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Default Rates on Leveraged ESOPs, 2009-2013

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Based on an analysis of 1,232 leveraged ESOP transactions at three large banks, 1.3% of ESOP companies in the sample defaulted on their loans in a way that imposed losses on their creditors for loans in effect between 2009 and 2013 (or an annual rate of 0.2%). The defaults accounted for 1.5% of the total value of the ESOP loan portfolio for these companies during this period. The bank data were only available for defaults imposing losses; the data presented here do not include defaults that resulted in loan restructuring where the loans were ultimately repaid or were being paid on the new schedule.

In a parallel analysis, the NCEO also asked ESOP appraisal firms to provide us data on defaults among the ESOP companies whose stock they appraised between 2009 and 2013. [Unless otherwise noted, in this report the word "default" refers only to defaults that impose losses on creditors]. Eighteen firms responded out of the 40 ESOP appraisal firms we asked to provide data. The firms were selected because they were members of the NCEO's directory of service providers. Previous NCEO data indicated that directory members account for about half of all the ESOP appraisals. The eighteen responding firms were able to report data on 845 companies over the study period. Of these, 9 (1.1%, or an annual rate of 0.2%) defaulted in a way that imposed losses on their creditors, while 26 (3.1%, or an annual rate of 0.6%) had to restructure their loans but had repaid or were repaying their loans currently.

Estimating the default rates on ESOP loans is essential to evaluating two of the most common criticisms of ESOPs, namely

- That they are excessively risky
- That appraisals tend to be too aggressive, causing ESOPs to overpay for the shares

Both criticisms suggest that the default rates on ESOP loans should be high, which does not seem to be the case with the loans included in this sample.

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Comparison Data

These default rates seem strikingly low given the economic turmoil of 2008-2011, a period that overlaps and immediately precedes the data represented here. It is not possible, however, to make valid comparisons to data for defaults on leveraged buyouts of non-ESOP companies. While there are some studies of default rates for private equity firm leveraged buyouts, these firms make very different risk assessments in their transactions. Reported default rates for these transactions have ranged from a few percent to 19%, depending on the study and how defaults are defined, but the most parallel transaction to an ESOP is a management-led leveraged buyout of a closely held company, and credible data on such transactions do not exist.

The best available comparison data comes from S&P's IQ Credit Pro report on default rates for mid-market companies borrowing less than $200 million. ESOPs would all be in this range, although the median ESOP loan would no doubt still be much smaller than the median for the S&P sample (data for smaller loans is not available). These loans defaulted at 3.75% per year from 2010 to 2013 and 1.99% for the period 2003 to 2013. Defaults here are defined as those imposing losses on creditors.

Reliability

The convergence of the default data from the banks and from the appraisers provides more confidence in the result than would be the case if the two sources were significantly different. Of course, there is overlap in the samples in that some of the companies in the bank sample would be clients of the appraisers.

The convergence is further supported by earlier work. In 2010 the NCEO asked major ESOP providers (lawyers, plan administrators, and two major banks) to estimate the percentage of their clients that had defaulted on their ESOP loans in the 2009-2010 period and in all prior years. The twenty-seven providers that responded represented a few thousand ESOP companies. For the 2009-2010 period, they reported that the defaults typically ranged between 1% and 2% for the responding providers, but some providers reported no defaults and one reported that 15% had defaulted. For the prior period, they reported lower ESOP default rates. In aggregate, their results suggest annual default rates under 0.3%, and one large plan administration firm that did a careful analysis reported a default rate of 0.13% annually. This work has substantial limitations: each responded provided estimates rather than actual numbers, and the number of total number of ESOP transactions represented was not available.

Characteristics of Companies with Loan Defaults

The tables below provide a detailed analysis of the results. Tables one and three look at the total number of defaults relative to the number of clients. Tables two and four details on the defaulting company characteristics.

Table 1: ESOP Loan Defaults Imposing Losses on Creditors from Reporting Banks

Number of loans	Number of loans imposing losses	Total ESOP Portfolio Loan Amount	Loss Amount	% of Loans Defaulting and Imposing Losses on Creditors	Defaulting loans imposing losses on creditors as % of total portfolio
1,232	18	$12.79 billion	$190 million	1.3%	1.5%

Table 2: Details on loans from bank data that defaulting and imposed losses

Industry	Size of Loan (nearest million)	Employees
Construction	$60 million	60
Banking	$25 million	65
Manufacturing	$19 million	100
Construction	$17 million	92
Construction	$13 million	200
Wholesale	$12 million	1,700
Printing	$9 million	95
Plumbing	$8 million	72
Wholesale	$8 million	Not available
Publishing	$5 million	265
Warehouse	$5 million	Not available
Apparel	$4 million	3,800
Manufacturing	$4 million	Not available
Engineering	$2 million	Not available
Manufacturing	<$1million	1,000
Trucking	<$1 million	Not available
Construction	$4 million	Not available
Totals	$187 million	

Total loan size was calculated before rounding the size of each loan.

