Employee Ownership: A Proven Strategy for Retaining Businesses, Jobs, and Communities

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DRIVING GROWTH
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Let’s take a look at some data

- Small businesses employed 56.8 million people, or the equivalent of 48% of the private workplace in 2013.
- In the first three fiscal quarters of 2014, small businesses added 1.4 million new jobs—39% of which were from very small businesses (with fewer than 50 employees).
- Small business accounts for 63% of net new jobs in the United States.

https://www.fundera.com/blog/what-percentage-of-small-businesses-fail

Let’s take a look at some data

- 20% of small businesses fail in their first year, 30% of small business fail in their second year, and 50% of small businesses fail after five years in business. Finally, 70% of small business owners fail in their 10th year in business.

https://www.fundera.com/blog/what-percentage-of-small-businesses-fail

Let’s take a look at some data

- 42% of small businesses fail because there’s no market need for their services or products.
- 29% failed because they ran out of cash.
- 23% failed because they didn’t have the right team running the business.
- 19% were outcompeted.

https://www.fundera.com/blog/what-percentage-of-small-businesses-fail

Let’s take a look at some data

- 18% failed because of pricing and cost issues.
- 17% failed because of a poor product offering.
- 17% failed because they lacked a business model.
- 14% failed because of poor marketing.
- 14% failed because they ignored their customers.

https://www.fundera.com/blog/what-percentage-of-small-businesses-fail

What should we take from this data?

What should we take from this data?

Existing, and successful, businesses have (for the most part) solved these major existential business issues

Family-Owned and Closely-Held Businesses

- 30 to 40 Years Ago
  - 30% made it to 2nd Generation &
  - 15% made it to the 3rd Generation
  - Transfers to family members (children) very common
- Today
  - 15% make it to the 2nd Generation &
  - 5% make it to the 3rd Generation
  - **Transfers to family members/children less common now than in past**

A Changing Business Landscape

- During the next 15 years close to 80 million baby boomers will be retiring – 10,000 per day!
- About 50% of small businesses are owned by Baby Boomers
- More than 70 percent of privately owned businesses will be changing hands within the next two decades.

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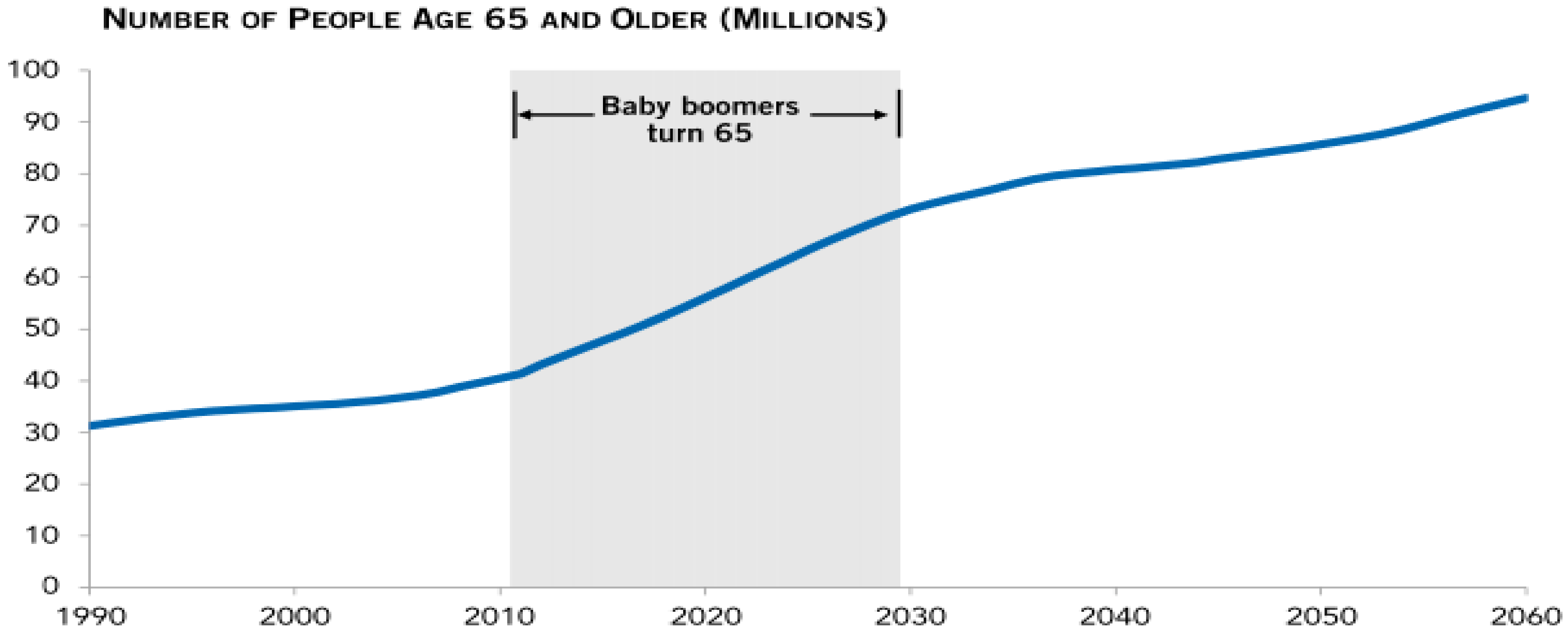
The aging of the Baby Boom Generation will boost the number of Americans age 65 and older



