine
months and will also require a loosening of the credit market (American Institute of
Steel Construction, 2009).

Among this dismal outlook, the areas of structural steel construction that are poised
perform the strongest are public projects and schools, who have only shown a slight
decrease by the second quarter of 2009. Raulli & Sons, Inc. specializes in school,
university and other public buildings, strengthening their market position in the
recovering economy.
**Current Financial Ratios**

The following sections review the financial strength of the company and update a 2002 valuation of the company as an indication of their future potential.

Raulli & Sons, Inc. remains in an extremely strong financial position according to the most recent audit for their 2009 fiscal year (May 1 – April 30) (Firley, Morgan, Freer & Eassa, P.C., 2009). Due to a recent increase in the company's bonding requirements, Raulli & Sons, Inc.’s financial statements must now be audited on a yearly basis instead of simply reviewed. Using the approved financial statements of the company, Exhibit A compares the key industry financial ratios to industry norms. These figures tell the story of a fiscally conservative company that is well positioned to take on the additional debt necessary should they decide to establish an ESOP with a bank loan.

**Valuation**

The initial valuation and the ongoing yearly valuations of the company are the most significant facets of an ESOP (Murphy & Murphy, 2006). Indeed, the first step to establishing an ESOP is to determine an accurate and defensible value for the company. While a high company value may benefit the selling owners by increasing their profit, it will also translate into a larger bank loan and increased risk to the company and future owners – the employees. An artificially low valuation may make for a more manageable bank loan, but is unlikely to induce the selling owners to establish an ESOP when they could sell the company to an outside buyer for a significantly greater profit.
IRS Code Section 401(a)(28)(C) requires a closely held company to conduct an independent valuation any time the ESOP acquires stock and annually thereafter. According to NCEO estimates, a valuation can cost between $8000 and $15,000 for the initial valuation and approximately half that amount for every subsequent year (Rodgers, 2010).

Valuation amounts for any given company can vary widely based on the purpose of the valuation. A liquidation determination of value is generally considered to be the lowest value, while a “fair market value” is generally considered the highest value. The IRS revenue ruling 59-60 defines “fair market value” as the price at which a property would change hands between a willing seller and a willing buyer, when the former is under no compulsion to sell and the latter is under no compulsion to buy, and both parties have reasonable knowledge of the relevant facts. A valuation for the purposes of an ESOP is generally only slightly below fair market value, taking into account the limited pool of buyers for the company stock.

Currently, Raulli & Sons has virtually no market for their stock. While the By-Laws of the company allow any of the existing three owners to purchase stock from one another, and it is possible for two other family members working at the company to purchase stock, the current value of the stock is too high to make any purchase of consequence feasible. In the company valuation from 2002, the valuator uses a 35% discount to the value of the company to represent, in part, this lack of a market for their stock. So, while the value of the company would be highest if the owners were selling on
the open market, the value for the purposes of establishing an ESOP is actually higher than the current value of the company as it operates under their current By-Laws.

The National Center for Employee Ownership strongly encourages companies to conduct an independent appraisal of the business that follows IRS requirements:

To ensure the thoroughness of the analysis, the valuation of the company's outstanding common stock should follow the guidelines set forth in Revenue Ruling 59-60. (Revenue Ruling 83-120 provides special methods for valuing closely held preferred stock.) The IRS issued Revenue Ruling 59-60 in 1959 to provide guidance in valuing closely held stock for estate and gift tax purposes. In 1965, the IRS broadened the scope of Revenue Ruling 59-60 with the issuance of Revenue Ruling 65-192 and 65-193. These rulings indicated that the general approach, methods, and factors outlined in Revenue Ruling 59-60 applied to valuations of closely held stock for income tax and other tax purposes. Further, Revenue Ruling 59-60 was deemed appropriate in determining the fair market value of business interests of any type, and of intangible assets for all tax purposes (Murphy & Murphy, 2006, p. 62).

Revenue Ruling 59-60 clearly indicates the factors that should be taken into account when valuing a closely held firm: the nature and history of the business; the economic outlook of the industry; the book value, financial condition, earnings capacity, dividends paying capacity, and goodwill of the business; percentage of stock to be sold, and the
market price of stocks of similar businesses that are openly traded. The relative weights of these factors are to be determined by the individual appraiser depending on the particulars of the business.

In addition to IRS regulations, ESOP valuations must take into account additional factors such as the marketability of the stock, as discussed above, and a risk premium associated with the passing of control of the company out of the hands of current owners.

**Common Approaches to Business Valuation**

Of the many acceptable approaches to business valuation, the three most common are the market, the asset-based, and the income approaches. These are reviewed briefly below with an eye toward their applicability to Raulli & Sons, Inc.

1. The market-based approach can often reveal the most accurate picture of the company’s value; however the most accurate data for this approach comes from previous sales of the company’s stock. As Raulli & Sons has never had an “at arm’s length” stock sale, there is no data available to inform this approach.

   In addition to the sale of the company’s stock, this method utilizes the sale value of other similar closely held companies, but accurate and timely data on the sale of private companies is generally not obtainable.
Finally, this approach utilizes the sales of stock for similar publicly traded companies to value a firm. The IRS strongly supports this method, but finding any realistically comparable publicly traded company is difficult and the business model of Raulli & Sons, Inc. as both a steel fabrication and a steel erection company makes any comparison difficult at best.

2. The asset-based approach, which was used in the company’s 2002 valuation for a final determination, is based on the adjusted book value of the business’ assets, or what the sale of the assets of the business would bring if the company liquidated. This approach is generally used to determine a floor value, or the lowest value of the company because it is premised on the company ceasing operation.

