CREATING SHARED VALUE

An Investor Guide to the Growing Employee Ownership Investment Opportunity

June 2023

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Acronyms

CDFI	Community development financial institution
EOT	Employee ownership trust
EPITDA	Earnings before interest, taxes, depreciation, and amortization
ESG	Environmental, social, and governance
ESOP	Employee stock ownership plan
M&A	Mergers and Acquisitions
SBA	US Small Business Administration
SEC	US Securities and Exchange Commission

Executive Summary

1

Employee ownership is a critical opportunity for investors to reduce economic inequality and address urgent environmental, social, and governance (ESG) issues.

Employee ownership is a **win-win solution**, supported by the vast majority of Americans.

Employee ownership **reduces economic inequality** and has the potential to significantly address racial and gender wealth gaps.

A recent study found that if private US companies had 30% employee ownership, the wealth of the bottom 50% of Americans and the median wealth of Black households would quadruple.

Employee ownership **creates high quality, stable jobs** and provides a foundation for strong business performance.

Employee-owned companies have been shown to have lower default rates than conventional firms and exhibit stronger growth.

Job security is higher in employee-owned firms, which were 3.2 times more likely to retain staff during the pandemic.

2

Increasing the number of employee-owned firms requires catalytic investment in emerging firm, fund, and deal structures.

A small number of companies are employee-owned at the point of formation and launch. However, **the majority of existing employee-owned firms were formed after an existing shareholder or founder transferred ownership to its workers.**

Approximately 550 conventional companies convert to employee ownership per year. Approximately half use external finance, with the remainder acquired by an existing employee-owned firm or converting ownership with no external funding.

Most existing conversions by dollar and number are traditional Employee Stock Ownership Plan (ESOP) conversions, with an estimated $3–7 billion in company value converted annually. However, there has been no growth in the number of these traditional conversions.

The opportunity for employee ownership conversions to scale is enormous. With a wave of business owner retirements and over $2 trillion in US ownership value changing hands annually, employee ownership has ample room for growth within the business sale market.

New approaches—such as search funds, holding companies, and subordinated debt—are unlocking conversions that would not be possible with traditional conversion structures. These approaches often provide attractive terms that appeal to a broad range of sellers and company circumstances, including an active "knock on the door," participating in a competitive sale process, or offering more cash at close to providing succession leadership.

Employee ownership start-up finance remains limited in scale, but **practitioners are developing and deploying tools that enable small employee-owned firms to scale.**

The main challenge in funding growth while remaining employee owned is that investors cannot use equity. Equity offers the flexibility for companies to use investment proceeds for growth with long-term payout through the sale of equity.

Employee ownership practitioners are deploying non-equity tools that aim to meet the same objectives. For example, many cooperative practitioners have developed loans with payment flexibility to help start-ups focus on growth. Equity-like debt tools include preferred shares with a target annual payout and revenue-based financing.

3 Employee ownership investors are intentionally catalytic in building infrastructure and momentum for employee ownership through their deals.

Catalytic investment in employee ownership can have several aims: to **fill market gaps and unlock deals** that would not otherwise be possible, to **create "lighthouse" businesses or funds** that serve as a replicable model and demonstrate to the public what alternative economic systems can look like, and to **back early innovations** with limited track records.

To achieve these aims, **many investors are using concessionary returns and terms** (where they can drive the most impact), **early investments in deals or funds** with higher perceived risk, **subsidized transaction costs and technical assistance**, and **requiring meaningful employee governance participation.**

4

There is a significant opportunity for catalytic investment in employee ownership across the risk-return spectrum.

A diversity of approaches is needed, with more experimentation and risk-taking. There is no silver bullet for employee ownership finance, just as there is no one type of deal or company.

Concessionary capital can help facilitate deals with higher transaction costs but deeper workplace impact.

Early financing of innovative scalable models is needed to prove out business models that can be adopted by more conventional investors.

Introduction

Employee ownership restructures businesses and the economy to build wealth for working people. Shifting corporate ownership to employees is a uniquely powerful vehicle to not only reduce wealth inequality, but also to improve the quality of work and build strong businesses. Providing all workers with the ability to share in the profits that they help to generate is also an important tool for addressing the significant race, gender, and class inequities that we face in society today. It is a win-win: through employee ownership, catalytic and ESG-oriented investors can achieve both deep impact and robust, risk-appropriate returns.

But to unlock the transformative potential of employee ownership we need more employee-owned companies. . . . To get more employee-owned companies, catalytic and ESG-oriented investors must start actively promoting employee ownership and investing in companies that are looking to become employee-owned.

