Employee Stock Ownership Plans as an Exit Strategy for Private Business Owners

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EXECUTIVE SUMMARY

With Baby Boomers owning roughly half of private businesses, there is a wave of ownership changes on the horizon that has the potential to impact workers across the economy. For certain private business owners, a way to preserve a firm's continuity, foster employee commitment, and build lasting economic value in a community is to sell the business to its employees through an employee stock ownership plan (ESOP).

This paper compares S corporation ESOP (or S ESOP) conversions with domestic and foreign mergers and acquisitions (M&A), initial public offerings (IPOs), and private equity buyouts, looking at tradeoffs in these popular exit strategies.

Domestic M&A. Domestic M&A is by far the largest category of exit strategy, with more than 8,500 deals in 2015. Domestic M&A deals can offer benefits through the economies of scale enjoyed by larger firms but can also potentially reduce competition in some instances.

Foreign M&A. Inbound M&A deals in the United States are the second-largest type of exit strategy but much smaller than domestic M&A, with roughly one inbound transaction for every six domestic deals. Inbound M&A can draw significant foreign capital into the United States, which is a positive, but it may also shift management abroad.

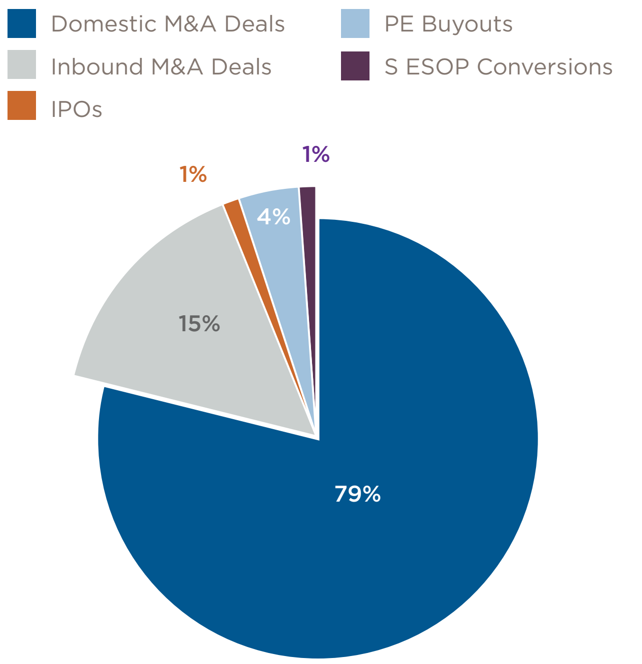
IPOs. Compared to M&As, the number of IPOs is small, ranging from as few as 27 in 2008 to as many as 244 in 2014. IPOs reflect a unique exit strategy reserved for relatively large firms and generally those that also expect significant future growth.

Private Equity Buyouts. Buyouts by private equity (PE) firms also represent a small portion of total deals, increasing from 50 in 2002 to nearly 500 in 2015. PE buyouts are often portrayed as detrimental to employees, since they can be followed by layoffs and other cuts. Of course, absent a PE acquisition, some firms may fail to remain in business at all.

S ESOP Conversions. S ESOP conversions have averaged around 100 per year since 2002, ranging from 86 in 2002 to 149 in 2012. S ESOPs represent a small share of common exit strategies but have been shown to have unique qualities, including greater firm longevity and higher wages, wage growth, job stability, retirement plan contributions, employment, and sales.

Considering the positive spillover effects of S ESOPs, it would be a welcome development to see the share of S ESOP conversions grow. With an S ESOP conversion a viable option for many business owners, it could be beneficial to the economy as a whole if more owners seriously consider this exit strategy and if policies to promote wider adoption of S ESOPs were pursued.

DEAL TYPES IN 2015



Source: Department of Labor Form 5500 data; Institute for Mergers, Acquisitions and Alliances; Pitchbook; and Securities and Exchange Commission filings (WilmerHale).

Note: S ESOPs with fewer than 15 active participants are excluded.

INTRODUCTION

When U.S. business owners or majority shareholders of closely held companies prepare to retire or otherwise exit their businesses, they face options for monetizing their businesses' value. Available exit strategies include transfer to a family member, merging, being acquired, a private equity buyout, an initial public offering, closure, and transitioning to employee ownership. Of course, all exit strategies are not necessarily viable or equally appropriate for all companies and their owners. There are risks and opportunities associated with each strategy that need to be evaluated in order to leave the company in the best hands for workers, customers, and the community while maximizing the firm's value. For certain private business owners, an excellent way to preserve a firm's continuity, foster employee commitment, and build lasting economic value in a community is to sell the business to its employees through an employee stock ownership plan (ESOP).