The data for the 2002 asset-based valuation was provided solely by the company president and adjusted according to IRS standards. Should Raulli & Sons, Inc. continue to research the establishment of an ESOP, the asset-based valuation should be similarly updated and the valuation result compared to the capitalization approach for a weighted average.

While this value is not appropriate as a stand-alone valuation, it is critical to the determination of the company’s goodwill. The generally accepted formula for determining goodwill is to subtract the adjusted value of the company’s assets from the value determined by the income approach discussed below (Malizia, 2010). This formula suggests that there is intangible value in company due to
things like patents and customer contacts. For Raulli & Sons, Inc., the significant goodwill value of the company comes from the three owners combined 100 + years of experience in the business, and the impeccable reputation they maintain in their region-based industry.

3. The third and most useful method of valuation is the income approach that is achieved by the capitalization of company earnings. Capitalizing earnings is most appropriate when the history of the company can be used to represent future earnings. Dividing the weighted average of earnings by a capitalization rate returns the valuation of the business.

This method was used in the 2002 valuation of the company, but discarded when the valuation achieved was below that of the adjusted book value rate determined by the asset approach. In the intervening years, however, Raulli & Sons, Inc. showed significantly higher profit, so the resulting valuation is currently higher than adjusted book value, and an indication of the goodwill integral to the business. Using this method is the most appropriate approach for Raulli & Sons, Inc. because the current owners would phase their retirement over several years, and it is reasonable to believe that past performance is indicative of future performance if this transition can occur slowly.
Determination of Capitalization Rate

For the purposes of this pre-feasibility study, I have updated the earnings capitalization worksheet used in the 2002 valuation (see Exhibit B: Determination of Capitalization Rate) using the methodology found in the 2002 report with additional description from “An Introduction to ESOP Valuation,” by Murphy and Murphy, a chapter in Employee Stock Option Plans, edited by Corey Rosen of the National Center for Employee Ownership (NCEO) (2006).

In the 2002 valuation, the “Built-up Method” is used to determine the capitalization rate. This rate is comprised of the 20-year Treasury Bond to indicate the “risk free” rate of return, the “equity risk premium” that is required by equity investors over the risk free rate, and other company specific factors.

The 20-year Treasury bond rate as of April 30, 2009 was 4.1% (US Department of the Treasury, n.d.). To this I have added 9.12%, the equity risk premium, and 5.81%, the risk premium for the smallest size companies, both listed in the 2009 Classic Yearbook: Market Results for Stocks, Bonds, Bills, and Inflation 1926-2008 (Ibbotson, 2009). This results in the average market return as of the valuation date of 13.22%. In the 2002 valuation, the company specific factors were given a cumulative value of 1% due to the following risk factors: The size of the company was even smaller than the company size in the 10th decile; the company’s management is capable but “thin,” meaning that there is no one working at the company that can replace the current owners; the company is part of an industry heavily dependent on the economy and a downturn in construction
can adversely affect the business; the substantial net worth required to maintain a steel erection business and finance large accounts receivable balances (Gerber, 2003). As these factors remain true in 2009, I have also used the 1% Company Specific Premium.

The net income of the company fluctuates, making a standard growth rate difficult to determine. For the purposes of this pre-feasibility study, I have used the same 5% growth rate as the 2002 valuation, but the owners of the business are cautioned that this figure is less reliable than a more rigorous determination would provide. Subtracting this growth rate from the total of other risk premiums gives the Net Earnings Capitalization for Next Year, which is then divided by one plus the growth rate to determine the Capitalization Rate for the Current Year.

**Determination of After-Tax Normalized Income**

The following areas of Raulli & Sons, Inc. financial statements need to be adjusted similarly to the adjustments made in the 2002 valuation, and are shown in Exhibit C: Raulli & Sons, Inc. Normalized Income. The business leases their office, shop and a warehouse from a related partnership. The leases for these buildings run through 2016, and have an annual cost to Raulli & Sons, Inc. of $252,000 and $48,000, respectively. The company also pays the real estate taxes on these buildings.

Based on a real estate analysis submitted to the appraiser in 2002, the fair market rent was calculated to be $3 per square foot (Gerber, 2003). Because the company is still
operating under the same leases as during the 2002 valuation, and these leases do not contain escalation clauses, I also use the $3 per square foot value for fair market rental.

The addition of the lease costs and property taxes paid, and subtraction of the calculated fair market rent combine to give the net adjustment to income shown in Exhibit C. These adjustments are pre-tax, so to value the after-tax income I have applied a tax rate of 42% to the net total adjusted amount to achieve the normalized income used in Exhibit E: Capitalization of Earnings.

**Capitalization of Earnings**

As shown in Exhibit E, Raulli & Sons, Inc. earnings are weighted to give the most recent years more impact. This is based on the assumption that more recent years are a better indication of future performance. The weighted earnings are then averaged. This total weighted earnings is then divided by the capitalization rate discussed above to determine the value of business operations before excess assets and marketability discount.

This valuation method includes both the operational income and goodwill of the company. Raulli & Sons has extra assets comprised from funds due from a related entity and, more significantly, excess working capital. In the 2002 valuation, Gerber explains,

> The owners’ compensation is relatively low in consideration of the work they perform for the Company. The owners have elected to “reinvest” the
profits back into the business. Some of this reinvestment is necessary because of the capital-intensive nature of the business. However, some of the reinvestment may be excessive. I have determined that the company has approximately $1,000,000 in excess working capital that is not necessary to effectively operate the Company (2003, p. 29).

The owners have continued in their practice of reinvesting profits into the business, so I have increased the $1,000,000 amount used in 2002 by an annual growth rate of 3% to achieve the Excess Working Capital amount used in Exhibit E: Capitalization of Earnings.

