Thinking Outside the Bud
Episode 426 - Darren Gleeman
https://www.thinkingoutsidethebud.com/podcast/cannabis-and-ownership-exploring-esop-strategies-with-darren-gleeman

EPISODE TRANSCRIPT

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Bruce Eckfeldt
Welcome, everyone. This is thinking outside the bud. I'm Bruce Eckfeldt. I'm your host. Our guest today is Darren gleeman. He is managing partner at MBO ventures. We've got an interesting conversation. Today we're going to talk about cannabis. We're going to talk about Aesop's. And that's employee stock ownership plan. For those that don't know the acronyms. Interesting kind of topic for today. This is coming up in cannabis more and more for a couple of different reasons. And Darren is going to kind of fill us in on why and why it's kind of an interesting option for cannabis companies. Why it's an interesting option for companies in general, but particularly cannabis, and really kind of figuring out where are we in the cannabis market? And how do these kinds of transactions happen? And why? So I'm excited for this, then with all that, welcome to the program.

Darren Gleeman
Thank you very much. I appreciate you inviting me to be here. Yeah.

Bruce Eckfeldt
So it's pleasure to have you on, before we dig into cannabis, and where you're finding kind of traction with Aesop's strategies in this space. Let's just understand what is an ESOP? How does it work? I'm sure many people listening to the program. I've kind of heard that term, but my guests probably have no idea what it actually means. So let's do some fab, some foundational work here. And then we can kind of get into what you're noticing in the cannabis market. Yeah.

Darren Gleeman
And interestingly, nobody knows what it is, you know, you'll talk to accountants, you'll talk to lawyers, everyone thinks they kind of know what it is, you know, most preconceived notions are it's some type of pension plan. Yeah. Yeah. You know, you don't need it. Everyone thinks they know. It's alright. Let's start the foundation. Yeah, it's not a pension plan. All right. And ESOP is just another way for a business owner to exit their company.

That's it, right? When you have a company, you can sell your company to a private equity firm, you can sell it to a strategic buyer, like a competitor, or which most people don't realize you can sell your company to your employees. Right. And when you sell to employees, you can use this structure. Of course, everyone, any business would love to sell to their employees, they would love it. But employees don't have any money.

Bruce Eckfeldt
They can't buy it, unless you paid them a lot of money. Exactly

Darren Gleeman
if they can't do it. Yeah. So bottom line is, it doesn't cost the employees anything to do this. Right is complete gift from the owner. And it's a gift from the IRS, because the IRS subsidizes the entire purchase, which is huge. So I like to do a comparison to explain what this thing is right? Again, it's a way to sell your company. Well, private equity, right? If I'm a private equity buyer, that's a financial buyer. How did they buy your company? And let's take an example I'd like to do to make it easy for everyone in the audience. Let's take a company that's making $20 million a year, and the value of that company is $100 million. Let's make it easy doesn't mean you can scale up or scale down. But let's make it easy, hundreds easy for people to see. Well, when private equity comes in. Here's the secret. I'm about to unload the secret for everybody in the audience about private equity. Okay, you ready? You've heard it here. Here it is. You're not getting $100 million from the private equity fund. That's not how it works.

The way it works is the private equity fund, plain vanilla, right? They're going to come out and they're going to give you from their own funds money, but $20 million 20 million. Then what they're going to do is they're going to lever up your company. They're going to let me and they're going to take a loan out of your company based on your assets or your cash flow. And this example is cash flow. If you're making $20 million a year, they are going to go to like JP Morgan, and JP Morgan is going to lend on $20 million a three times 20 60 million bucks. JP Morgan Olins 60 million off of the cash flow to the company. And then that 30 million, yeah, goes to the owner. So again, they get 20 million from the fund. That's the funds risk. Then 60 million they borrow from JPMorgan, which goes to the owner, that's 80 million. The last 20 million is what's called an urn out. And what that means is as long as you reach former owner, as long as you reach those multiples, you say you're gonna reach just hitting gonna grow by five 10% a year. Great, you're then gonna get paid that last $20 million.

If you don't reach those numbers, you're not getting paid that last 20 million. Yep. That is a typical plain vanila private equity deal with an ESOP. Again, I guess it doesn't cost the employees anything. It's structured, just like that private equity deal. But instead of having right instead of having a third party, a third private equity party coming in to lever up your company, the company leverages itself up. So what happens is it takes that same set $30 million that it was going to get from JP Morgan. It borrows it, the company borrows it and the rates will be a little bit better. And I'll tell you why.

