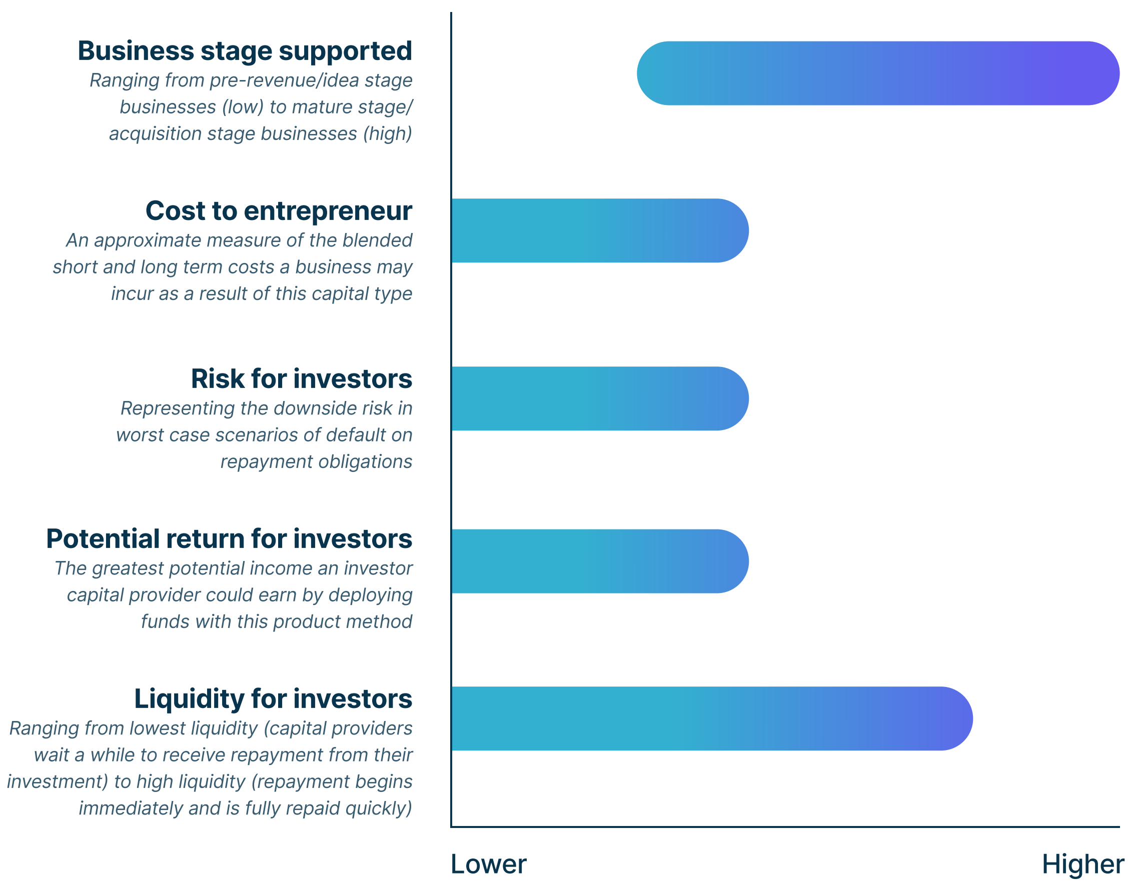
Employee Ownership

TL;DR

Employee ownership financing allows owners to sell their businesses and workers to become owners.



What is employee ownership?

Employee ownership financing is equity or debt capital that supports businesses transitioning to employee ownership. Employee ownership provides owners an exit pathway, working capital to businesses to rebuild post-COVID, and workers access to business ownership.

Employee ownership models have been around for decades and can help rebuild a more equitable and resilient economy. They can shift ownership to workers of color and transition to diverse leadership to close the racial wealth gap. Employee-owned businesses are an overlooked and tiny segment of the US with only 6K Employee Stock Ownership Plan (ESOP) businesses, 460 worker-owned cooperatives (co-ops), and Employee Ownership Trusts (EOTs). Employee-owned businesses have higher productivity, more committed workers, less firings, wealth that stays in communities, and better wages.

