

Time to Take a Fresh Look at ESOPs
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Recent changes in the oversight of contractors servicing the Federal government may have adverse effects on both the marketability and valuation of some of these entities. As a result, an exit strategy utilizing an Employee Stock Ownership Plan (ESOP) may be a way to avoid these adverse effects and allow the owner(s) of these businesses to achieve liquidity for their investment.

The Small Business Administration (SBA) recently issued its final rule dealing with the time at which size of a business is determined for the purposes of long-term Federal contracts. This rule, which goes into effect June 30, 2007, impacts several contracts and seeks to increase the contracting opportunities available for small businesses. Historically, some contract awards were for a time period of up to 20 years. Often, the company receiving these awards would outgrow its status as a small business during this time period yet continue to receive the benefits of the contract throughout its entire term.

In addition, in the event of a merger or acquisition under previous regulations, the acquiring company (regardless of size) was able to continue performance through the length of the contract and receive small business reporting credit for the remainder of the life of the contract. This often resulted in some of the nation's largest contractors providing services originally intended for qualified small businesses.

The new rule requires recertification of contractors after five years or 30 days after the closing of an acquisition. As a result, there is now greater uncertainty as to whether the agency granting the contract will terminate the contract upon notification that the contractor servicing the contract no longer qualifies as a small business. The impacts could be reduced valuation and marketability for businesses holding these types of contracts. In addition, it is likely that prospective purchasers of these type of businesses will conduct additional due diligence prior to consummating a transaction. Finally, the use of earnouts and holdback arrangements could become more prevalent.

Therefore, there could be further emphasis (and value) placed on certain qualities of potential target companies including:

- The number of employees at the target company having high-level security clearances;
- The success rate of the target company in winning both re-compete and bid and proposal opportunities;
- The strength of relationships with highly sought after agencies such as Homeland Security and the various intelligence agencies; and

- The overall uniqueness of the target company's skills and capabilities.

During the past few years, companies possessing these attributes were often achieving attractive valuation multiples from strategic buyers within the industry. The valuation delivered through an ESOP sale is viewed from a fair market value (hypothetical willing buyer and willing seller) point of view and generally fell below that which could be achieved through a strategic acquisition. However, given the potential impact of the new regulations on the valuation and marketability of certain contractors, the ESOP vehicle could become more attractive. The sale to an ESOP would not result in reducing the value of these small business set-aside contracts as they would not be subject to potential termination.

Given the success ESOPs have enjoyed within the government contracting arena (such as Science Applications International Corp. (SAIC) and Alion Science and Technology Corp. having successfully implemented an ESOP), now may be a time for the owners of government contractors to re-examine the use of these vehicles as an exit strategy.

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