SOURCE: U.S. Census Bureau, *National Intercensal Estimates; 2016 Population Estimates*, June 2017; and *2017 National Population Projections*, September 2018. Compiled by PGPF.
NOTE: The highlighted period represents the time span between the years when the oldest and when the youngest of the baby boom generation turn age 65.

Family-Owned and Closely-Held Businesses

60% to 70% don't have succession plans

Potential outcomes when proper succession planning does not occur

- Business my be sold for less than optimal value
- Family could lose investment
- Business may shutdown
- Employees lose jobs
- Communities loses tax base
- Quality of life and services suffer
- Domino effect

Three Area Examples

- The OEOC used US Census data to collect information on businesses and business owners. Using this data, as well as other statistics on business owners and the lack of their preparation for "exiting" their business, we were able to estimate the potential companies, jobs, and economic activity at risk for three communities in Ohio….

Three Area Examples

- Methodology
  - Owners 55 years of age and older
  - 5-100 employees,
  - Sales of $500,000 or more,
  - And assumes that 50% of boomer businesses that fit these specifications will successfully transfer – probably a bit optimistic

Three Area Examples

- Methodology Explanation
  - Can sometimes be arbitrary and subject to the breakdown/categories of available data
  - 55 years old is a good time to start succession planning, assuming normal retirement age of 65
  - Larger companies tend to have access to resources and advisory services that make it harder to NOT do proper planning
  - Many businesses, especially the smaller ones, probably do not have a viable succession option

Coshocton/Coshocton County

- Estimated Population – 37,000
- Boomer Businesses- 239
- Number of businesses at risk of closure – 33
- Number of jobs at risk – 327
- Potential payroll loss - $12.5 Million

Youngstown/Mahoning County

- Estimated Population - 230,000
- Boomer businesses* – 2,102
- Number of businesses at risk of closure^ – 224
- Number of jobs at risk – 4,598
- Potential payroll loss - $83 million

Columbus/Franklin County

- Estimated Population - 1.3 million
- Boomer Businesses* – 8,507
- Number of businesses at risk of closure^ – 828
- Number of jobs at risk – 27,350
- Potential payroll loss - $950 Million

Sale to an Outside Buyer

- Can be lucrative for the seller - can also be rarer, unless the business is in a highly sought after market or industry
- Can also result in business dislocation, or even business closure, depending on what the needs or wants from the business

Sale to Family

- Was, and to a lesser degree still is, a viable option for a seller
- Usually results in business staying in community
- Is becoming a much less likely option

Sale to Employees

- Can be appealing to many selling owners, especially those without other options
- Helps root company in community
- Can result in much better economic outcomes for business and employees, and by extension the community – more on that in a bit…

What is an ESOP?