However, there is still limited financing available to US small business owners looking to transition their businesses to employee ownership. Expanding the number of financing opportunities available for transitioning businesses to employee ownership structures would create more opportunities for equitable business ownership.

Here are the three major forms of employee ownership:

1. **Employee Stock Ownership Plans (ESOPs)** are qualified retirement plans used to transfer all or part of the company's shares to a trust, administered on behalf of the employees. Employees earn their shares as a retirement benefit. ESOPs come with significant tax benefits, which, coupled with regulation, mean they can be a fit for companies with more than 30 employees, given higher set up and ongoing costs.

2. **Worker Cooperatives (Co-ops)** are 100% employee-owned and governed by the people who work there. Employees pay a small equity buy-in and the board of directors is made up of a majority of employee-owners who are elected by the full membership. Profit-sharing is built into the model and is based on hours worked. Worker cooperatives have lower transaction and ongoing administration costs than ESOPs. Co-ops can be the right structure for companies of all sizes, but they are primarily used by smaller companies with fewer than 30 employees.

3. **Employee Ownership Trusts (EOTs),** sometimes called Perpetual Employee Trusts, preserve the business over the long term for the benefit of the employees. Employees don't pay for their ownership benefits, and they receive a share of the company's annual profits. EOTs have lower transaction and ongoing administration costs than ESOPs.

Employee ownership financing from private equity, lenders, and other capital providers helps fund these business conversions. Typically, the employees do not have enough savings or access to capital to purchase all or the majority of the shares from the small business owner(s). Beyond whatever the employees can afford to contribute, they need to raise outside financing from a local bank, venture capital, private equity, etc. to acquire the business.

Here are the three basic components of a worker co-op conversion:

1. **Business Entity Creation:** The creation of a business entity that is a worker-owned cooperative. This can be accomplished by converting the existing business or by forming a new cooperative entity.

2. **Sales Transaction:** A sales transaction executed between the current owner(s) and the new worker co-op to sell the existing business to the worker co-op and execute a Purchase & Sale Agreement. Each worker-owner "buys in" to the co-op and receives a single voting equity share. The sales transaction is typically financed by a group of lenders.

3. **Governance & Cultural Shift:** A transition of roles and culture among the new worker-owners to take on the ownership responsibility of the new entity and run it under democratic governance.

There are financing nuances depending on the employee ownership model. Worker co-ops must avoid raising equity and selling controlling shares of the company to anyone who is not an employee-owner. This means venture capital, private equity, and common stock offerings are typically off-limits. However, co-ops can raise preferred equity with nonvoting stock that does not include any ownership or control rights. Given the equity restrictions and smaller nature of worker co-ops, they are usually funded by a group of lenders like banks and CDFIs with a mix of secured and unsecured loans.

Unlike worker co-ops, ESOPs can actually raise equity from investors like VC and PE to finance the business conversion.

Here are the four basic components of an ESOP conversion:

1. **Trust Creation:** In an ESOP, a company sets up a trust fund, into which it contributes new shares of its own stock or cash to buy existing shares. Alternatively, the ESOP can borrow money to buy new or existing shares, with the company making cash contributions to the plan to enable it to repay the loan.

2. **Sales Transaction:** Owner(s) use an ESOP to create a ready market for their shares and sell their shares directly to employees. The company can make tax-deductible cash contributions to the ESOP to buy out an owner's shares, or it can have the ESOP borrow money to buy the shares. In the borrowing scenario, the employees then make tax-deductible contributions to the ESOP to repay the loan, meaning both principal and interest are deductible.

   In almost all ESOP transactions, the seller finances the ESOP's acquisition by taking the majority of proceeds in the form of a Seller Note, which is paid down out of the company's cash flow over the next five to 10 years. Compared to a traditional acquisition event, business owners are sacrificing cash upfront at exit to share ownership with their employees. The owners' liquidity event is spread out across five to 10 years.