An ESOP, a tax-exempt defined contribution retirement plan, buys the shares of a company's stock from the owner and holds them on behalf of the company's employees. S corporation ESOPs (or S ESOPs), which represent approximately half of all ESOPs (3,036 of the 6,795 ESOPs in the United States), are often wholly employee-owned.[1] They are typically small or midsized businesses, with roughly 175 employees on average.[2] As detailed in previous analyses I have conducted, S ESOPs are more resilient in the face of economic distress and outperformed other private employers in the United States during and after the Great Recession.[3] Other research has shown that S ESOPs foster firm productivity, growth, and job stability.

Considering that S ESOPs play an important role in the economy and that nearly a third of U.S. workers are employed at firms with 20–499 employees,[4] it is worth encouraging wider adoption of this ownership structure. It is also important to evaluate alternative exit strategies and their pros and cons.

Given that Baby Boomers own roughly half of private businesses,[5] the expected wave of ownership changes raises a series of important questions. How are retiring business owners today successfully exiting their businesses? What are the consequences of various alternatives with respect to workers, firm continuity, industry consolidation, and domestic versus foreign ownership? In this study, I present an original analysis of trends in popular exit strategies and look at how they compare to S ESOP conversions.

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1 Employee-owned S Corporations of America (ESCA) and National Center for Employee Ownership (NCEO), "Economic Growth through Employee Ownership: How States Can Save Jobs and Address the Wealth Inequality Gap through ESOPs," 2016, available at www.nceo.org/assets/pdf/Economic_Growth_Through_EO.pdf.

2 Based on data reported on Form 5500, available from the Department of Labor.

3 See Alex Brill, "An Analysis of the Benefits S ESOPs Provide the U.S. Economy and Workforce," Matrix Global Advisors (MGA) White Paper, July 26, 2012, available at www.matrixglobaladvisors.com/storage/mga-studies/S_ESOP_analysis_Final.pdf; and Alex Brill, "Macroeconomic Impact of S ESOPs on the U.S. Economy," MGA White Paper, April 17, 2013, available at www.matrixglobaladvisors.com/storage/mga-studies/S_ESOP_Macro_Impact.pdf.

4 Small Business Administration (SBA), "United States Small Business Profile," 2016, available at www.sba.gov/sites/default/files/advocacy/United_States.pdf.

5 SBA, "Demographic Characteristics of Business Owners and Employees: 2013," Issue Brief no. 6, April 28, 2015, available at www.sba.gov/sites/default/files/advocacy/Issue_Brief_6_Demographic_Characteristics_2013.pdf.

TRENDS IN EXIT STRATEGIES FOR U.S. BUSINESS OWNERS

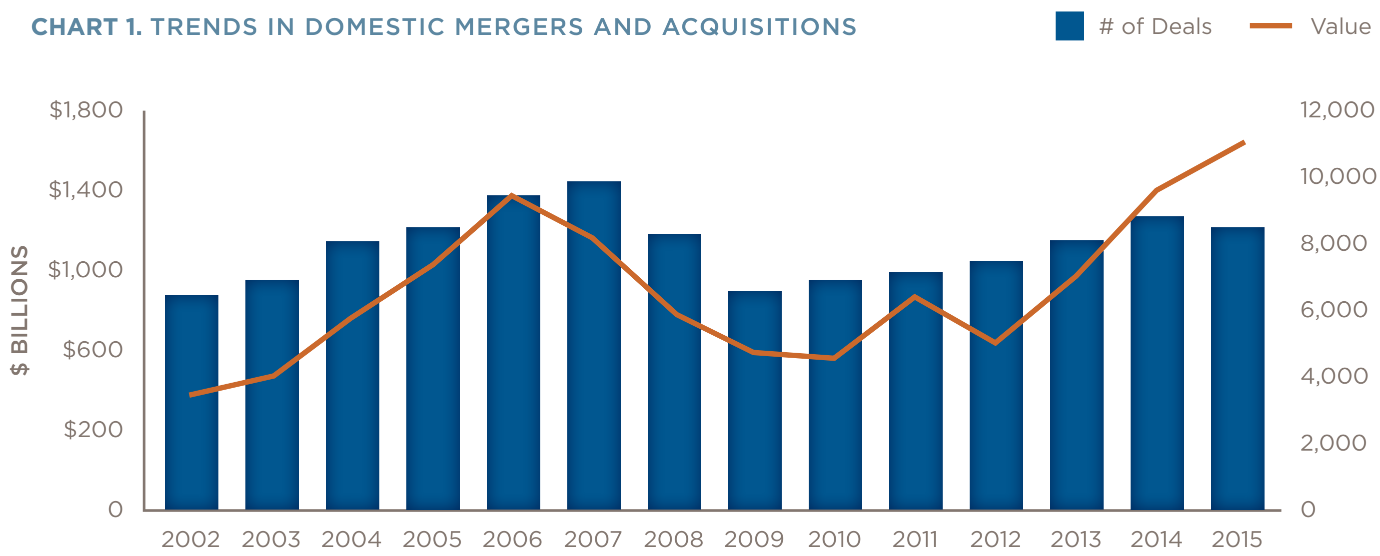
In addition to the consequences of different exit strategies, it is important to understand the relative popularity of various options. Drawing on several data sources, I analyze domestic mergers and acquisitions, foreign acquisitions of American-owned businesses, initial public offerings, private equity buyouts, and S ESOP conversions. I also look at how the number of S ESOP conversions compare to the number of other deals.