They take that they borrow that same $60 million, which then goes to the honor 60 million. The other 40 million is called the seller note, which is an IOU from the company, back to the owner. Okay. That's how they get that 100 million dollars. Okay, a question that someone in the audience for most people at some point, they're gonna think Wait a second, JP Morgan is going to lend $60 million, and there's no equity. There's nothing tying them in. There's nothing locking them in. They usually need some equity. Yeah. Well, this is cool. Normally, anybody listening to this, Bruce, in any of the companies that you've ever owned anybody that has taken out a loan, there's interest, everyone could deduct interest when they find the taxes. But nobody, nobody can take a deduction of the loan itself. Yeah, the principal.

Yeah. You can't do that. That's just not the way it works. Except when the ESOP is acquiring the company. The company can take a full deduction of the entire principle of the law. So in this example, right is 60 million from JP Morgan, that's a loan 40 million seller note, that's a loan that's $100 million, the company can take a $100 million deduction. On day one, well, not on day one, they can take $100 million deduction. And theoretically, it could be in the first year, but most people don't do that. It's usually a deduction of $100 million is usually spread out over about four or five years. Okay, that's how it's done. But that 100 million dollars is huge. That's equivalent to the government writing a check, depending on your state have about 40 million bucks. Now, unfortunately, in the cannabis world, because of 280 E. We can't take any deductions. Yeah, exactly. So for cannabis, you can't take that subsidy. But it's pretty cool. And it doesn't matter if or cannabis, the way we've been structuring it. Okay, the idea of taking $100 million deduction is huge. That's how the employees in the normal industries pay for it. By that one deduction itself. Gosh, is is pretty insane. So

Bruce Eckfeldt
at that point, so the ESOP, then owns the company, the company has paid the owner for 100% of the equity. In this example, you don't miss example. So you don't have to you could owner could retain some amount of equity on this. That's the ESOP then owns the either all of or, you know, a significant majority portion of it. The then the employees, I guess, how do you set up like, who in your employees actually participates in this? Or I guess, what are the options in terms of what group of employees or type of employees participate in these

Darren Gleeman
forces? There's one additional thing? A couple different things. So I said, right, you sold 100% of this company for $100 million. Now, normally, if you sell your company for $100 million, and Bruce, this is great, because you've had companies that you've sold. So when you sold your company's unfair, unfortunately, you had to pay capital gains tax. Yeah, exactly. Which is, that's huge.

So if it's $100 million sale, depending on the state, you have to pay about $30 million in capital gains tax. Well, not if you sell it to your employees, if you sell it to your employees via the ESOP structure, those capital gains have deferred and if you structure correctly, is deferred forever. So that's a big advantage to selling to your employees, no capital gains, you get to defer. And like I said, you structured correctly deferred forever.

Bruce Eckfeldt
So there's no tax on that payout on that sale. If you

Darren Gleeman
structure correctly, yes, there's no capital gains tax on that, which is huge. And then the very last thing before I get into the employee question is if you do sell 100%, of the company to your employees, which is this is why the cannabis is super interesting. If you sell 100% of the company, to the employees, and for $100 million, so you get $100 million.

You The owner is not paying capital gains tax. Right? You the owner, also going to get something called warrants to buy back a little chunk of the company in the future. But the company itself, the company itself now pays zero federal tax, and zero state tax forever. No tax. So in the cannabis world, if you're paying no federal tax and no state tax, does it really make a difference? That you're not allowed to take deductions interesting. It doesn't matter. Yeah. Because deductions are all about paying,

Bruce Eckfeldt
setting, offsetting your tax.

Darren Gleeman
That's it. And if you pay no tax you don't need at all offset. So that's why in the cannabis space, we're getting so much traction, because the effective tax rate in the cannabis space, as, let's say right now is about 60%. Yeah, so a lot, right in the normal world, right? The normal world, the effective tax rate for businesses are, you know, 44 to 40 40% 45%? Yeah, so it's a lot more. It's great in any industry, but because of 280 II, that's where we get in our traction, because of that benefit.

So those are all those huge tax benefits to create our fundamental foundations we were talking about in the beginning. Now, your daddy question, which is, which employees are part of it? Yeah, well, this is called non discriminatory plan, which means everyone is part of it. You can't discriminate against any group, except you are allowed to give union employees the choice, you as an owner can say to your union employees, look, say in the union, that's awesome. But if you're gonna be in the union, you're not going to be an owner in this, you're not gonna be part of the ESOP. Or you can choose to be part of the ESOP. And now you have to leave the union. So you can make that choice. Or you can make the choice you can be in the union, Abby and ESOP, it's up to the initial owners when they set up the plan. So those are the only individuals that can be excluded. Other than that, everyone is part of the ESOP. And the way it works is purely based on math.