Shareholder Liquidity & Ownership Transition Alternative

Retirement Plan

- An ESOP is a qualified "defined contribution" retirement plan
- ESOPs are unique from other qualified plans in that an ESOP has the ability to borrow money to acquire stock
- ESOPs are designed to be primarily invested in Company stock
  - These combined elements create a mechanism for transferring ownership to employees

Employee Benefit Plan

- **Long-Term Retirement Benefit**
- **Performance-Enhancing Incentive**
- **Reward Employees**

★★★

Congress enacted ERISA in 1974 enabling ESOPs as a way to make U.S. businesses more competitive

Tax Advantaged Vehicle

- **Company Tax Benefits**
- **Seller Tax Benefits**

★★★

The Internal Revenue Code has been amended several times since 1974 targeted to incentivize use of ESOPs

What is an ESOP?

Liquidity	Ownership Transition	Tax Benefits	Employee Benefits
▪ Seller can sell up to 100% of Company ▪ Seller can receive full fair market value ▪ ESOP transactions can create opportunities for tax efficient estate planning and wealth transfer strategies	▪ ESOP is friendly buyer ▪ Preserve **legacy**, protect and perpetuate Company's **culture** ▪ Seller 'may' participate in ESOP ▪ Seller 'may' retain operational and/ or board control of Company	**Shareholder:** ▪ Seller 'may' be eligible to **defer** or **eliminate** capital gains tax on the sale of stock to an ESOP (IRC Section 1042) **Company:** ▪ Purchase price is deductible over time ▪ 100% S Corp ESOP **may pay no income taxes** ▪ Enhanced cash flow available to repay transaction debt and finance growth	▪ Jobs! ▪ Employees **obtain ownership** and can build significant retirement benefits on a tax-deferred basis ▪ Motivation / Job Satisfaction ▪ Key employees may participate in additional equity-based incentive plans ▪ ESOP does not give employees rights to confidential information.

Tax Incentives

- Contributions to an ESOP are tax deductible, including contributions used to pay interest and principal
- C Corporation dividends on employer stock can (in certain circumstances) be deductible
- S corporations can avoid income taxes on shares owned by an ESOP
- The tax exemption for S Corporations significantly increases the ability of the Company to meet the debt obligations

Summary of Benefits - Employees

- Company remains in existence and in the same location, so employees keep their jobs
- An ESOP rewards employees who have promoted the employer's success
- Research shows that employees of ESOP companies have better benefits and pay than employees of comparable non-ESOP companies
- Tax savings significantly increase the value of the benefits through income distributions or increase in value of the stock

Summary of Benefits - Company

- Advantages to Selling Shareholder
  - Liquidity with control
  - Flexibility in sale (percentage and timing)
  - Maintain confidentiality during sale
  - Lack of marketability and minority interest discounts under an ESOP are less than in traditional transactions
  - Preserves legacy/jobs
  - Seller often may participate in the ESOP
  - Key Tax Benefit #1: Potential deferral of capital gains tax

ESOP Companies Perform

- According to the 2012 General Social Survey (GSS), employees in the U.S. who had employee stock ownership were four times less likely to be laid off during the Great Recession than employees without employee stock ownership*
- https://www.esopassociation.org/explore/employee-ownership-news/resources-for-reporters#statistics

ESOP Companies Perform

- Updated GSS figures released in June 2015, found that 1.3% of employees with employee stock ownership, which includes the ESOP model and other forms of employee ownership, said that they were laid off in the last year compared to a 9.5% rate for employees without employee stock ownership.

https://www.esopassociation.org/explore/employee-ownership-news/resources-for-reporters#statistics

ESOP Companies Perform

- "…firms offering [an] ESOP significantly outperform firms not offering ESOPs. Further, on average, as ESOP participation increases within organizations, so too does firm profitability."
- "A 2018 survey of S corporation ESOPs … reports that ESOP participants represented in this survey have more than twice the average total retirement balance of Americans nationally and that those making less than $26,000 a year also have on average more than double the retirement savings compared to similar workers nationally."
- "A 2017 report … compared workers early in their careers, ages 28 to 34, with employee ownership to their peers without and found being in an ESOP associated with 92% higher median household net wealth, 33% higher median income from wages, and 53% longer median job tenure."

