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Mature Employee Stock Ownership Plans Are Innovating When Balancing the Crossroads of Past and Future Success

By Jeff Buettner

In this article, the author explains that more today than in prior years, mature Employee Stock Ownership Plan-owned companies are more regularly marrying the sophisticated tools of the broader corporate finance world within the ESOP structure.

As a result of the steady progression of privately held businesses transitioning ownership to an Employee Stock Ownership Plan (ESOP) over the past 20 years, there are more companies than ever that have been ESOP owned for over 10 years. At this stage of maturity, ESOP-owned companies face a set of challenges unique to the structure.

EMPLOYEE EVOLUTION AND THE PARTICIPATION EXPERIENCE

Many ESOP-owned companies have evolved considerably over the past decade or more. Whether it is the competitive landscape,

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demographics of the workforce, members of executive leadership, or operating lines of business, things likely look different today than they did at the onset of ESOP ownership. For some companies, the evolution involves the aging of a leadership team and an employee base who need to be replaced with next generation talent. For other companies, the evolution may be that the growth of the business is coming from a larger contribution from newer rather than tenured or international rather than domestic employees.

For companies that have been ESOP owned for over 10 years, the ownership experience may vary demographically across the broader employee base, creating a set of circumstances unique to the structure. It is not uncommon for these mature ESOP companies to find themselves in a situation where the captivation of participating in the ESOP can vary widely between employee cohorts. This is often the case when the evolution of the employee base results in a misalignment of perceived rewards with perceived contributions.

Traditional share administrative strategies have often been the common tool to address differences in employee experiences. These strategies may result in a situation in which benefit levels not only deviate from original intentions but also deviate from the amount considered optimal to support the business model and corporate strategy.

Properly aligning incentives and award allocations can support recruiting and retention efforts, while also ensuring benefit levels are consistent with target levels. Inherently, the ESOP structure has limitations on eligibility and award allocation that creates a unique challenge of aligning award with merit. Consequently, many companies seek ways outside the ESOP to address the differences in employee experience that exist inside the ESOP. Commonly used strategies often create another near-term liability that needs to be supported alongside other demands for capital. Today, there are more contemporary methods that an ESOP-owned business can consider if it is willing to contemplate a modified structure.

THE EVOLVING NEED FOR CAPITAL

In any ownership structure, businesses evolve over time. Companies adopt modified philosophies on manufacturing and the placement of factories given supply chain dynamics, as well as the availability and location of labor with the goal of adapting to evolving forces. New business lines require new leaders and employees, and there is an ongoing need for employees due to turnover and retirement at both senior levels and across the broader employee base.

ESOP-owned companies are not immune to these dynamics and face a unique structural element in repurchase obligation. Simply, this is the requirement that the company repurchase shares held by departing participants. As many leaders and employees of mature ESOP-owned companies can attest, the corporate tax exemption afforded to ESOP-owned companies paired with an employee base motivated to increase corporate value over time can result in creating wealth for ESOP participants that far exceeds what could be realized in other traditional retirement plans. For ESOP-owned companies that have grown for over a decade, the account values of long-tenured employees can be sizable. Capital will be needed to fund these share repurchases as they come due.

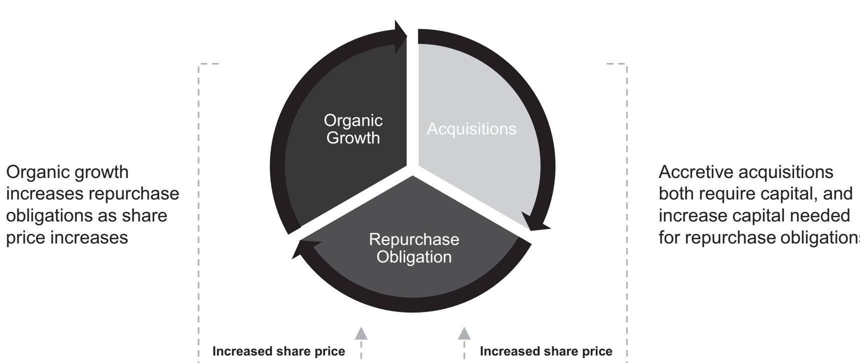
Businesses will continue to be forced to adapt to changes in the competitive landscape, shifting consumer behaviors, and technological innovation. Capital will be needed to support a company's response to these forces, and its desired growth initiatives. As the effects are realized in share value, the liability of the shares repurchased by the company will come due at a higher price.