If you Bruce are making 100 grand a year, and I, Darren are going to be making 200 grand a year, then I am going to be able to receive twice as much stock in the company as you very, very simple in terms of how do you become vested? How do you actually become part of this? Well, the stock itself is allocated over, let's say, a 20 year period, and over a 20 year period, that means that every year 5% smore, stock is allocated to me as an individual to anybody 5% more stock. Yeah, so if I'm there, for five years, I've received five times five, it's 25% allocation of stock. And if I stay there another year, I get another 5%, another year, another 5%. So I am incented, to stay long, because the longer I stay, the more stock I receive. And then there's another thing, which is called vesting, because I can't be there for let's say, five months, and then expect to get the stock. Yeah, I have to vest into it. So vesting is usually over a five year period, and I vest probably about 20% a year, that's how much I'll be allowed to get. So after year one, I invest 20%, year to 40 6080 100%. Got it. That's how that works.

Bruce Eckfeldt
Got it. So I guess what kind of companies normally would do this listen to talk about non cannabis for a minute. Like, what types of situation and types of companies? You know, does the ESOP strategy work particularly well, like, give us a kind of a scenario?

Darren Gleeman
Yeah, the scenario is at let's say, who it's not good for, okay. Who it's not good for is anything that has a very high premium on the company like a for instance, right now, artificial intelligence is big. Yeah. So wherever you look, every single company is somehow doing artificial intelligence, because

Bruce Eckfeldt
it is everyone's on this podcast is AI driven. Exactly.

Darren Gleeman
And that's because if you're AI driven, you're gonna get a little bit more money for the value of your company. Yeah. So that is not good. Because these companies that are artificial intelligence and robotics, they can get multiples of 3040 times your net income, which is crazy, but those are the multiples that you're going to get for an ESOP, the multiples for the valuation of your company are going to be the normal multiples in that normal industry. So for instance, manufacturing, a multiple for manufacturing might be five times your net income. So if you're making $5 million a year, the company will be valued around say, 25. Nine, a staffing firm is great. Let's say that multiple is a multiple of nine.

So there, if you're making, you know, $10 million a year in income, then 10 times nine is 90 million will be your valuation. So anything that you see around you are usually great. Aesop's medical companies, yeah, door manufacturers, landscaping companies. I have automotive manufacturing companies. We have hot tub manufacturers. We have retail chains of restaurants. It really is for the, you know, I would say like a hard asset that you look around you. That's really what it's great for. Got it. And the reason why actually more of these, Aesop's don't exist, and there's very few Aesop's is about I think it's about six See 500 in the entire country? Oh, that's amazing. Yeah. Yeah, not many at all that 230 240 A year take place. The sole reason people don't know about you, I was just gonna say,

Bruce Eckfeldt
like, I didn't know that much about it. And it also seems a little How do I say, like, you kind of have to want to do this, you'd have to kind of this would have to have some kind of desirability to want to do this differently. Because it's so much pressure to do a normal, either a private equity round, or you know, do a strategic sale. Right. Those are the obvious ones. And there's so much industry around doing this. It feels like it cuts out a whole bunch of people that make a lot of money doing the other ways. Yeah, you

Darren Gleeman
hit the nail on the head. I mean, the entire ecosystem of our country, the financial ecosystem, is built towards what you just said. It's built towards private equity, and towards, you know, strategic buyers, acquiring companies, not Aesop's. The biggest issue that we have, is not that people don't want to do it. Of course they want to do it is better. The problem is they don't know that it exists. Yeah. They don't know it exists. I mean, think about it. You have a company that examples $20 million manufacturing firm or cannabis firm $20 million cannabis firm EBIT da valued at $100 million. Well, if you sell to private equity for 100 million bucks first you got to pay your capital gains.

Yeah, you are going to end up firing probably 20% of your staff, C suite, they're gone because the C suite, right. And then buy buy with an ESOP, you're selling it for the 100 million dollars, you don't pay your capital gains tax, you're staying in, you're not leaving that throwing you away. The the magic team stays in the owners have just sold it they're in, they sell it, they're still there, they get warrants to buy back a chunk in the future.

The company runs completely tax free forever, until the next exit. Now let's say the next exit in this cannabis company is in 2032, federal legalization occurs. And now Budweiser comes in to buy your chain for a billion dollars. All right, great. Budweiser comes in. we terminate the ESOP. All right, terminate the ESOP. You hand in the warrants, the owners hand in the wallet, say those warrants are for let's just use a random number 20%. Hand in those warrants, you get back 20% of the equity, the billion dollars comes in you as the former owners, right, the warrants get 200 million, and the employees get $800 million, which goes into their retirement accounts. And they do not pay tax on that until they actually take it out. Yeah. It's a win win win across the board. Yeah. And it does sound too good to be true. But you know, it's not it's just government subsidies. Is the government gone? Right?