   However, a private equity-backed ESOP offers full cash proceeds for the acquisition of the company. A PE firm such as Mosaic Capital Partners or Apis & Heritage Capital Partners raises all of the capital to acquire the company and lends it through the company to a newly formed ESOP Trust, which then purchases the company from the selling shareholders. Over the next three to five years, the company creates equity value by paying down the acquisition debt, including the PE's investment. Once this debt is fully paid off, the company is free of external stakeholders and can remain an ESOP-owned company in perpetuity.

3. **Employee Vesting:** Shares in the trust are allocated to individual employee plans. Allocations are made either on the basis of relative pay or some more equal formula. As employees accumulate seniority with the company, they acquire an increasing right to the shares in their account or vesting. Employees must be 100% vested within three to six years, depending on whether vesting is all at once or gradual.

4. **Employee Departure:** When employees leave the company, they receive their vested stock, which the company must buy back from them at its fair market value. Private companies must have an annual outside valuation to determine the price of their shares.

Benefits vs. Costs

Benefits

Tax Advantages / No Federal Taxes for ESOPs: A small business that is 100% owned by workers and structured as an S-Corp ESOP does not pay federal income taxes. This meaningful tax savings generates immediate capital that can build cash reserves or be reinvested for growth. The small business owner will have significant federal tax benefits by selling at least 30% of the business to the ESOP; he or she can then defer capital gains indefinitely, and other tax benefits kick in as the ESOP ownership increases. For example, an S-Corp ESOP with 100% ownership pays no federal income tax. ESOPs are also free to workers who receive gifted shares as a retirement benefit.

Wealth Creation / Workers Become Owners: Employee ownership buyouts provide business owners with a cash exit and higher wages and job preservation for workers. It offers owners a clear succession plan and exit pathway without giving up ownership to a private equity firm or larger corporation outside their community. Employee-owned businesses incentivize workers to create value for the business because their ownership stakes can increase in value as the business sustainably grows over time. Workers can sell their stakes back to the business for cash when they either retire or leave the business. This model can build more resilient local economies and help close the racial wealth gap with a path to business ownership for workers of color.

Access to Capital / Resilient Jobs & Communities: Employee ownership buyouts offer growth capital for small businesses that face significant barriers to accessing capital from VCs and lenders. This growth capital can help businesses rebuild from the COVID-19 pandemic and preserve local jobs in underserved communities.

Costs

Regulations / Complex & Regulated ESOPs: There are a number of benefits for owners, workers, and investors with an ESOP business transition, but ESOPs remain complicated and highly regulated. This complexity and regulation comes with higher set up costs, starting at $40K, and administrative costs.

Capital Product Fit

When is employee ownership financing a ***good*** fit for businesses?

Annual Revenue: $2M+

Employees: 30+ for ESOPs; <30 for co-ops and EOTs

Financials: 2+ years of financial statements

Business Entity: C Corp or S Corp for ESOPs; more flexibility for co-ops and EOTs

When is employee ownership financing ***not*** a fit for businesses?

Too Young: If a business does not have at least two years of financial statements, then it is difficult for an employee ownership investor to underwrite and make an investment.

Too Small: For ESOPs, businesses need to have at least 40 employees and $2M in annual revenue to take advantage of the tax benefits compared to the legal and regulatory costs.

Blitzscalers: Businesses that require rapid growth to take over an entire market or create a new market and need large amounts of VC funding to scale. These “Blitzscalers” typically focus on speed and growth over cash flow and profits.

Why would business owners want to ***choose*** an employee ownership deal?

Community Succession Plan: Small business owners looking to retire or take a step back from their business have the opportunity to transition and sell it to employees. Employee ownership can keep these businesses and jobs in local communities and enable the next generation of leaders.

FAQs

What is an Employee Ownership Buyout?