Further, today an increasing number of mature ESOP-owned companies are including acquisition strategies alongside organic growth strategies. Capital will be needed to fund identified acquisitions. The integration of an acquired business and the realization of cost and revenue synergies from the acquisition can have both immediate and longer-term positive effects on value. As these effects are realized in share value, the number of shares repurchased by the company will come due at a higher price. Further, the acquisition will bring with it more employees and consequently more participants in the ESOP.

Growth from the successful achievement of organic initiatives coupled with incremental value from acquisitions can amplify the growth trajectory of the company and directly impact future repurchase obligations. Figure 1 illustrates this interrelationship.

The convergence of capital demands from past success with capital demands for future growth initiatives creates a unique demand for

Figure 1



capital that non-ESOP-owned competitors do not similarly face. The challenge for ESOP-owned companies as it pertains to this facet of the structure is both funding the liability as well as ensuring the capital needed to fund the liability does not constrain capital needed to fund other future growth initiatives or to respond to competitive forces.

When repurchase obligations take precedence, available capital is allocated away from productive uses. If the company is unable to access capital in excess of that needed for repurchase obligations, corporate growth initiatives, modernization plans, strategies to respond to competitive forces, or acquisitions, it will likely suffer and consequently place a governor on share value. If mature ESOP-owned companies reach this point, it can lead to questions around the viability of sustaining the ESOP structure. When that arises, a common belief is that the only way to access capital to fund growth is to sell the business and terminate the ESOP in order to relieve the company from its share repurchase liability. Fortunately, other options are available.

CAPITAL PROVIDER EVOLUTION

Traditionally, available capital centered around the regulated banks. In this universe, capital availability starts with a company's balance sheet and collateral, the amount of which may be inherently limited depending on the business.

Since the early 2000s, financial liquidity has increased. Today, capital is abundant. Regulated banks are no longer the only source of funds. The proliferation of the non-bank market has long provided non-ESOP-owned businesses with a larger universe of capital providers. Over time, the non-bank market has not only expanded their investment mandates and ability to offer flexibility in structuring, but also their areas of focus. It is only recently that their areas of focus have expanded to include capital for ESOP-owned businesses. In the past, structural limitations and administrative policies common to traditional ESOP ownership structures impeded the ability of an ESOP-owned company to gain access to this broader universe of capital providers and the flexible financing structures they can provide. Today, mature ESOP-owned companies are seeking ways to gain access to this flexible capital and are willing to modify their structure for that access. The ability of an ESOP-owned company to access this broader universe of flexible capital can help balance the capital utilized for repurchase obligation with capital utilized for other corporate initiatives, including acquisitions. Accessing a wider universe of capital providers gives the ESOP-owned company flexibility to determine the appropriate source of capital for the desired use of capital.

INNOVATIONS IN MATURE ESOPS

Today, many mature ESOP companies are coming to realize that the best course for ensuring that the ESOP structure can continue to support growth initiatives and meet repurchase obligation liabilities is to not manage the structure to the status quo. ESOP ownership does not have to be all or nothing, and ESOP-owned companies do not have to sell the company to be relieved of repurchase obligations and gain access to capital for future growth initiatives. Non-bank capital providers are investing alongside ESOP ownership. Ownership structures are evolving. Growth capital providers are partnering alongside the ESOP as a shareholder and ESOP-owned companies are altering their corporate legal structure to accommodate. Modified structures may require an understanding of corporate tax implications and revisiting various corporate tax minimization strategies not previously needed to be considered in the traditional S Corporation ESOP structure.

For mature ESOP companies that have a desire to be acquisitive, the ability to use stock as a form of acquisition currency provides the acquiring ESOP company with the ability to increase its purchasing power over and above that of the borrowing capacity based solely on its balance sheet. With the increased number of buyers of businesses in today's marketplace, this ability can make the mature ESOP business more competitive with other buyers of businesses and aid success in a competitive bid process.

Companies can be employee owned without being solely ESOP owned. Direct employee ownership outside of the ESOP can help with perceptions of inequality inside the ESOP, align reward with contributions, provide an incentive for both newer employees lacking meaningful ESOP participation and international employees not eligible for participation. Share buyback strategies can be employed to minimize corporate liabilities.

Similar to how market transformation requires company leadership to rethink approaches to business models, competitive strategy, corporate purpose, and metrics of success, the evolution of the business, its employees, and the capital markets necessitate revisiting the appropriateness of a mature ESOP company's existing capital and ownership structure to ensure it supports rather than inhibits business strategies for the next decade. More today than in prior years, mature ESOP-owned companies are more regularly marrying the sophisticated tools of the broader corporate finance world within the ESOP structure.

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