Domestic Mergers and Acquisitions (M&A)

Domestic M&A is by far the largest category of exit strategy. Since the early 2000s, the number of domestic M&A deals has ranged from approximately 6,500 to 10,000, according to data from the Institute for Mergers, Acquisitions and Alliances. After a steady rise from 2002 to 2007, the number dropped off with the Great Recession but has gradually increased since 2009. The value of domestic M&A has roughly followed the same trajectory as the number of deals, with a corresponding drop-off related to the Great Recession. In terms of M&A value, however, the growth since 2012 has been dramatic, indicating some large deals in certain years. The total value of domestic M&A exceeded the 2006 record in 2014 and increased again to a new high in 2015. The average deal size has grown on net, from $61 million in 2002 to nearly $200 million in 2015. (See **Chart 1**.)

Domestic M&A deals can offer benefits through the economies of scale enjoyed by larger firms but can also potentially reduce competition in some instances. In addition to improved efficiencies from combining firms, the acquired firm could also gain opportunities into new markets and new products depending on the specifics of a transaction.

CHART 1. TRENDS IN DOMESTIC MERGERS AND ACQUISITIONS



Source: *Institute for Mergers, Acquisitions and Alliances.*

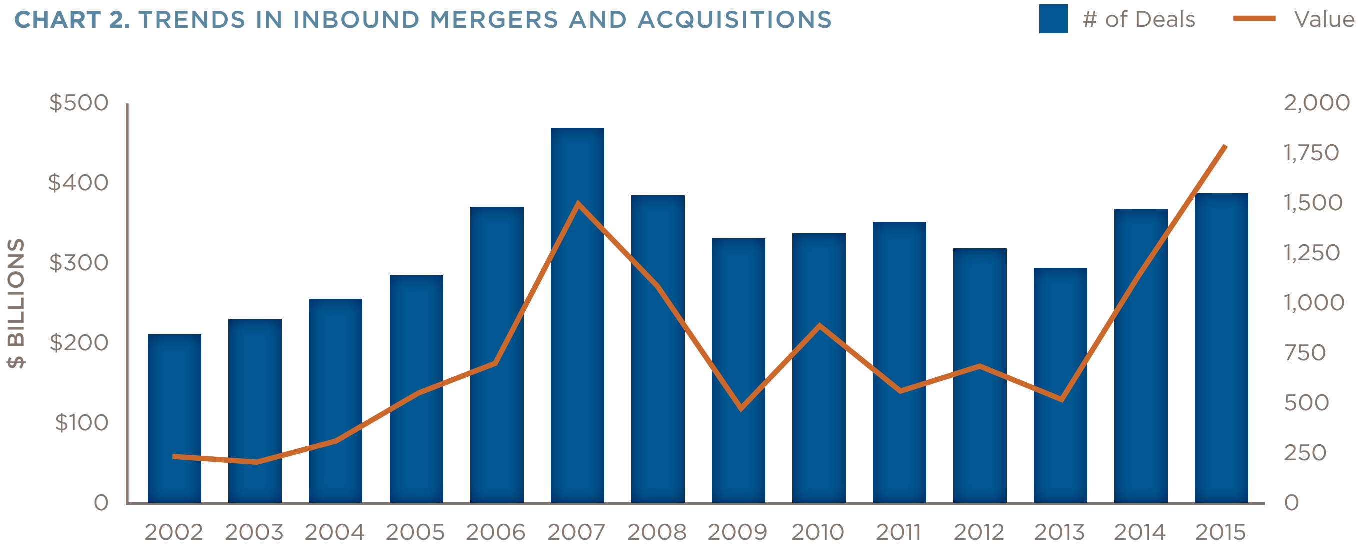
Foreign M&A

Inbound M&A deals in the United States have ranged from nearly 900 in 2002 to more than 1,800 in 2007 and followed a pattern similar to the trends in domestic deals but on a much smaller scale. Since 2002, there has been roughly one inbound merger or acquisition for every six domestic M&A deals, with the total value of inbound M&A totaling approximately 20 percent of the value of domestic M&A. Like domestic M&A, inbound M&A also declined corresponding to the Great Recession but has since rebounded, with spikes in value representing large deals in certain years. (See **Chart 2**.)