- https://www.nceo.org/employee-ownership-data/academic-research

ESOP Candidates

- Owner may want to continue working but wants liquidity
- Owner desires or is comfortable with employee ownership
- Management or family can't buy or owner has no desire to sell to them
- Owner not interested in outside buyer due to culture/legacy/employees or none exists
- Tax-benefits of ESOP increase value above an outside buyer
- Creates a buyer where none may exist
- Lack of strategic buyers

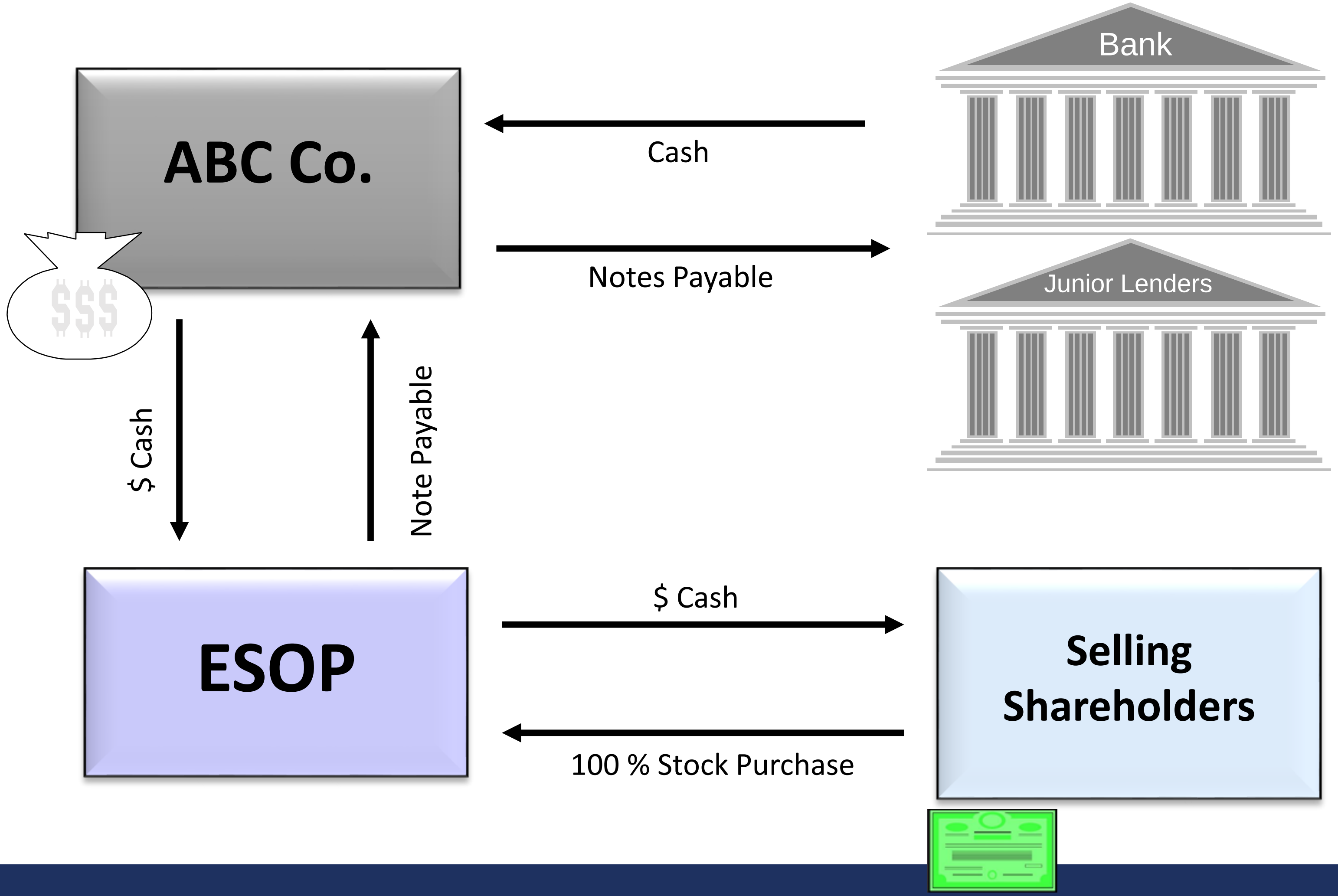
ESOP Candidates

- Desire for certainty of closing a transaction
- Multiple heirs – some in business, some not
- Contentious shareholders or external ownership of stock is difficult to manage
- Good management but they no ability or desire to put skin in the game
- Been down the path of a sale without favorable results

ESOP Candidates

- Desire for quick transaction (2-6 months)
- A history of sustainable profits
- Currently making contributions to a qualified retirement plan
- Desire for or currently have good internal controls and strong corporate governance
- Desire to reduce cost of capital

Leveraged ESOP: 100%



Results

- Advantages
  - More capital provides for larger transactions and may speed up ownership transition
  - Transaction may immediately qualify for tax deferral
  - Eliminate federal and, perhaps, state corporate income taxes
  - Employees accumulate larger share accounts
- Limitations
  - Fixed charge for debt repayment reduces cash flow for other corporate purposes
  - Financial risk for borrowing in a market downturn
  - Overleveraging with the “wrong” debt

Employee Cooperatives

- Unlike an ESOP, an Employee Cooperative is a type of corporate entity
- Has similarities to Partnerships, S-Corporations, C-Corporations, and LLCs, but is different than all of them!
- Instead of shareholders, an Employee Cooperative has members
- Every member must be an employee, but not every employee needs to be a member
- Members vote for Board (one member one vote) and (usually) a majority of Board must be members

Employee Cooperatives

