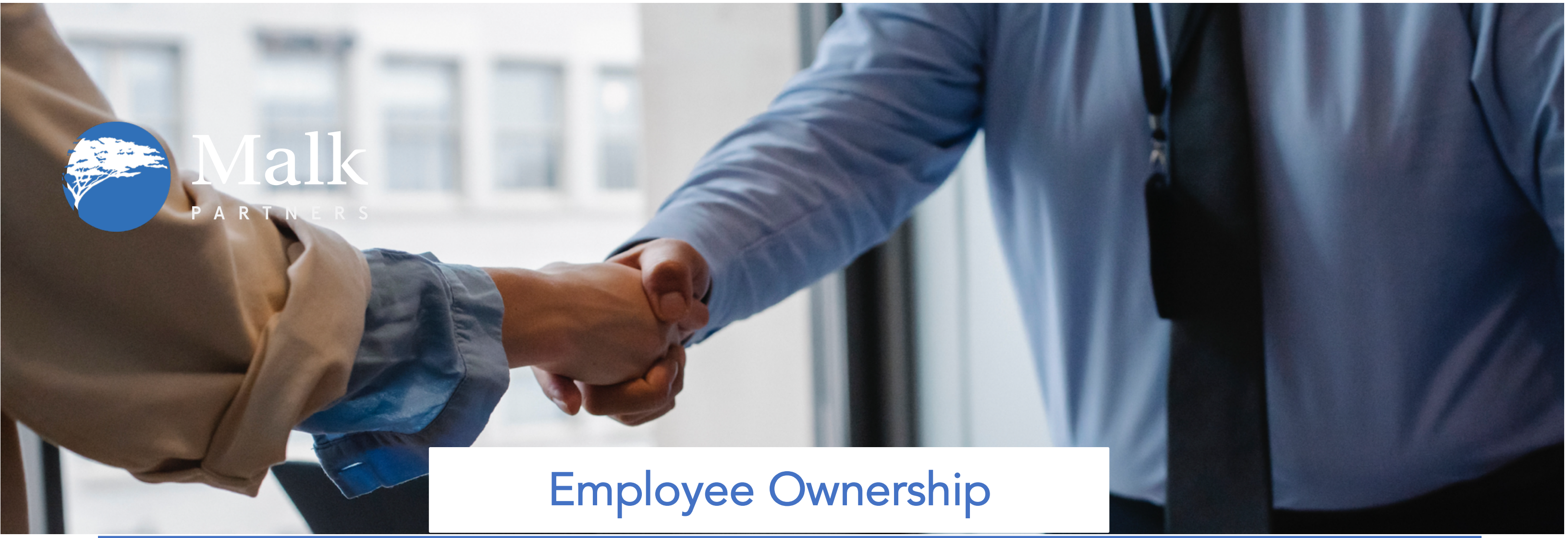

Employee Ownership

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KEY TAKEAWAYS

1. Employee ownership presents a valuable opportunity for private equity firms to enhance worker satisfaction, increase productivity, reduce turnover costs, and gain public recognition; however, these opportunities must be weighed against challenges posed by regulatory compliance and valuation concerns.
2. The appeal of employee-owned companies and employee ownership structures are on the rise in private markets, prompting private equity firms to explore various forms of employee ownership that take company structure and investment strategy into consideration.

Following the COVID-19 pandemic and the subsequent war for talent, employee ownership received significant attention as a possible channel to improve employee value proposition and increase engagement. At a high level, employee ownership refers to any arrangement where a company's employees can own shares or the right to the value of shares in their company, typically at reduced or no cost. The rise of ESG and social impact investing in the private markets has created a heightened focus on responsible business practices, and as a result, private equity firms have increasingly considered employee ownership options as a potential tool to support social impact goals, promote inclusive growth, and foster a sense of shared prosperity among employees. Furthermore, employee ownership programs received an influx of interest as an avenue to reduce income inequality and racial wealth gaps exacerbated by the pandemic. Today, as inflation has driven economic uncertainty, the question has become — how important is employee ownership?

MAKING EMPLOYEES OWNERS

Among available employee ownership models, key examples include stock options, restricted stock units (RSUs), and phantom stock. Stock options require employees to contribute to employee stock purchase plans (ESPPs) which may pose participation challenges for less financially stable employees. Notably, however, they offer the advantage of allowing employees to retain their equity in the event of a resignation. Comparably, RSUs grant employees stock based on specific conditions, enabling them to benefit from stock appreciation without shouldering any financial risk. Phantom stock plans offer a cash-based incentive linked to the company's performance. While these employee ownership models offer notable advantages, they can present challenges for private equity firms, as firms must effectively manage and monitor stock conditions within portfolio companies and grapple with the intricacies of tax implications, liquidity concerns, and exit considerations.