The marketability discount is a highly subjective figure used to represent the lack of an available market for shares of a closely held company. As discussed in an earlier section, the establishment of an ESOP may in fact improve the marketability of Raulli & Sons, Inc.’s stock. According to Gerber, this discount is dependent on the impact of factors such as: restrictions on transfer, a buy-sell agreement, the prospect of a public offering or sale of the company, a put option\(^5\), dividend payouts, and the market available that may be interested in purchasing shares (2006).

In the 2002 valuation, Gerber used a 35% discount without explanation. For the purposes of this pre-feasibility study, I have started with a discount rate of 25%, which was the rate used for a firm in the same industry as Raulli & Sons, Inc. that established

\(^5\) A put option requires the company to repurchase a departing employee’s stock. While the ESOP often has the right to repurchase stock from the employee, a put option is an obligation of the company, not of the ESOP (Murphy and Murphy, 2006)
an ESOP in 2005 (Creed, 2010). Because this rate is highly subjective and has such a
critical impact on the final valuation amount of the business, I am including Exhibit D:
Sensitivity Analysis of the Marketability Discount showing the difference in business
value at 5% increments. Moving from the 35% discount used in the 2002 valuation to
the 25% used in the comparable company adds over $4.6m to the valuation of the firm.
Should the owners decide to move ahead with establishing an ESOP, they must address
the calculation of this Marketability Discount with their auditor.

**Additional Valuation notes for Company Owners**

Valuation mistakes can become costly when they give rise to challenges by the IRS or
Department of Labor (DOL). Some common mistakes that give rise to these challenges
are: The corporation or an employee of the corporation performing the valuation; the
corporation’s regular accounting firm performing the valuation as they lack the
necessary independence; valuation by a firm or person unfamiliar with ESOP
valuations; the use of unconventional valuation methods, inadequate documentation,
and using an out-of-date valuation. Contracting with an independent, professional
valuation firm with documented experience in ESOP valuation will ensure the company
reduces these risks. The IRS and DOL base their assessment of the quality of the
valuation largely on their assessment of the expertise, credibility and independence of
the appraiser (Murphy & Murphy, 2006).
ESOPS

Employee Stock Ownership Plans (ESOPs) are the most common form of worker-ownership in the United States. They are structured as ‘qualified employee benefit plans’, similar to retirement benefit plans, and therefore subject to Federal regulation under the Employee Retirement Income Security Act (ERISA) and IRS Code Section 4975(e)(7). An ESOP is structured as a trust fund jointly owned by the eligible employees of a company. This trust fund is a legally separate entity that holds stock of the corporation and is administered by a trustee or trustees acting on behalf of the employees.

The theory behind ESOPs is credited to the German economist, Johann Henrich Von Thunen working in the early days of the Industrial Revolution. Von Thunen wanted to spread wealth directly to the people\(^6\), so he set aside a share of his farm’s profits for his employees and invested these profits into machinery that would improve productivity and, consequently, increase earnings. A portion of the resulting profits was then put into each employee’s name and invested. While the interest from these investments was then given to each employee, the principal continued to grow from farm profits and was distributed to the employees upon their retirement (Frisch R. A., 2001).

Congress gave defined benefit pension plans favorable tax treatment in 1920, and in 1921, passed legislation establishing profit sharing and stock bonus plans. In 1942, the Tax Revision Act encouraged many businesses and industries to employ these tax-

\(^6\) As opposed to the theory of his contemporary, Karl Marx, who believed capital should be owned by the government.
sheltered retirement plans. The first leveraged ESOP took place in 1954; one year after Revenue Ruling 46 permitted qualified retirement plans to borrow money in order to purchase stock.

ESOPs were given the ability to borrow money to fund capital requirements with the Regional Rail Reorganization Act of 1973, and the Trade Act of 1974 established the first fund giving preferential treatment to companies with ESOPs. Throughout the 1970s and 1980s, Congress used a Tax or Revenue Act nearly every year to expand, liberalize and clarify the tax credits for ESOPs (Frisch R. A., 2001). Of particular note is the Deficit Reduction Act of 1984 that established the tax-free rollover for shareholders selling stock to an ESOP owning 30% or more of the company, and made dividends to the ESOP tax deductible if they were used to pay back share purchase debt or passed through to the employees. Congressman Russell Long chaired the Senate Finance Committee and used his position to influence many of the pro-ESOP tax changes (Blasi, Kruse, & Bernstein, 2003).

In 1997, The Taxpayer Relief Act made it possible for S Corporations to establish and benefit from an ESOP.

Defined benefit plans promise employees a specific benefit at retirement and must adjust contributions to reach that declared benefit. Defined contribution plans (such as ESOPs) differ in that the company can vary its contribution from year to year and makes

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7 The owner of the Peninsula Newspaper wanted to retire and transfer ownership to the employees. A bank loaned money to the ESOP trust, in which employees participated. This first ESOP is considered to have been eminently successful.
8 The benefits remain greater for a C Corporation, however, and some ESOP experts encourage companies to carefully consider switching from an S Corp to a C Corp before establishing an ESOP. Once the ESOP is established and funded, the company can switch back to an S Corp in five years (National Center for Employee Ownership, 2010).
no commitment to the employees of any specific benefit amount. Instead, the ESOP invests predominantly in the corporation, linking the benefit to the employees directly to the success of the company.