Bruce Eckfeldt
So why is the government making this advantageous? Like what's in it for the government? Why did they like it? So

Darren Gleeman
back in the 50s, there was a lot of conversations about capitalism versus communism. And this guy that Louis Kelso one of the first private equity guys came up with the capitalist manifesto. And he talked about what it's gonna take to make capitalism work. And he said, Look, we have a lot of workers in the United States line workers assembly guys, well, they're never going to really, really do what's really have the American dream. In order to get the American dream. We need them to become owners. Well, why would anybody sell to these employees? What's going to drive you, Bruce, you want a business? What's going to drive you to sell to your employees versus sell to a private equity firm?

Yeah, well, it's gonna come down to the bottom line. And so he came up with this idea of the ESOP structure. And then back in the 1973, it was codified, and there happened to be a bill that was sitting there, ERISA, that was the bill, and so they stuck it in the ERISA bill. They literally stuck it in centers along was the head of the Senate stuck it in that bill. And that's how it became this E sub structure. And then over the years, they kept on giving more and more incentives. And the biggest incentive, which is for cannabis, is in 1998. Congress said, let's come up with a way that these companies that are owned by the employees pay zero tax, so they created a bill. And then President Clinton signed into law in 1998, which became a completely 100% tax free company, again, that people do not know any of this. Yeah.

Bruce Eckfeldt
So tell me a little bit about the actual sort of ESOP structure. So when we say the employees on the company, like, what is the actual ESOP? Is this an entity is this I mean, how does an individual employee actually have the ownership and you mentioned vesting schedules you'd invest? You know, you mentioned kind of earn outs on these things. Like what is mechanically? What are the actual entities? And how do things work?

Darren Gleeman
Yeah, mechanically, it's structured as this thing was created called an employee stock ownership trust, okay. And that was empowered with a lot of things, which is that trust, pays no taxes, the pays no federal taxes, no state taxes is the actual entity itself. It's an employee stock ownership Trust, the employees are beneficiaries of this trust. So the stock is actually owned by that one entity, the employees like ownership trust, that the employees are beneficiaries. So every year, as the employees stay in the company, they find out there's a

record keeping of how much stock they're entitled to, let's call it entitled to music, air quotes, the distrust, so they never actually get stock itself.

And this is how we keep it a tax free entity, if they had the stock, and they'd have to pay tax on it. Because you're keeping it in this trust, no tax is ever paid. It's a record line item that they know that they have the equivalent of, let's say, 1000 shares of stock. So now let's say they're in the company, and they have 1000 shares of stock, and they it's retirement time, and now they're 65, they retire every year with an ESOP, there's a valuation of the company, the company goes, well, valuation gets better, the company doesn't do well, the valuation doesn't do as well. So, and the employees understand this takes a couple of years, but they get this, they're owners, they really are owners.

So understanding that this huge benefit is waiting for them, they actually do they become a lot more productive, and ease up on company is actually much more productive than a private equity owned company. So they want to retire, they figure out their amount at the end of the 65,000 shares for them is equivalent to let's say, it's $100,000. When they retire, the company has like, if it's at 65, they have you know, a certain amount of time to pay them out that $100,000 And they get paid out that money then goes into their retirement accounts.

And let's say it's 100 grand. Like I said, they do not have to pay any tax on that until they take it out of their retirement accounts. Interesting. Yeah. Now with cannabis, that is not how I see the exits happening with candidates I see not waiting for retirement, I think everyone is looking at federal legalization. Because that is when there should be a an expansion of the multiple of these companies. Meaning that today the company has a valuation of 20 million to 500 million, when federal legalization occurs that multiple might be 10. Everyone is waiting for that. And then there's a lot more money floating around to buy companies. So at that point, yeah, when this happens, they will actually employees and the owners will sell because they're actually working together with this. So when the company sells, they will get their money right away along with the owners got it via those warrants.

Bruce Eckfeldt
So it because of the way it's set up, there's going to end the fact that we're kind of waiting to vids federal legalization and really kind of change for the industry, this becomes an interesting kind of, it's almost like a holding pattern. It's like, hey, we can do this now. And then when we get federal legalization and we can really kind of do a different deal or we can realize the true value of the company. And yeah,

Darren Gleeman
and so why not waiting till federal legalization, why not structured this way and pay, you know, get an exit today. Yeah, pay zero tax for as long as you want until your real exit of the second exit down the road. And now everyone, everyone does well, and the employees it can be it's life changing for them. This is the ESOP structure, right, which is interesting, you know, who really loves Aesop's? Bernie Sanders. He's a huge lover of it because of what it does for you know, the employees. It's amazing. And on the other side, who also loves Aesop's, Mr. McConnell. Oh, was because of all of the business advantages that they have.