Not only have the volume and deal value been increasing, but the total number of affected employees is large. According to the Bureau of Economic Analysis, there were 719,000 employees in U.S. firms acquired by foreign direct investment in 2014 and 418,000 in 2015.[6] The total number of workers employed by U.S. affiliates of foreign multinationals reached 6.4 million in 2015, 5.2 percent of all private workers.[7]

Given that roughly one-third of U.S. exports originate from small and medium-sized enterprises,[8] cross-border M&A is not surprising and can offer U.S. firms greater access to foreign markets. These deals originate from all over the world, with significant increases in activity from China and India. Inbound M&A can draw significant foreign capital into the United States, which is a positive, but it may also shift management of the acquired firm abroad. The acquired U.S. firm may gain better access to foreign markets but may lose some of the inherent advantages of U.S.-based corporate leadership.

CHART 2. TRENDS IN INBOUND MERGERS AND ACQUISITIONS



Source: *Institute for Mergers, Acquisitions and Alliances.*

6 Bureau of Economic Analysis (BEA), data on new foreign direct investment in the United States, available through www.bea.gov/iTable/index_MNC.cfm.

7 Sarah Stutzman, "Activities of U.S. Affiliates of Foreign Multinational Enterprises in 2014," BEA, August 2016, available atwww.bea.gov/scb/pdf/2016/08%20August/0816_activities_of_us_affiliates_of%20foreign_multinational_enterprises.pdf.

8 SBA, "Small Businesses Key Players in International Trade," Issue Brief no. 11, December 1, 2015, available at www.sba.gov/sites/default/files/advocacy/Issue-Brief-11-Small-Biz-Key-Players-International-Trade.pdf.

Initial Public Offerings (IPOs)

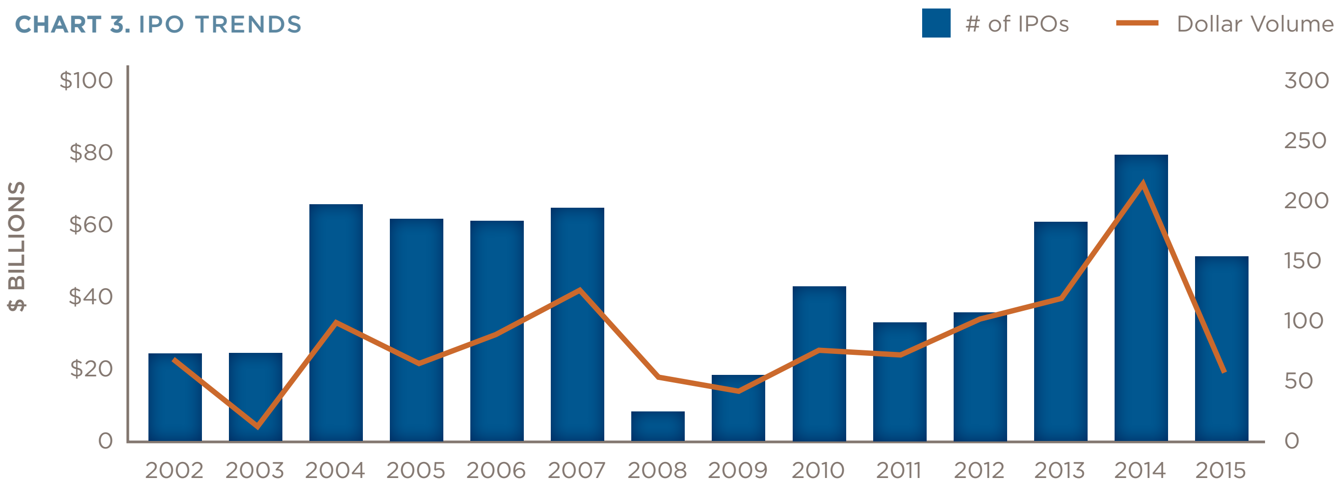
Compared to M&As, the number and value of IPOs is small. Since 2002, the number of companies going public has ranged from as few as 27 (in 2008) to as many as 244 (in 2014), according to Securities and Exchange Commission filings. The highest annual value of IPOs during this time period reached nearly $75 billion in 2014, also small compared to M&A value. (See **Chart 3**.)