The following section of this report discusses the benefits of establishing an ESOP to the current owners, the company, and the economic development benefits to the community in which the business is located. There are also benefits to the employees as future owners of the company, but these are not discussed herein because these benefits depend largely on the ability of the company leaders to cultivate a culture of ownership at the business. For a thorough treatment on creating a culture of ownership, see The Ownership Edge, by Corey Rosen and Loren Rodgers, available through the National Center for Employee Ownership.

**The Benefits of Establishing an ESOP**

The tax benefits of ESOPs make them a particularly attractive option for shareholders looking to free up some of their capital in the company. The three major tax breaks for ESOPs are:

1. Contributions of stock (or cash to buy stock) from the company to the ESOP trust are deductible from taxable income, saving the company approximately 42 cents in taxes for every dollar contributed to the ESOP.

2. Owners of the company selling 30% or more of the company to the ESOP are able to rollover their profits into “qualified domestic securities” and delay paying capital gains tax. Taxes become due when these securities are sold,
however if they remain part of the owner’s estate upon death, there are not taxed. This is discussed in detail below.

3. For the employees, the tax on the stock received is deferred until the employee leaves the business, similarly to employer contributions to 401(k) plans (Worker Owner Institute, 1998).

Benefits to the owners

IRS Code Section 1042 is the tax-deferred rollover provision that allows a current shareholder to sell shares to an ESOP owning 30% or more of the company and defer paying personal gains taxes on the profits of the sale. The 30% hurdle may include the sale being transacted, so if the first sale to the ESOP is equal to or greater than 30% of the shares, that sale and all future sales are eligible for deferred tax treatment. Also, any combination of shareholder and company sales or gifts can be considered one sale for the purposes of achieving 30%, so, for example, the three owners of Raulli & Sons, Inc. can each sell 10% to the ESOP simultaneously to take advantage of the tax deferment. Preferred stock does not count toward the 30% hurdle (Frisch R. A., 2001).

The selling shareholders must have owned the stock they are selling for at least three years to be eligible for tax deferment, and, similarly, the ESOP must hold the stock for three years after acquisition or the company will face a 10% excise tax under Code Section 4978. Statutory distributions such as employee termination, disability, death and retirement are exempt from this three-year hold period (Frisch R. A., 2001).
The selling shareholders must rollover the proceeds from the sale of their company stock into Qualified Replacement Property (QRP) – namely, securities of domestic corporations during a precisely defined period from three months before the sale to the ESOP to twelve months after the sale. The securities purchased must be in companies with more than 50% of their assets in active business or no more than 25% passive income. Mutual funds, certificates of deposit, government securities, real estate, or securities of a company affiliated with the original company are not qualified QRPs. The proceeds can be used, however, to fund a new corporation (Frisch R. A., 2001).

In the year of the sale, the shareholder must notify the IRS in writing on their 1040 tax return by attaching the election “statement of purpose” which included the cost, description and selling price of the QRP, a statement indicating that the property is QRP. The statement of purpose must be notarized within 30 days after the purchase date. Similarly, the corporation must attach a signed statement agreeing to the 10% excise tax in the event that the ESOP does not hold the shares for the three-year minimum and a signed statement agreeing to a 50% excise tax if an allocation is made to a member of a prohibited group (i.e. family member). Frisch (2001) adds a cautionary note about deviations from these rules and urges particular care in following the regulations very carefully.

When these replacement securities are sold, the gain (sale price minus basis) is taxed at capital gains rate. However, according to current tax law, if these replacement securities are not sold and pass into the estate of the shareholder upon death, the basis adjusts to the current rate of the securities and all tax liability up to that point disappears.
Of particular concern in a family owned business, is Code Section 1042(n). This stipulates that selling shareholders cannot have any portion of the shares they sell allocated to his or her ESOP account, and the shares cannot be allocated to the ESOP account of a family member. For the purposes of this regulation, family member is defined as spouse, parents, brothers and sisters (including half-siblings), ancestors or lineal descendents. Not included in this definition are aunts, uncles, nieces, nephews, stepchildren, stepparents or in-laws. Also prohibited from receiving ESOP stock allocations are any stockholder who owns more than 25% of any class of the outstanding shares of the corporation. Stock owned by the shareholder’s spouse, parents, children and grandchildren are counted in this 25% threshold.

**Benefits to the Company**

Several academic studies tout the productivity increases achieved after establishing an ESOP (Bai & Xu, 1995)(Jones & Kato, 1995). The eleven studies completed before 2001 were reviewed and reported on by Blasi, Kruse, and Bernstein in their book, *In the Company of Owners*. They aggregate the studies to indicate an average 4.4% increase in productivity for the companies studied after establishing an ESOP. For these studies, companies were studied both longitudinally and comparatively with similar companies. The same book summarizes several studies showing a higher shareholder return for publicly traded companies with ESOPs, and concludes this research review chapter with several studies pointing to the simultaneous efforts to create a culture of ownership at
the same time as an ESOP is being established as a critical component in productivity improvements.

However, it is important for company managers to keep this ownership incentive in perspective. The National Center for Employee Ownership and other advocacy organizations remind managers of the continued work necessary to create and maintain a “Culture of Ownership” at an ESOP company. Realistically, a company that sells 30% of the business to 100 employees can only expect employee behavior to change so much with their newfound ownership of .3% of the business. NCEO recommends several ideas to improve the ownership culture, including: providing a financially meaningful stake in the company, provide continued education and financial training about the organization and the employees’ role in profit-making, share and explain performance data with employees, share profits with bonuses or other profit sharing tools, and to build employee involvement through regular feedback opportunities, teams and devolution of authority (National Center for Employee Ownership, 2010).