Table 3: ESOP Loan Defaults Imposing Losses on Creditors from Reporting Appraisal Firms

Size of valuation firm	Number of appraisals	Number of defaults Imposing Losses	Number of defaults restructured but not imposing losses
More than 100 appraisals reported	438	6	24
50-100 appraisals reported	138	1	2
Fewer than 50 appraisals reported	269	2	1
Total	845	9 (1.1%)	26 (3.6%)

In other words, 269 of the companies included in this firm were reported by valuation firms that do no more than 50 valuations. Valuation firms that do over 100 ESOP valuations collectively provided data on 438 companies.

Table 5: Details from defaulting loans imposing losses on creditors, appraisal firms

Industry	Size of Loan (rounded to nearest million)	Employees
Manufacturing	$74 million	n.a.
Manufacturing	$6 million	507
Construction	$6 million	14
Real estate	$4 million	600
Construction	$3 million	21
Accommodation/food service	n.a.	364

Background on Using ESOPs for Leveraged Buyouts

One of the most difficult problems for owners of closely held businesses is finding a way to turn their equity in a business into cash for retirement or other purposes. For some business owners, the answer to these problems will be to turn over the company to an heir or sell to an outsider. But many owners do not have heirs interested in the business, and outside buyers are not easy to find. Even if they can be found, they may want to buy the company for its customer lists, technology, or facilities, or may just want to put a competitor out of business.

Some owners in this situation find ESOPs (employee stock ownership plans) an attractive alternative. For the owner of a C corporation, proceeds on the gain from the sale to the ESOP can be tax-deferred by reinvesting in the securities of other domestic companies. If these securities are not sold prior to the owner's death, no capital gains tax is ever due. If the company is an S corporation, LLC, or partnership, it can convert to a C corporation before the sale to take advantage of this tax deferral. If the company stays S, the owner does pay capital gains tax on the sale, but reaps all the other benefits of selling to an ESOP. The most important of these is that the owner's shares are bought in tax-deductible dollars, either from company contributions or plan borrowings. The sale can be all at once or gradual, for as little or as much of the stock as desired. For the employees, no contributions are required to purchase the owner's shares. The owner can stay with the business in whatever capacity is desired. The plan is governed by a trustee who votes the shares, but the board appoints the trustee, so changes in corporate control are usually nominal unless the plan is set up by the company to give employees more input at this level.

An ESOP is a kind of employee benefit plan, similar in many ways to qualified retirement plans and governed by the same law (the Employee Retirement Income Security Act). ESOPs are generally funded by the employer, not the employees. Stock is held in a trust for employees meeting minimum service requirements and allocated to employees based on relative pay or a more level formula, then distributed after the employee terminates. ESOPs cannot be used to share ownership just with select employees, nor can allocations be made on a discretionary basis.

Financing an ESOP

The simplest way to use an ESOP to transfer ownership is to have the company make tax-deductible cash contributions to the ESOP trust, which the trust then uses to gradually purchase the owner's shares. In this study, we looked at the much more common alternative in which the ESOP borrows the funds needed to buy the shares. In this way, larger amounts of stock can be purchased all at once, up to 100% of the equity. Normally, the bank will loan to the company, which then reloans to the ESOP, not necessarily on the same terms. In some cases, such as when the total debt would exceed current book value, the bank may also want a personal guarantee, or may be willing to loan only part of the total sought. In that case, the ESOP would buy part of the shares now, and part after some of the debt has been paid.

Perhaps half of all ESOPs, however, are funded all or in part instead by a seller note (we look here only at loans involving banks making all or part of the loan). The ESOP acquires the shares then pays back the seller at a reasonable rate of interest (not more than what a commercial lender would charge for loans of similar risk.). Sellers often like this idea because not only do they get their shares sold, but they get a reasonably good rate of return on the note. In this scenario, however, the rollover would apply only to what is reinvested in the first year. The entire amount of the sale could only be reinvested, therefore, if the seller has other funds available or, as normally happens, the seller borrows money from a bank to buy special ESOP bonds that qualify for this kind of sale (an increasingly common approach). The seller then repays the banks with the proceeds of the note. However the money is obtained, the price is set by an independent appraiser, as discussed below.