IPOs reflect a unique exit strategy reserved for relatively large firms and generally those that also expect significant future growth. Some high-profile IPOs are for high-tech or social media businesses not yet profitable (the recent IPO for Snapchat, for example) while others are for more traditional businesses, such as Univar, a nearly century old chemical distribution company.

Private Equity (PE) Buyouts

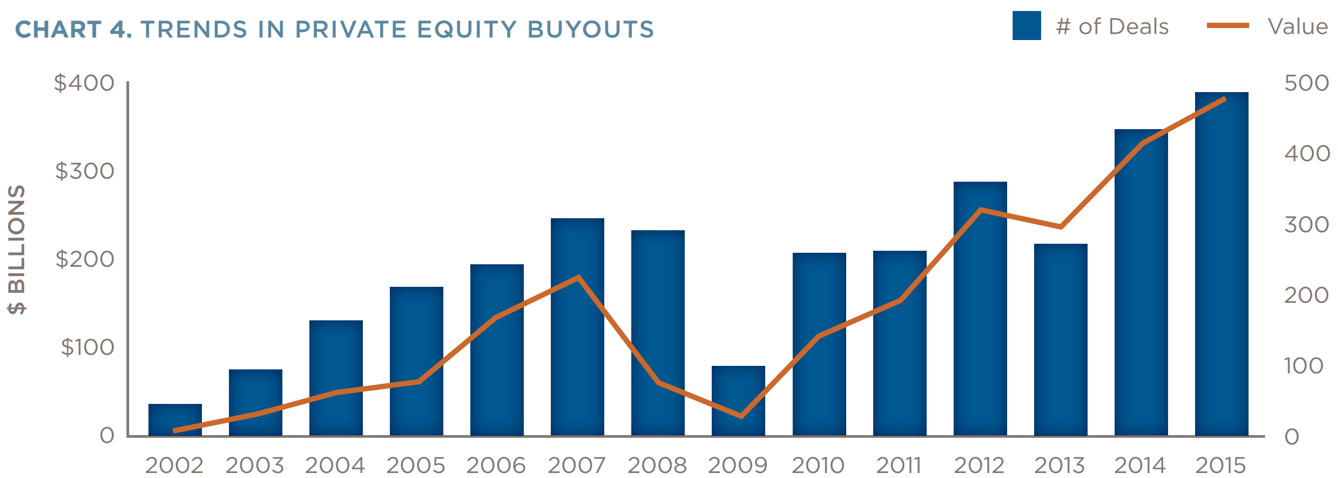
Buyouts by private equity firms also represent a small portion of total deals but on occasion attract considerable media attention. On net, PE buyouts have increased since 2002, when they totaled fewer than 50, according to my analysis of data culled from PitchBook. In 2015, completed PE buyouts in the United States totaled nearly 500. Compared to other types of deals, PE buyouts tend to be high-value. (See **Chart 4**.)

CHART 3. IPO TRENDS



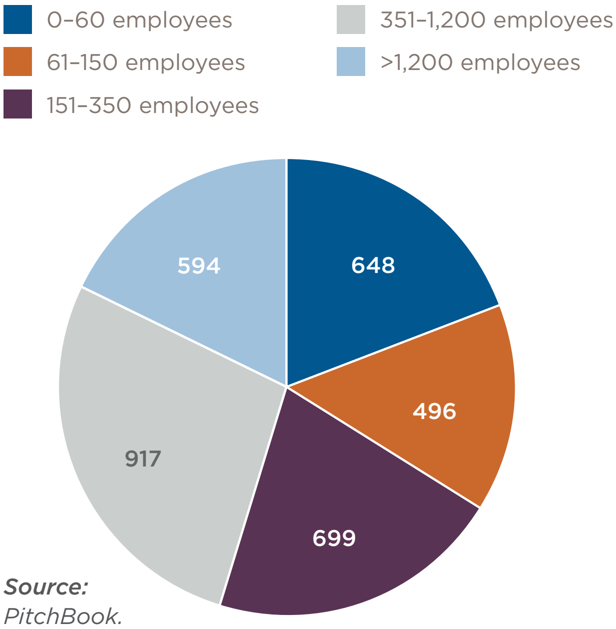
Source: *Securities and Exchange Commission filings (WilmerHale).*