ESOPs are said to produce other economic, social and political benefits in addition to making workers more committed to their companies: Providing more equality in the workplace; easing tensions between workers and managers, especially in unionized workplaces; and the ability to ward off take-overs with large blocks of friendly stock (Blasi, Kruse, & Bernstein, 2003). However, according to Frisch, employees are usually more concerned with accruing balances in their ESOP account than they are with having much of a say in the governance of the company, suggesting productivity increases are
more like correlated with individual financial gain than more symbolic measures like having a minority vote on the Board of Directors (Frisch R. A., 2001).

ESOPs create a market for company shares where there otherwise may not be one. In closely held or family businesses that strictly regulate those whom can buy into the business have no market outside of these options. This creates a situation where the majority of an owner’s net worth is wrapped up in the business and leaves the owners with few options for funding their retirement other than sale.

The market created by ESOPs is still not comparable to a public market, as the shares cannot be freely traded, but there is a ready market available to the employees in the requirement of the company to re-purchase shares of retiring or terminating employees. This cash payout to employees can be regulated over a period of years when necessary to protect the net worth of the company.

A final benefit is that, unlike other tax qualified plans, ESOPs can borrow money from a variety of sources including from the company and the stockholders themselves. Principal and interest payments from the corporation to repay these loans are tax deductible. The idea of using debt as leverage to buy ownership for the employees was one of the benefits touted by Senator Long and Louis Kalso, the first businessman to establish an ESOP (Blasi, Kruse, & Bernstein, 2003).
Economic Development Benefits to the Community

The use of leveraged ESOP buyouts has become more popular when current business owners begin to look for outside buyers that are likely to move the company to a better labor market, economic environment, or for other similar reasons. In these situations, the employees lose their jobs and add to the local unemployment rate.

Many state and county economic development agencies help in funding the establishment of ESOPs to prevent the loss of jobs at a company that may otherwise be bought and moved. Raulli & Sons, Inc. employs 100 people in the Syracuse community and pays property taxes on significant acreage within City limits. To avoid losing jobs and tax income, City, County and State economic development departments have a large incentive in keeping the ownership of the company local.

Process to Establish an ESOP

Should the owners of Raulli & Sons, Inc. be encouraged by this pre-feasibility assessment, their next step would be to conduct a more thorough feasibility analysis. Julie Goodison, a representative of the New York State Department of Labor in Syracuse, is authorized to make recommendations for this service locally (Goodison, 2010). It would also be very important to stay in close contact with Ms. Goodison over the next several months as a grant to fund feasibility studies has been proposed and may be approved in the near future.
If the company is interested in pursuing a leveraged ESOP, they should begin discussing their loan options with several area banks at this point, including the two banks that Raulli & Sons, Inc. currently has relationships with. See the information on loan funds below for a program that could reduce the interest rate on a loan granted for the purposes of establishing an ESOP.

If the outcome of the feasibility study convinces the owners to move ahead with either a leveraged or unleveraged ESOP, they will then need to bring aboard legal counsel that is experienced in ESOP establishment. Finding counsel that is also familiar with the construction industry would be advantageous. Counsel is needed to draft the documents necessary for the establishment of the ESOP.

During discussions with counsel, the company will need to identify the administrator for the ESOP and appoint a trustee or trustees. From discussions with a NCEO employee and the president of an ESOP firm, I recommend appointing the company’s Human Resources Manager to administer the program, and approximately three non-management employees to act as trustees. The executive I spoke with strongly recommended having more than one trustee and that they should not be management level employees or office staff.

Counsel should also be able to recommend an appraiser familiar with experience with ESOP valuations. It is critical that the appraiser be familiar with ESOPs since simply having an ESOP impacts the value of the firm.
With the business valuation and the ESOP documents from counsel in hand, the company will be able to finalize the bank loan should they decide to use one. After closing on the loan, the management of the ESOP can be handed over to a company administrator\(^9\).

**Costs to Establishing an ESOP**

According to Frisch (2001), the costs of establishing an ESOP are generally less than the tax savings achieved in the first year of the ESOP (Frisch R. A., 2001). The primary costs of establishing an ESOP are comprised of performing a pre-feasibility plan, a more through feasibility plan should the pre-feasibility plan look promising, and the hiring of counsel and appraiser familiar with ESOP structuring and valuation. It is helpful, although not necessary for counsel to also be familiar with the industry. Estimated costs to establish an ESOP were provided by a project director for the NCEO and are summarized Exhibit F: ESOP Set Up Costs (Rodgers, 2010). Not included in Exhibit F is the cost for outside trustees for the ESOP that can run from $10,000 to $50,000 per year since it is uncommon to have an outside trustee in closely held firms. Once the ESOP is established, there are ongoing costs to administer the ESOP that are roughly equivalent with the costs of administering other benefit plans.

\(^{9}\) Administration of an ESOP is outside the purview of this report. The administrator must be adequately trained to ensure the company conforms with Department of Labor and IRS regulations. Refer to the NCEO for workshops, conferences, books and online training materials.
**Funding the ESOP**

There are basically two ways that Raulli & Sons, Inc. can fund the ESOP – either with or without debt. These options are reviewed below.

**Leveraged ESOP**

A leveraged ESOP is created by taking out a bank loan to fund the share purchase for the ESOP trust. Banks will generally not lend directly to ESOP trusts as they have no assets for collateral, so the company must secure the bank loan and in turn lend that amount to the ESOP. This mirror loan is most commonly done at the same terms as the bank loan. The ESOP uses the loan proceeds to purchase stock from the selling shareholders and allocates that stock to the employees as the employees become vested.

A major advantage to a leveraged ESOP is that both principal and interest payments to the bank in repayment of an ESOP loan are tax deductible for the business. It is very likely that Raulli & Sons, Inc. will qualify for the Linked Deposit Program and receive at least a 2% reduction on the interest rate for the ESOP loan (Empire State Development Corporation, 2010). Using leverage to fund the ESOP also keeps the business’ working capital free for operational needs.