- Useful for those companies who want or appreciate the governance difference
- Useful for those companies too small to set up an ESOP
- Also anchors businesses in their communities
- Provides greater wealth accumulation for employees

Employee Cooperatives

- Advantages
  - Provides similar tax advantage to selling owner
  - Provides similar benefits to employee owners
  - Cheaper to setup and maintain without the ESOP regulatory burden
- Limitations
  - Governance is sometimes more complex, or at least different
  - Requires a culture change that is optional for ESOPs
  - Employees are taxed annually for their share of the yearly profits

Employee Cooperatives

- Has an interesting set of tax rules that require specialized expertise
- Perceptions can be attractive, and not so much, for a selling owner
- Different terminology for similar concepts

How can we combat the problem?

- A structured, and local, approach to the problem
- Do you know the scope of the issue in your area or region?
- When you contact your local businesses, or when they contact you, do you ask about the status of the owner's succession plan?
- Are SBDCs, Chambers, and Economic Development professionals aware of the employee ownership option, and how it works?

Understanding the Scope - Example

- There is a strong correlation between businesses that were started 25+ years ago have owners 65+ years old
- On average, these businesses employee 17 percent of the workforce
- The ratio of small business closures to business sales among independent firms operating for more than 25 years was 9 to 1
- **How many of these businesses are in your community?**

Source: https://www.capitalimpact.org/worker-co-op-conversion-potent-tool-economic-empowerment/

Capital Impact Partners, ICA Group, Citibank Study

How can we combat the problem?

- Resources
  - State employee ownership centers
    - Ohio, Indiana, Michigan, Vermont, Colorado, California, Pennsylvania, Massachusetts, others
  - National
    - The ESOP Association, National Center for Employee Ownership
  - Business Advisory Community

Questions?