CHART 4. TRENDS IN PRIVATE EQUITY BUYOUTS



Source: *PitchBook.*

CHART 5. SIZE OF COMPANIES ACQUIRED BY PRIVATE EQUITY FIRMS, 2002–2015



Source: PitchBook.

TOTAL BUYOUTS = 3,354

Overall, 11.3 million workers are employed in the United States in firms backed by PE.[9] Companies bought by PE firms tend to be relatively large. The most common size for a PE buyout was 351–1,200 employees. (See **Chart 5**.)

PE buyouts are often portrayed as detrimental to the employees of the acquired firms, since the buyouts can be followed by layoffs and other cuts. A 2014 study in the *American Economic Review* finds that firms acquired in a PE buyout experience 3 percent greater job loss two years post-buyout and 6 percent greater job loss five years post-buyout than comparable firms.[10] However, the study finds that firms acquired in PE buyouts create new jobs at a faster rate than other firms. In short, a PE buyout and the ensuing streamlining of the business may be good for a company's productivity and profits, but it can come at the expense of some employees' livelihoods. Of course, absent a PE acquisition, some firms may fail to remain in business at all. In this regard, PE buyouts can mitigate potential job loss.

S ESOP Conversions

S ESOP conversions have averaged around 100 per year since 2002. There is less variability in this exit strategy than in IPOs and PE buyouts – the two strategies with comparable totals in some years. The fewest conversions were in 2002 and totaled 86, while the most occurred in 2012, when 149 conversions took place.[11] (See **Chart 6**.)

An S ESOP is not a viable option for all firms. Among other factors, a company must be profitable enough to finance the cost of buying out an owner.[12] But, as explained in greater detail below, there are many benefits to a firm and its employees from an S ESOP buying out the owner.

Comparing S ESOP Conversions with Popular Exit Strategies

While it is important to acknowledge that different types of exit strategies are appropriate for different companies, it is nonetheless telling to compare the number of S ESOP conversions with other types of deals. It should be noted that the data are not precisely comparable. But, as noted above, the trends are still informative.

S ESOP conversions represent a small share of the common types of exit strategies. After domestic M&A deals (which dwarf the other types of deals), inbound M&A deals are the most popular.

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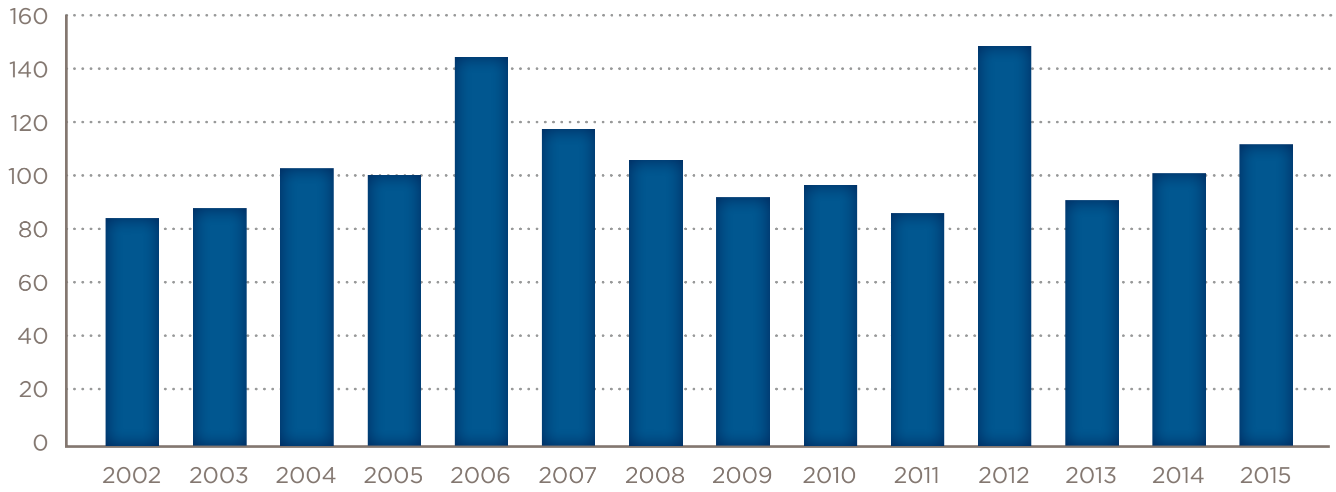
9 American Investment Council, "Who Benefits?" available at www.investmentcouncil.org/private-equity-at-work/education/who-benefits.