Another significant advantage to a leveraged ESOP is for the selling shareholders. So long as the initial sale to the ESOP is equal to or greater than 30% of the business, the
shareholders can take advantage of the 1042 roll over and defer paying taxes on the gains.

**Unleveraged ESOP**

An ESOP can be established without involving a bank by either using the profits of the company to purchase stock from the shareholders or by creating new stock to give to the ESOP. The company can make tax deductible contributions of stock to the ESOP trust, and in doing so, save on taxes and not disburse cash. So long as the value of shares grow proportionately with the value of the company, this method can create capital for the employees to own while retaining the value of current shares. However, creating new stock without a commensurate increase in value to existing stock will dilute the value for existing shareholders and will not help the existing shareholders liquidate their stock, so this method is not recommended.

The company can establish an ESOP over several years by purchasing small percentages of stock from the owners with annual profits. This is the plan underway at an engineering firm based out of Raleigh, NC. This firm plans to buy out the current owners at a rate of 10% each year for 10 years, so long as the profits are able to support this. The CEO points out two advantages to this method. First, this option avoids having the company take on more debt at a critical juncture like an ownership transition. Second, capital gains rates are at a record low 15%, so paying that tax for the first two years

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10 President Obama has recommended the capital gains tax rate be raised to 20%, but Congress has not yet addressed this, so any potential effective date is unknown.
was an easy trade-off for a solution that allows them to sell the company slowly while retaining their jobs and control over the company (Creed, 2010).

**Loan Funds and Grant Programs**

New York State’s Linked Deposit Program (LDP) is a State program managed by authorized commercial banks\(^{11}\). The program, among other purposes, specifically targets ownership transitions with a public-private partnership that reduces loan interest rates by 2-3%. The maximum loan amount is $500,000 over a four-year term. Raulli & Sons, Inc. may qualify for the 3% interest rate reduction under the eligibility criteria “Businesses in a Federal Empowerment Zone, or Enterprise or Renewal Community with 100 or fewer full-time employees (Empire State Development Corporation, 2010)\(^{12}\). If not, however, the information available on the Empire State Development Corporation (ESDC) strongly suggests they will be eligible for the 2% reduction. Details of the program including a frequently asked questions document, and the program application are available on the ESDC website\(^{13}\):

http://www.empire.state.ny.us/BusinessPrograms/LinkedDeposit.html

The Empire State Development Corporation’s Industrial Effectiveness Program (IEP) provides “technical and financial assistance to help New York State manufacturing firms addressing competitiveness issues that increase productivity, efficiency and market

\(^{11}\) The two banks that Raulli & Sons, Inc. currently banks with, Solvay Bank and M&T Bank, are both authorized to participate in this program.

\(^{12}\) 213 Teall Ave is in an Empowerment Zone according to the Syracuse Land Records Parcel Search (Syracuse-Onondaga County, 2010).

\(^{13}\) Frequently Asked Questions document for the Linked Deposit Program is attached to this report.
share (Empire State Development Corporation, 2010).” This program offers a maximum $50,000 grant to cover the costs of contracting with outside consultants who develop projects that increase productivity and competitiveness. Eligible projects include organizational assessments. Program eligibility and application information can be found on the Empire State Development website of Business Programs: http://www.empire.state.ny.us/BusinessPrograms/IEP.html.

The City of Syracuse offers gap financing through a publicly assisted loan program. This program is targeted at for-profit businesses starting or staying within the City of Syracuse. Detailed eligibility requirements and the application process description can be found on the City of Syracuse website under the Business Assistance tab (City of Syracuse, 2009).

Finally, there is a proposed State grant program that, if approved, will be administered by the NY State Department of Labor aimed at funding feasibility studies for ESOP conversions, among other projects. Details of the proposed program and eligibility requirements are unclear at this point, but a representative of the Department of Labor expects program information to become available around April 1, 2010 (Goodison, 2010).

**When are ESOPs not a good choice?**

ESOPs will not turn an unprofitable company profitable. They often make the news when being used to buy-out a failing manufacturing firm, but this represents a small
percentage of ESOPs and are not often successful. James B. Lieber’s book, *Friendly Takeover: How an Employee Buyout Saved a Steel Town*, is an exception to this, with the successful establishment of an ESOP thoroughly explained in the enjoyable narrative of Weirton Steel. According to Frisch, “An ESOP will not make a bad company good but will make a good company better (Frisch, 2001, p. 11).”

While this report may serve as a template for many small businesses considering the establishment of an ESOP, there will be a handful of issues particular to every company. Below, I review the issues particular to Raulli & Sons, Inc. including changing their corporate structure from an S to a C Corporation, an environmental review that may be triggered by a change in ownership, the existing personal guarantees of the current owners for the company’s lines of credit, and the difficulty of including non-owner family members in any new ownership structure.
Issues of Concern for Raulli & Sons, Inc.

Changes to corporate structure: C or S Corp?

The CFO of Raulli & Sons, Inc. has recommended the company consider reverting back to an S Corporation. While S Corporations are now eligible for some of the tax benefits available to ESOP corporations, the regulations still heavily favor C Corporations. Once the ESOP is established, the regulations allow a company to change to an S Corporation after five years.

Environmental review

Any change in ownership of a business triggers a Phase 1 Environmental review of the property. The land that Raulli & Sons, Inc. owns and operates on has been a foundry, among other uses, for nearly a century. Any required remediation may place a heavy financial burden on the company. Although, its continued use as a steel fabrication plant should keep the level of possible remediation required relatively reasonable.