Employee stock ownership plans (ESOPs) and employee ownership trusts (EOTs) are appealing employee ownership options for private equity firms due to their inclusive nature (i.e., do not require employee payments) and ability to foster employee engagement. Growing in popularity within the U.K., EOTs offer employees shares from existing founders or owners rather than from the company directly; employees may not hold direct voting rights based on ownership share. EOTs may be more suitable for companies where the preservation of the business' legacy and long-term stability are key considerations. They are commonly used in succession planning scenarios and can be useful to private equity firms looking to retain long-term ownership or foster employee engagement beyond the hold period. While ESOPs are the most common form of employee ownership in the U.S., both EOTs and ESOPs offer a combination of direct ownership, financial benefits, tax advantages, succession planning capabilities, and regulatory support, cementing them as preferred choices.

EMPLOYEE OWNERSHIP SPOTLIGHT: ESOPs

Employee Stock Ownership Plans allocate trusts which own company shares to employees via structured vesting schedules. These vesting schedules permit employees that meet predetermined criteria accrued ownership rights, enabling them to become beneficiaries of the trust. Though public companies may also establish ESOPs, these ownership structures are predominantly found within small to mid-sized private companies. As of February of 2023, ESOPs are utilized by over 6,000 companies and provide ownership to more than 14 million employees.

ESOPs were first implemented in the private equity setting by the founder of Kelso & Company, Louis Orth Kelso, in 1956. Kelso believed ESOPs paved the way to a more equitable and democratic economy, gradually transforming labor workers into capital workers. In the modern investment landscape, ESOPs remain appealing to many investors, offering financial benefits for employees and being particularly advantageous for high-growth companies where employees directly influence the company's future value.

ESOPs in During Economic Uncertainty

As companies seek opportunities to reduce expenses, layoffs are often employed as a means of cost-saving, presenting a difficult trade-off between financial considerations and employee wellbeing. The resiliency that employee ownership facilitates can be advantageous to private equity firms looking to create value. Through retention of key talent, increased employee engagement, and avoided turnover costs, employee-owned companies can experience greater profits than their counterparts in times of economic downturn while simultaneously enjoying reputational benefits and increased attraction of socially minded investors.

Employee ownership plans also contribute to improved financial stability for employees, mitigating risks associated with the potential negative impacts of job loss. Notably, research conducted by the National Center for Employee Ownership (NCEO) found that ESOPs in particular can have significant benefits for workers and their families, reflected through retirement balances nearly four times higher than those of workers at non-ESOP companies. Participants also experienced higher median salaries, longer job tenures, and greater access to retirement benefits. With these benefits, ESOPs serve as a catalyst to engagement and in turn, can increase productivity by approximately 2.5%. Furthermore, Rutgers University identified that lower-income workers at employee-owned firms are more financially secure than their peers; employee-owned firms also show less income disparity among minority workers, with Black and Latinx employees reflecting wealth as much as twelve times the median of Black and Latinx households nationally. The convergence of these factors underscores the powerful impact of employee ownership for both enhanced job security and the potential for robust financial returns.

In times of economic downturn, employee ownership can provide benefits to both companies and employees by fostering a sense of responsibility between employees and owners for economic performance. Furthermore, the significance of employee loyalty becomes even more pronounced, as economic uncertainty can damage employee trust and engagement. Notably, employees at ESOP companies have a median tenure 46% greater than employees at those without an ESOP.

Financial Considerations for ESOPs

Given the typical hold period of five to seven years in private equity investments, firms must thoroughly evaluate the feasibility and suitability of incorporating employee ownership models into their portfolios. Employee ownership arrangements can present challenges for companies, notably the financial strain of repurchasing shares from departing ESOP employees and the need for operational cash flow. Companies with mature ownership plans may be open to selling to private equity firms in situations where they lack a succession plan or require additional capital to generate growth, among other reasons. For companies with an ESOP, private equity firms can collaborate with trustees to acquire a controlling interest in the company through direct share purchases, leverage buyouts, or hybrid deal structures.