10 Steven J. Davis, John Haltiwanger, Kyle Handley, Ron Jarmin, Josh Lerner, and Javier Miranda, "Private Equity, Jobs, and Productivity," *American Economic Review* 104, no. 12 (December 2014): 3956–90.

11 It should be noted that these totals exclude S ESOPs with fewer than 15 active participants since these records are likely not complete.

12 NCEO, "Using an Employee Stock Ownership Plan (ESOP) for Business Continuity in a Closely Held Company," available at www.nceo.org/articles/esop-business-continuity.

CHART 6. S ESOP CONVERSIONS

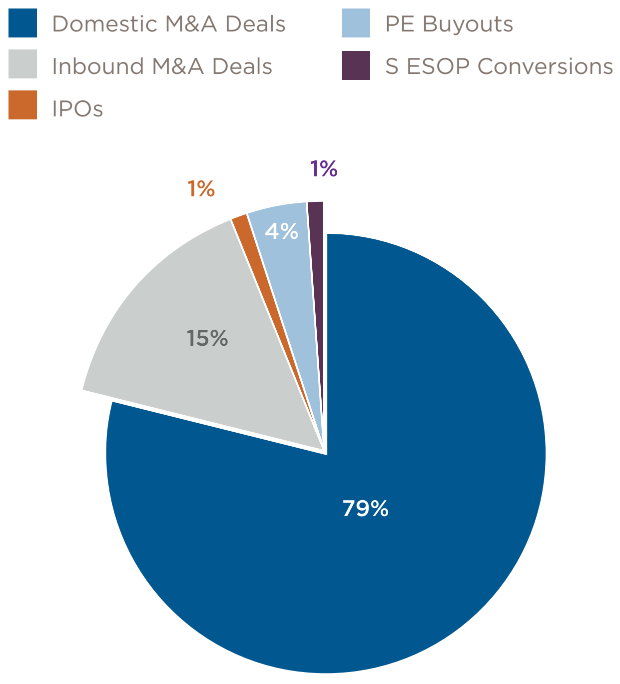


Source: *Author's analysis of Department of Labor Form 5500 data.*
Note: *S ESOPs with fewer than 15 active participants are excluded.*

Focusing just on 2015, the most recent year for which there is complete information, S ESOP conversions represent 1 percent of the exit strategy transactions. S ESOP conversions are roughly as common as IPOs (1 percent), less common that PE buyouts (4 percent), and well below the share of acquisitions by foreign buyers (15 percent). Domestic M&A accounts for nearly 80 percent of deals. **Chart 7** illustrates this breakdown. Considering the positive spillover effects of S ESOPs, discussed next, it would be a welcome development to see the share of S ESOP conversions grow.

"Considering the positive spillover effects of S ESOPs, it would be a welcome development to see the share of S ESOP conversions grow."

CHART 7. DEAL TYPES IN 2015



Source: *Department of Labor Form 5500 data; Institute for Mergers, Acquisitions and Alliances; Pitchbook; and Securities and Exchange Commission filings (WilmerHale).*