Personal guarantees of existing lines of credit

The company’s two lines of credit for working capital are guaranteed with the assets of the business as well as personal guarantees of the three owners. If the owners sell off some of their stock, these personal guarantees will become less valuable and may impact their existing loans. The loan contracts should be reviewed to see if this circumstance is expressly forbidden or how a sale of stock may impact the loans.
Similarly, the companies bonding contracts must be reviewed for the impact the sale of shares might have on the contracts.

**Including other working family members in ownership**

One of the most difficult aspects of establishing an ESOP for Raulli & Sons, Inc. will be to arrange the ownership of the company in such a way that current family members that are not currently owners can become shareholders as well. The anti-abuse laws in place for ESOPs will make it difficult to apportion ESOP money to family members; counsel with this particular experience must be consulted if the family hopes to do this.

**Conclusion**

As can be seen through this case study of Raulli & Sons, Inc., ESOPs may be used to successfully navigate the succession of ownership in a small business. ESOPs have an additional advantage over other succession options in their ability to address the unique problems faced by many family-owned business owners in their succession and retirement planning.

While the regulations guiding the establishment of an ESOP and its continued administration are fairly rigorous and have a significant associated financial cost, these disadvantages are outweighed by the benefits to the company, its owners, employees
and community. ESOP experts suggest that the financial costs of establishing an ESOP are most often recouped in the first year’s tax savings. Additionally, an ESOP will allow the owners to keep their jobs and retain a controlling interest in the company for as long as they like while training their successors.

ESOPs are a viable option for any business contemplating their succession options, however for family owned businesses that focus on more than the financial bottom line, they can be a superior direction. In addition to the tax savings, the owners can choose the level of control they want to retain after the ESOP is established, unlike in a sale of the company when they cede control to the new owners even if they remain an employee. By retaining some control, the owners can keep the business in alignment with their value systems that may diverge from traditional business in favor of other considerations such as family and community, as well as do their part to ensure the long-term viability of the business in keeping with their generational timeframe.
### Exhibits

#### EXHIBIT A: Raulli & Sons, Inc. Financial Ratios

<table>
<thead>
<tr>
<th>Ratio</th>
<th>F2009</th>
<th>Auditor's Hurdle Rate</th>
<th>Explanation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current Ratio</td>
<td>3.71:1</td>
<td>minimum 1:1</td>
<td>Indication of company's ability to pay current liabilities</td>
</tr>
<tr>
<td>Debt to Equity</td>
<td>.55:1</td>
<td>3:1 or lower preferred</td>
<td>Indication of who is truly invested in the company, the owners or investors</td>
</tr>
<tr>
<td>Debt to Revenue</td>
<td>.23:1</td>
<td>Looking for consistency - Auditors state Raulli’s ratio has remained consistent for years</td>
<td>Upward trend indicates deteriorating financial condition.</td>
</tr>
<tr>
<td>Revenue to Equity</td>
<td>2.34:1</td>
<td>15:1 or lower</td>
<td>Higher ratio signifies a company that may not have enough capital to support operations</td>
</tr>
<tr>
<td>Revenue to Working Capital</td>
<td>2.79:1</td>
<td>30:1 or lower</td>
<td>Higher ratio indicates company is lacking in permanent working capital</td>
</tr>
<tr>
<td>Overhead to Equity</td>
<td>.26:1</td>
<td>1:1 or lower</td>
<td></td>
</tr>
<tr>
<td>Days Remaining Cash</td>
<td>93</td>
<td>14 to 21 is acceptable, higher is preferable</td>
<td></td>
</tr>
<tr>
<td>R-Score</td>
<td>0.46</td>
<td></td>
<td>The R-Score combines revenues, assets, liabilities, and net worth to determine a company’s financial risk. It is used by the owners and advisors of closely held construction companies.</td>
</tr>
</tbody>
</table>
EXHIBIT B: Determination of Capitalization Rate,

Comparing 2002 with the 2009 update

<table>
<thead>
<tr>
<th></th>
<th>2002</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>Risk-Free Rate</td>
<td>5.89%</td>
<td>4.10%</td>
</tr>
<tr>
<td>General Risk premium</td>
<td>7.40%</td>
<td>9.12%</td>
</tr>
<tr>
<td>Average Market Return at Valuation date</td>
<td>13.29%</td>
<td>13.22%</td>
</tr>
<tr>
<td>Increments for risk differentials</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Risk Premium for size</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Expected Micro-capitalization Equity Size Premium: The 10th Decile (Smallest Companies)</td>
<td>6.96%</td>
<td>5.81%</td>
</tr>
<tr>
<td>Company Specific Premium</td>
<td>1.00%</td>
<td>1.00%</td>
</tr>
<tr>
<td>Net Earnings Discount Rate</td>
<td>21.25%</td>
<td>20.03%</td>
</tr>
<tr>
<td>Average Growth Rate</td>
<td>5.00%</td>
<td>5.00%</td>
</tr>
<tr>
<td>Net Earnings Capitalization Rate for Next Year</td>
<td>16.25%</td>
<td>15.03%</td>
</tr>
<tr>
<td>$1 + g</td>
<td>105.00%</td>
<td>105.00%</td>
</tr>
<tr>
<td>Net Earnings Capitalization Rate for the Current Year</td>
<td>15.48%</td>
<td>14.31%</td>
</tr>
</tbody>
</table>
**EXHIBIT C: Raulli & Sons, Inc. Normalized Income**