An employee ownership buyout offers full cash proceeds for the acquisition of the target company. In this style of transaction, a private equity firm such as Apis & Heritage Capital Partners raises all of the capital to acquire the business and lends it through the company to a newly formed ESOP Trust, which then purchases the company from the selling shareholders. In effect, it is similar to buying a house with a 100% mortgage. Over the next three to five years, the company creates equity value by paying down the acquisition debt, including the private equity firm's investment. Once this debt, which is similar in structure to any company that has recently been acquired through a leveraged buyout, is fully paid-off, the company is free of external stakeholders and can remain an ESOP-owned company in perpetuity.

Employee Ownership Case Studies

A&H

Apis & Heritage Capital Partners

A&H Co-Founders & Managing Partners: Todd Leverette (left) and Philip Reeves

Overview

Bethesda, MD-based Apis & Heritage Capital Partners (A&H) helps small and mid-sized businesses with large workforces of color transition to employee ownership. A&H is a Black-led firm with founding partners Todd Leverette and Philip Reeves.

A&H is seeking to raise $50M for its Apis & Heritage Legacy Fund I to invest in at least eight employee ownership buyouts over five years. In June 2021, A&H held its first close at $30M for its first fund, including its anchor LP the Rockefeller Foundation via the Zero Gap Fund ($3M), Ford Foundation, Skoll Foundation, Capricorn Investments, Gary Community Investments, Ascension Investment Management, and others. Co-investment capital for A&H's portfolio companies will come from a strategic partnership with the Local Initiatives Support Coalition's New Markets Support Co. (NMSC). NMSC will provide the senior debt tranche of the employee-led buyouts.

A&H expects to hold a final close later in 2022.

Why Employee Ownership?

The founding team at A&H wanted to help close the racial wealth gap for workers of color in the US through employee ownership. For many communities of color in the US, the primary ways to generate wealth—home ownership and entrepreneurship—have historically been blocked. The average white family has nearly 8x the wealth of the average Black family and 5x the wealth of the average Latino/a family. Additionally, roughly 60% of Black workers and 75% of Latino/a workers retire with no retirement savings. A&H aims to reduce this wealth gap by financing the conversion of companies with large workforces of color into 100% employee-owned businesses. This innovative capital model helps workers of color build wealth and potentially retire with $70K to $120K in savings, according to A&H.

A&H has been successful in raising LP capital from mission-driven investors, such as foundations that leveraged their PRI programs to back this employee ownership model. However, the team has struggled to secure funding from larger institutions such as endowments and pension funds—those requiring longer track records and larger fund sizes.

Investment Strategy

A&H makes employee ownership investments in small- and mid-sized, essential-service businesses with workforces of color across the US. The team seeks companies with $1-4M EBITDA, healthy gross margins, strong cash flow, and 30+ employees, of which at least one-third of the workforce are BIPOC and 50% low income. The fund will invest in up to 10 companies over its five-year investment period with $3M+ check sizes. A&H is targeting 15% net IRR and 2.0 gross MOIC for the fund.

Their "employee-led buyout" (ELBO) model helps close the racial wealth gap by converting workers of color into owners. It also supports retiring business owners looking for liquidity and an exit by transferring ownership to employees at a fair market price. A&H primarily finances businesses transitioning to the ESOP model. Post-investment, the Oakland-based Democracy at Work Institute (DAWI) will support portfolio companies in building strong ownership cultures and other employee ownership services. These technical assistance services help companies become more resilient, pay higher wages, produce higher profits, and lower turnover.

Track Record

Apis & Heritage Legacy Fund I (2021, $50M target) has closed its first two deals as of June 2022. The two portfolio companies employ a total of 170 workers, who will now own 100% of each company.

Portfolio companies include:

Apex Plumbing (Denver) was founded in 1985 and is a sewer and water systems company with roughly 50 employees, 50% of whom are Latino/a. As of May 2022, the company became 100% employee-owned.