ALTERNATIVE EMPLOYEE OWNERSHIP MODELS IN PRIVATE EQUITY

ESOPs may be preferential for some firms due to their established structure and regulatory framework; however, other ownership models offer different advantages and may be more suitable in certain circumstances. Stock options, restricted stock units (RSUs), and phantom stocks can provide more flexibility to firms as they create incentive options to employees without requiring a substantial upfront investment. They also allow firms the ability to offer stock options selectively to key employees or those in critical roles, aligning ownership with performance and retaining top talent. This added flexibility enables firms to design ownership programs that suit their specific needs or investment strategies while adjusting the level of financial commitment required. During periods of economic uncertainty, ownership structures that rely on employee stock purchasing may offer comparable advantages to ESOPs in terms of increased employee engagement or retention, however, they also face similar challenges in relation to potential employee dissatisfaction caused by a decline in stock prices.

Challenges of Employee Ownership

Importantly, ownership itself does not guarantee a company increased engagement, and it can become a burden to private equity firms who struggle to manage the intricacies of regulations and changing employee sentiment. Depending on firm structure and investment strategy, employee ownership plans are subject to market volatility, which can lead to potential dissatisfaction or financial instability among employees. Additionally, these programs can be time-intensive, requiring significant administrative resources and steep legal costs that may not align with the typical shorter hold periods of private equity investments. During periods of economic uncertainty, employee ownership plans can be difficult for firms due to heightened market volatility and decreased company valuations, which may amplify employee dissatisfaction, particularly among those whose retirement savings are affected. They can also impact the ability to execute exit strategies as decreased market demand may hinder the firm's ability to sell the company or take it public, which could affect the liquidity of employee-owned shares. This limited exit landscape can complicate the private equity firm's plans to maximize returns and potentially result in longer hold periods.

These challenges may be alleviated through a steadfast commitment to prioritizing clear governance mechanisms and fostering effective communication channels between employees and management. By engaging in proactive communication and obtaining a comprehensive understanding of the ownership landscape before making any binding commitments, firms can effectively sidestep potential negative implications and instead reap the rewards of heightened productivity and satisfaction within their employee base.

Ownership Works

While PE firms can independently set up programs to encourage the pursuit of employee-owned companies, Ownership Works (OW), a nonprofit organization founded by KKR partner Peter Stavros, aids companies and investors in providing all employees with the opportunity to build wealth at work. The nonprofit has experience establishing ownership plans across industries and unionized environments. The process typically involves designing and implementing ownership programs, incorporating employee decisions and feedback, disseminating financial education materials, and providing data analytics capacity.

Case Study

Some PE firms have already taken steps to integrate employee ownership into their ownership structures, demonstrating both their feasibility and their advantages. Tailwind, a founding partner to Ownership Works, established the Tailwind Ownership Program (TOP) to provide every full-time employee within the firm the opportunity to participate in and benefit from the company's continued growth.

Tailwind has shared its successes by establishing employee ownership programs within certain portfolio companies. One company, National Trench Safety (NTS), maintains an Employee Equity Participation Program that awards $10,000 in equity to each employee on an annual basis, an initiative that Tailwind has directly correlated to reduced employee turnover. In addition, NTS has publicized its program each time a cash dividend is paid out to employees, likely bolstering recruitment. Ultimately, Tailwind believes that a reduction in total ownership of its portfolio companies is worth the benefits derived from investments in employee ownership, a clear indicator of the benefits they can provide to PE firms in environments of both economic growth and contraction.

NAVIGATING EMPLOYEE OWNERSHIP IN THE PRIVATE MARKETS

When looking to acquire companies with employee ownership plans, PE firms must be prepared to navigate the complexities of the ownership structure and ensure that the interests of both the employees and investors are aligned. Firms must first assess the investment for feasibility and alignment between the company's goals and the firm objective by assessing factors such as employee demographics, company financials, organizational culture, and employee buy-in within the portfolio, as well as legal and regulatory considerations for the firm. Defining objectives of the programs and conducting stakeholder discussions can provide firms with additional insight into their ideal ownership structures and allow for more tailored legal and financial due diligence. For employee ownership more broadly, addressing these complexities (i.e., balancing the interests of plan participants with firm objectives such as maximizing returns, improving operational efficiency, company exit) though use of governance structures and communication strategies can aid private equity firms in facilitating successful transactions. In effectively managing these dynamics, PE firms can tailor their strategies to create more robust and profitable companies.

Employee ownership offers a viable avenue for private equity companies to foster stronger engagement and provide a better employee value proposition to their portfolio company employees. Despite challenges, the benefits for employees in terms of financial stability and satisfaction, as well as for companies in terms of growth, retention, and reputation, make employee ownership a worthwhile pursuit to meet ESG goals.

Employee Ownership at Malk

In 2020, Malk launched an ESOP to solidify its commitment to stakeholder capitalism. Today, employees, as partial owners of the firm from their first day of employment, work to drive Malk's mission forward to steer the flow of capital to responsible investors and investments.

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