<table>
<thead>
<tr>
<th>For Year Ended April 30,</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Income</td>
<td>307,411</td>
<td>1,192,869</td>
<td>641,378</td>
<td>2,470,593</td>
<td>6,339,176</td>
</tr>
<tr>
<td><strong>Adjustments</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Additions</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Property Taxes</td>
<td>39,583</td>
<td>39,794</td>
<td>41,048</td>
<td>40,955</td>
<td>111,513</td>
</tr>
<tr>
<td>Rent Paid for office and shop</td>
<td>252,000</td>
<td>252,000</td>
<td>252,000</td>
<td>252,000</td>
<td>252,000</td>
</tr>
<tr>
<td>Rent paid for warehouse</td>
<td>48,000</td>
<td>48,000</td>
<td>48,000</td>
<td>48,000</td>
<td>48,000</td>
</tr>
<tr>
<td>Dividend and Capital Gains</td>
<td>150,000</td>
<td>200,250</td>
<td>0</td>
<td>0</td>
<td>750,000</td>
</tr>
<tr>
<td><strong>Subtractions</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Rent at $3/sq ft</td>
<td>(54,708)</td>
<td>(54,708)</td>
<td>(54,708)</td>
<td>(54,708)</td>
<td>(54,708)</td>
</tr>
<tr>
<td><strong>Total Normalized Adjustments</strong></td>
<td>434,875</td>
<td>485,336</td>
<td>286,340</td>
<td>286,247</td>
<td>1,106,805</td>
</tr>
<tr>
<td>Less Income Taxes at 42%</td>
<td>(182,648)</td>
<td>(203,841)</td>
<td>(120,263)</td>
<td>(120,224)</td>
<td>(464,858)</td>
</tr>
<tr>
<td><strong>Adjustments, Net</strong></td>
<td>252,228</td>
<td>281,495</td>
<td>166,077</td>
<td>166,023</td>
<td>641,947</td>
</tr>
<tr>
<td><strong>Total Normalized Income</strong></td>
<td>559,639</td>
<td>1,474,364</td>
<td>807,455</td>
<td>2,636,616</td>
<td>6,981,123</td>
</tr>
</tbody>
</table>
EXHIBIT D: Sensitivity Analysis of Marketability Discount

<table>
<thead>
<tr>
<th>Discount Percentage</th>
<th>20%</th>
<th>25%</th>
<th>30%</th>
<th>35%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Discount Value</td>
<td>(5,033,001)</td>
<td>(6,291,251)</td>
<td>(7,549,501)</td>
<td>(8,807,751)</td>
</tr>
<tr>
<td>Resulting Business Valuation</td>
<td>20,132,003</td>
<td>18,873,753</td>
<td>17,615,503</td>
<td>16,357,252</td>
</tr>
</tbody>
</table>

EXHIBIT E: Capitalization of Earnings

<table>
<thead>
<tr>
<th>Years Ended April 30</th>
<th>Weight</th>
<th>Pre-tax Normalized Earnings</th>
<th>Weight x Earnings</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005</td>
<td>1</td>
<td>559,639</td>
<td>559,639</td>
</tr>
<tr>
<td>2006</td>
<td>2</td>
<td>1,474,364</td>
<td>2,948,728</td>
</tr>
<tr>
<td>2007</td>
<td>3</td>
<td>807,455</td>
<td>2,422,366</td>
</tr>
<tr>
<td>2008</td>
<td>4</td>
<td>2,636,616</td>
<td>10,546,465</td>
</tr>
<tr>
<td>2009</td>
<td>5</td>
<td>6,981,123</td>
<td>34,905,615</td>
</tr>
<tr>
<td>Totals</td>
<td>15</td>
<td>51,382,811</td>
<td></td>
</tr>
<tr>
<td>Divide by Weighted Years</td>
<td>15</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total Weighted Projected Earnings</td>
<td>3,425,521</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Divided by Cap Rate</td>
<td>14.31%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Value of Business Operations Before Excess Assets and Marketability Discount</td>
<td>23,930,784</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Additions of Excess Assets

Due from Related Entities | 4,346
Excess Working Capital | 1,229,874

Value of Business | 25,165,004
Marketability Discount at 25% | (6,291,251)

Adjusted Value of Business | 18,873,753
## EXHIBIT F: ESOP Set Up Costs

<table>
<thead>
<tr>
<th></th>
<th>Low estimate</th>
<th>Average</th>
<th>High estimate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lawyer</td>
<td>15,000</td>
<td>20,000</td>
<td>25,000</td>
</tr>
<tr>
<td>Feasibility</td>
<td>500</td>
<td>1,500</td>
<td>2,500</td>
</tr>
<tr>
<td>Initial Valuation</td>
<td>8,000</td>
<td>11,500</td>
<td>15,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>23,500</strong></td>
<td><strong>33,000</strong></td>
<td><strong>42,500</strong></td>
</tr>
<tr>
<td>Bank fees</td>
<td>0.50%</td>
<td>1.25%</td>
<td>2%</td>
</tr>
<tr>
<td><strong>ESOP Ongoing costs</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Subsequent valuations</td>
<td>4,000</td>
<td>5,750</td>
<td>7,500</td>
</tr>
<tr>
<td>Administration</td>
<td>2,500</td>
<td>5,250</td>
<td>8,000</td>
</tr>
</tbody>
</table>
Works Cited


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Malizia, E. (2010, February 9). Chair, Department of City and Regional Planning, UNC - Chapel Hill. (C. Raulli, Interviewer)


Raulli & Sons, Inc. (1981, August 5). Minutes of Special Joint Meeting of the Board of Directors and Shareholders. Syracuse, NY.

Raulli & Sons, Inc. (1988, November 23). Special Resolution of the Board of Directors of Raulli and Sons, Inc.