Note: *S ESOPs with fewer than 15 active participants are excluded.*

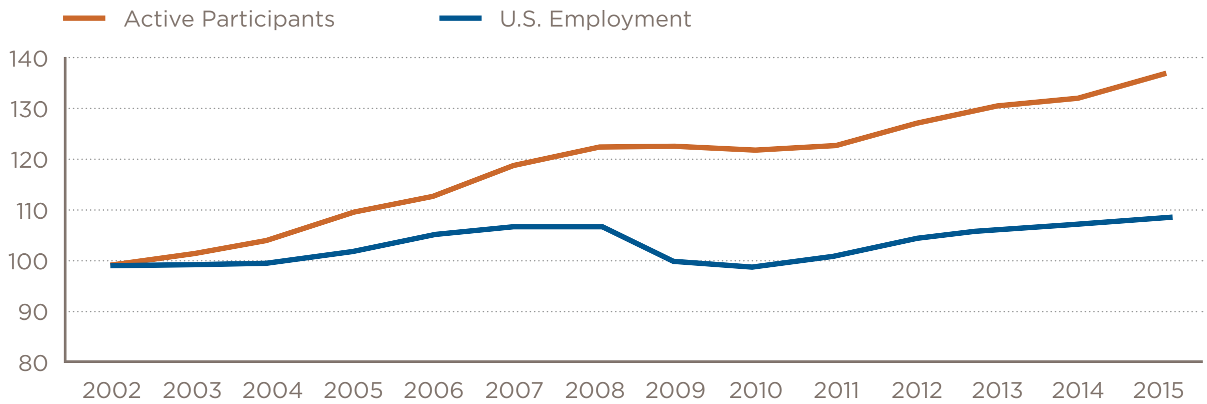
BENEFITS OF S ESOPS

An S ESOP conversion is a viable option for many business owners. The qualities of S ESOPs are such that it would be beneficial to the economy as a whole if more owners seriously consider this option when selling their businesses. As I have written previously, employee loyalty enhances firm prosperity.[13] And employee ownership — which an ESOP makes possible — cultivates employee loyalty.[14] S ESOPs in particular lead to greater firm longevity and higher wages, wage growth, job stability, retirement plan contributions, employment, and sales.[15]

In 2015, there were roughly 2,500 S ESOPs with nearly 500,000 active participants in these firms. From 2002 through 2015, there has been a steady rise in the number of S ESOPs and the number of active participants except for a brief dip at the time of the Great Recession.

Despite this dip, the Great Recession showcased the impressive resilience of S ESOPs. As **Chart 8** shows, a subset of S ESOPs — those that have existed since 2002 — proved far more resilient than private employment. While total nonfarm private employment in the United States has increased 8 percent since 2002, employment among S ESOPs in continual operation since 2002 has increased an impressive 37 percent.

CHART 8. ACTIVE PARTICIPANTS IN S ESOPS IN EXISTENCE 2002–2015 VS. TOTAL NONFARM PRIVATE U.S. EMPLOYMENT (2002=100)



Source: *Author's analysis of Department of Labor Form 5500 data.*
Note: *S ESOPs with fewer than 15 active participants are excluded.*

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13 See Alex Brill, "An Analysis of the Benefits S ESOPs Provide the U.S. Economy and Workforce," MGA White Paper, July 26, 2012; and Alex Brill, "Macroeconomic Impact of S ESOPs on the U.S. Economy," MGA White Paper, April 17, 2013.

14 See Thomas E. Becker, Robert S. Billings, Daniel M. Eveleth, and Nicole L. Gilbert, "Foci and Bases of Employee Commitment: Implications for Job Performance," *The Academy of Management Journal* 39, no. 2 (April 1996): 464–82; Daniel J. Koys, "The Effects of Employee Satisfaction, Organizational Citizenship Behavior, and Turnover on Organizational Effectiveness: A Unit-Level, Longitudinal Study," *Personnel Psychology* 54, no. 1 (Spring 2001): 101–114; and Jon L. Pierce, Tatiana Kostova, and Kurt T. Dirks, "Toward a Theory of Psychological Ownership in Organizations," *The Academy of Management Review* 26, no. 2 (April 2001): 298–310.

15 See NCEO, "Research on Employee Ownership, Corporate Performance, and Employee Compensation," 2012, available at www.nceo.org/articles/research-employee-ownership-corporate-performance.

CONCLUSION

Despite the steady growth in the number of S ESOPs and their active participants, S ESOPs remain an underutilized exit strategy for business owners preparing to exit their firms. Given the manifold benefits that S ESOPs generate for employees and the economy alike, it would be a positive development if more private business owners choose this exit strategy when it is a viable one for them and their company and if policies to promote wider adoption of S ESOPs were pursued.

ABOUT THE AUTHOR

Alex Brill is the CEO of Matrix Global Advisors, an economic policy consulting firm. He is also a research fellow at the American Enterprise Institute and in 2010 served as an advisor to the Simpson-Bowles Commission. Previously, he was chief economist and policy director to the House Ways and Means Committee. Prior to his time on the Hill, he served on the staff of the President's Council of Economic Advisers.

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