Accent Landscaping Contractors (El Paso, TX) is a commercial landscaping company founded in 1982 with roughly 120 employees, the majority of whom are lower-income Latino/a workers, and serves the states of New Mexico, Colorado, and Texas. Founder Cameron Stevens wanted to retire and transfer ownership to his employees at a fair market price. He said, "I could have sold my business to a competitor or private equity, but I know what can happen next—the culture changes and people get laid off. I didn't want that for my employees."channels, and scale inventory. Prior to GCVF's redeemable equity investment, the company raised $150k in angel funding to expand its product offerings.

More Reading & Listening

https://impactalpha.com/black-and-brown-employee-ownership-for-the-post-covid-economy/

https://www.notion.so/Apis-Heritage-Resource-Library-93a5fc269f28466aa1e6b99d3ed2a310

For more tools and resources, visit innovative.finance/resources.

THE LOCAL BUTCHER SHOP

Photo credit: The Local Butcher Shop

Overview

Founded in 2011 by Monica and Aaron Rocchino, The Local Butcher Shop is an independent butcher shop in Berkeley, California. They offer locally sourced, sustainably raised meat, and cooking classes to the East Bay community.

Why Employee Ownership Transition?

The two founders and previous owners were dedicating most of their lives to the store, but they wanted to spend more time with their young child. So the Rocchinos started exploring ways to sell their business and, eventually, got connected with Oakland-based nonprofit Project Equity, which offers programs to support transitions to employee ownership.

When they learned about this exit strategy in 2019, the Rocchinos wanted to transfer ownership to their deeply dedicated and hard-working team. They prioritized giving back to their workers and maintaining the store's legacy of locally sourced meat for their customers. However, the transition was too costly for them to justify until the COVID-19 pandemic disrupted the food industry. More people in their neighborhood started cooking their meals at home, and the store's revenue ramped up by 50% in 2020. The revenue boost allowed the founders to afford the employee ownership transition.

Worker-Owned Business

In January 2021, the “transition team” of five employees began to meet with Project Equity for weekly classes on business, finance, and worker cooperatives. The transition team included butchery manager Caleb Avalos, value added products manager Jason Fallock, butcher Koji Fujioka, butcher Merl Goodsell, and general manager Scott Miller.

Project Equity helped the transition team raise a grant through the City of Berkeley and partnered with full-spectrum impact investment fund manager Mission Driven Finance (MDF) to form the Employee Ownership Catalyst Fund that would provide financing for the transition.

The national Employee Ownership Catalyst Fund supports businesses throughout the US that want to transition to employee ownership and need capital to finance the transition and transaction. Short term, the fund will also help companies that are transitioning to employee ownership with working capital to support their strong footing coming out of the pandemic and to bridge the costs associated with an ownership transition.

Employees don’t need to come up with the financing themselves; the Employee Ownership Catalyst Fund fills this gap. When business owners understand there is capital available to make this transition, more possibilities and opportunities open up.

MDF performed due diligence and underwriting, while Project Equity led the pre- and post-transition advisory. The Employee Ownership Catalyst Fund provided a $213K loan to the company for the transition.

In October 2021, The Local Butcher Shop became an employee-owned business. Overnight, the five transition team members officially became owners and the rest of the staff had the opportunity to buy-in and become owners until February 2022. The founders took a step back to focus on their family and transitioned from owners to board members and mentors.

The profit-sharing model of the worker co-op has helped retain the store’s staff and made it easier to afford to live locally with higher compensation.

Deal Terms

Company: The Local Butcher Shop

Investor: Employee Ownership Catalyst Fund

Investment Date: November 2021

Investment Type: Loan secured with a blanket UCC

Investment Amount: $213,150

Employee Ownership Structure: Worker Cooperative

Ownership: None	**Interest Rate:** 5.5% per year
Grace Period: None	**Payment Schedule:** Monthly
Maturity: 5 years	**Board Seat:** None

Use of Proceeds: Financing will be used for the transition to employee ownership