Bruce Eckfeldt
I see. We just kept getting that pure business advantage and purely taxable.

Darren Gleeman
Yeah, exactly. I mean, they both love it.

Bruce Eckfeldt
But for really different reasons, for totally different reasons. Because Mitch

Darren Gleeman
McConnell is in the belief, you know, that, look, you can have all these tax advantages to these companies. They can really grow, expand and hire more employees. Yeah, that's what he loves it and then you'll see economy. No, yeah. There's nothing better in terms of tax advantages and Aesop's. Yeah, it's pretty phenomenal. It works. It definitely works.

Bruce Eckfeldt
So you mentioned that, you know, the reason people don't do this is they don't know about it, right? Like, what do people need to know? Or like, what's the thinking process or kind of assessment process that you suggest, you know, companies go through when kind of trying to make a decision or thinking if this is the right strategy for them?

Darren Gleeman
Oh, yeah. They never get to the point of actually thinking that this is a strategy for them. They don't know that's the strategy. If you go to an investment banking firm To sell the company, they're gonna go out and pitch it to, you know, four or five different private equity firms, maybe, you know, five or six strategic buyers. And that's how it works. They're not going to tell the business owner. Oh, by the way, there's another structure here called an ESOP, which is much better, because number one, they're not going to make the fees. Yeah, exactly. Yeah. And number two, they don't know about anyway. Yeah. They just don't know about it.

Bruce Eckfeldt
It's not like they know all about it. And they don't recommend it. They don't even know about it. Yeah, so that

Darren Gleeman
really is if I, whenever I'm able to speak to business owners, and explain this to them. It's a whole different world. Because now it's like, Oh, my God, this sounds too good to be true. I know, explains it correctly. And then they say, how do they never know about this? Well, and that, you know, that's just it. Just people just don't know about it. Yeah. Fascinating. That is it?

Bruce Eckfeldt
Is there any, any good case studies or examples that you can give in cannabis that, you know, either either specifically or you can anonymize them for us. But what like what's actually happened in this space so far? Yeah.

Darren Gleeman
So as of December 1, All this took me in the cannabis space, it's taken me two years of pleading, begging, talking with every accounting firm, every law firm that I could speak to. Now, again, like I said, they have no

idea that this exists. Now, even these larger law firms that have ERISA departments, they still don't talk to each other. So it's not like they know what's going on. So for me, it's taken so long to actually explain this. And the first thing was, this sounds too good to be true. I don't know if it's true. But I have spoken to, sometimes in these law firms, I've had to go through 10 levels of literally 10 levels, to them to finally say, Oh, my God, this actually does work. This is real. There's still accounting firms out there that still scratching their heads, they're like, I don't know. Like, really, it just sounds too good. So here's some, we actually closed three deals in December.

And we will be closing another deal within the next probably, I think, hopefully, like five days. And we have about six more that will be closing by the end of this year. So I'll give you an example of one company. It's a an MSO, let's say an operator cannabis company vertically integrated. They're doing you know, EBIT dies about anywhere else getting between 10 million and $20 million EBIT, da, super, super smart owners, great C suite. And they really care about their employees. They're very, very employee focused, focused. Through counting firm, they gave me the introduction, we explain what it was.

They were blown away. We had a series with these guys, probably six, seven meetings, very smart. They were digging into every single aspect of it. And what was great is they really did want to do it was phenomenal for the employees and they wanted the tax benefits. So it took us about the entire process for them was about seven, eight months. They are now a completely 100% tax free entity. It worked. No luck. Good. We're waiting for that. Well, they are they are a completely tax free entity. The employees are so far, loving it. Everything I just said to you before is actually taken root is actually it's a it's real company. That worked. Of course it's gonna work. Yeah.

Bruce Eckfeldt
Fascinating. And if people want to find out more about you more about the process and how this works, what's the best way to get that information?

Darren Gleeman
So my name is Darren gleeman. go to LinkedIn, you can link in with me there. You can email me. So my email is D gleeman. D GL e ma n at MBO ventures.com. MBO is management buyout, MBO ventures VNTR, yes.com.

Bruce Eckfeldt
Perfect, I'll make sure all the the links and everything are in the show notes so people can get that awesome there and it's been a pleasure. Thank you so much for taking the time today. Thanks, Bruce. I appreciate it.

About Eckfeldt & Associates

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