Tax Benefits

If the company is a C corporation and the owner has held the shares for at least three years, once the ESOP owns 30% of the company's shares, the owner can reinvest the gains in the securities of other U.S. companies (other than real estate trusts, mutual funds, and other passive investments) within 12 months after or three months before the sale, no taxes are due until the replacement securities are sold. If the owner buys income-yielding securities and lives on the proceeds, giving them to an estate at death, no capital gains tax is due. If part of the securities are sold, tax is due only on a prorated basis. (This tax incentive is not available for S corporation owners.)

The benefits of a sale to an ESOP are clear when compared to two other common methods of selling an owner's shares: redemption or sale to another firm. Under a redemption, the company gradually repurchases the shares of an owner. Corporate funds used to do this are not deductible. A $3 million purchase in a redemption might require over $5 million in profits to fund once taxes are paid. Moreover, the owner must pay tax on the gain, at capital gains or dividend rates. In a sale to a C corporation ESOP, the money made is considered a capital gain, not ordinary income, and taxes can be deferred. Even more important, the company only needs

$3 million to fund the $3 million purchase, something that applies as well to sales to ESOPs in S corporations. Or consider the second alternative, selling to another company or individual. In a cash sale, taxes would be due immediately. If the sale is for an exchange of stock in the acquiring company, taxes can be deferred until the new stock is sold, but 80% of the company must be sold all at once and the owner ends up with an undiversified investment for retirement.

If a company is an S corporation, the rollover benefit is not available, but the profits attributable to the ESOP are not taxable. So if the ESOP is a 30% owner, income taxes are not due on 30% of the profits; if it is a 100% owner, no taxes are due, a rule that has led to the rapid growth of 100% S corporation ESOPs, often conversions from C corporation companies with ESOPs after they make the final purchase of shares. About half of all ESOPs are now S corporations, and most of these are 100% ESOPs. The tax benefits these companies have make it easier to repay their loans.

How the Price Is Determined

The price the ESOP will pay for the shares, as well as any other purchases by the plan, must be determined at least annually by an outside, independent appraiser. The appraiser's valuation will be based on several factors. Most appraisers try first to find comparable public companies and use their price/earnings ratio, price/assets ratio, and other guides for setting a price. Discounted cash flow, book value, the company's reputation, future market considerations, and other factors will be considered as well. The appraiser will try, as much as possible, to determine how much the business would be worth if there were a market for it. The appraiser is assessing what a financial buyer would pay, one who would operate the business as a stand-alone entity. A strategic buyer, such as a competitor, by contrast, might pay an additional premium because when the target company is acquired, there are perceived operational synergies that make the target more profitable to the buyer than it would be as a stand-alone entity. The ESOP cannot match this price because it cannot generate these synergies. Sales to synergistic buyers do trigger capital gains taxes, however, and often come with numerous contingencies.

Basic Rules

ESOPs are much like other tax-qualified retirement plans. At least all employees who have worked at least 1,000 hours in a plan year must be included. They receive allocations of shares in the ESOP based on relative pay or a more level formula. If there is an ESOP loan, the shares are allocated each year based on the percentage of the loan that is repaid that year. The allocations are subject to vesting for as long as six years. Employees do not receive a distribution of shares until they terminate, and then the distribution can be delayed for five years if for reasons other than death, retirement, or disability. The plan is governed by a trustee appointed by the board; employees only have very limited required voting rights (they do not have to elect the board, for instance), although companies may provide additional rights.

It is important to understand that ESOPs do not allow employers to pick and choose who can get stock or to make allocations based on discretionary decisions. It is also critical to remember that ESOPs do not entail employee using their own money to buy shares. The company funds the plan.

Conclusion

ESOPs were created by Louis Kelso in the 1950's as a technique of corporate finance that could spread ownership more broadly than would be the case in other corporate transactions. Today, there are almost 7,000 ESOP companies with over 10 million active participants and $904 billion in assets as of 2011. While there have been numerous studies showing that ESOP companies perform better than conventional companies, that ESOP participants have 2.5 timers the retirement assets of employees in non-ESOP companies[1], and that employee-owners are one-third to one-fourth as likely to be laid off as non-employee-owners, this is the first study to evaluate how well ESOP companies do in repaying their debt. The results provide strong support for the argument that on this measure as well ESOP companies perform at a very high level.

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At no time did the NCEO receive information that would allow us to identify individual companies.

[1] For details on these studies, see the article Employee Ownership and Corporate Performance, and Employee Compensation on the NCEO's Web site (http://www.nceo.org/articles/research-employee-ownership-corporate-performance).