THERE ARE THREE SIGNIFICANT STEPS THAT FINANCE PROVIDERS CAN TAKE IN ORDER TO GROW EMPLOYEE OWNERSHIP:

1. Promote employee ownership as a critical strategy for addressing economic inequality and advancing ESG goals.
2. Increase awareness within the business community about the models, viability, and value of employee ownership.
3. Create easier access to finance for those looking to establish or convert companies to employee ownership.

This paper aims to demonstrate the value of employee ownership to society as well as to provide an overview of the existing strategies for financing employee ownership. This paper collates information about the different models for employee ownership and the range of different financing strategies into one resource. The goal is to create a self-contained repository of a baseline of information for potential employee ownership investors that can make it easier to understand potential investment opportunities, find partners, and ultimately, invest. To achieve this, the paper is structured as follows:

PART 1: Employee Ownership: A Critical Tool for Investors Seeking to Combat Inequality and Improve the Lives of Working People

An outline of how employee ownership is a critical tool for combatting inequality and improving the lives of working people and why employee-owned companies should be in every impact-driven investor's portfolio

PART 2: Context: Employee Ownership Structures

A brief summary of the current employee ownership landscape, including the different legal structures and considerations for creating employee-owned companies

PART 3: Strategies for Direct Investment in Employee Ownership

A guide to different financing strategies (including funds and deal terms) for directly investing in employee-owned companies and the key organizations and groups affiliated to each

PART 4: Maximizing Catalytic Impact through Employee Ownership Investment

Guidance for maximizing worker impact through employee ownership investment

Throughout, this paper spotlights specific companies, deals, and strategies. We believe it is important to highlight the small but strong constellation of actors who are already providing technical and financial support for employee ownership. We encourage newcomers to reach out to those actors, all of whom have expressed a willingness to be open in their approaches and strategies—as well as to us—in order to foster new relationships and help seed an ownership revolution.

Understanding the Problem

By definition, employee ownership limits conventional uses of equity by external investors. Instead, equity ownership is held by employees who generally contribute little, if any, capital for their stake. For this reason, employee ownership finance requires the use of alternatives to conventional equity that can simultaneously support growth or compensate selling shareholders while maintaining employee ownership.

Too often entrepreneurs wishing to launch or create employee-owned companies—as well existing founder and shareholders looking to transfer their ownership shares to employees—report difficulties obtaining appropriately-structured finance for these transactions.[01] Existing capital infrastructure is insufficient in volume and structure to address the growing demand for employee ownership.

Structurally, the traditional employee ownership conversion finance approach, with a sellers note and senior debt, generally only enables conversions in limited situations. It typically requires a low-debt and financially strong business with a seller who independently pursues an employee ownership conversion and is willing to receive less cash at close than a comparable sale. New structures aim to make employee ownership possible for more companies.

Beyond the existing limitations around access to suitable capital, there is the more foundational lack of awareness about employee-ownership as a viable alternative to investor-ownership. Many existing founders and shareholders are unaware of or do not fully understand the implications of selling or transferring ownership to their employees. Unlike competing businesses and private equity firms which “knock on the door” to compel a sale, employee ownership conversions are typically initiated by the shareholders with limited outside influence. Catalytic and ESG-oriented financiers are well placed to change this.

01 Amelia Evans, “Redefining the Concept of an Ethical Company,” 2020 ICDE Research Reports (Institute for the Cooperative Digital Economy, 2020), 13–15, https://platform.coop/blog/2020-research-reports-by-the-fellows-of-the-institute-for-the-cooperative-digital-economy/.

Promisingly, over the past several years, the field of dedicated employee ownership finance has experienced significant growth and a proliferation of innovative, impactful, and scalable strategies. Yet information about these new and exciting approaches—as well as some basic information about the size, scale, and terms of traditional employee ownership finance—remains fragmented and difficult to obtain. Different strategies, structures, and terms for employee ownership are not well known even between different practitioners within the employee ownership space, let alone among the wider financial industry.

This paper aims to close that knowledge gap and to enable new investors to embrace and advance employee ownership.

Methodology, Terminology, and Scope

This paper was developed through a literature review and interviews with over fifty expert practitioners in the field (see the appendix for a full list of the individuals). The spotlights were written by the specific companies or individuals profiled. Given that this is an evolving space, many industry dynamics have not yet been published externally. Where claims are not specifically cited, conclusions presented represent the broad consensus of interviewees.

The paper builds on the work of numerous groups, including the Democracy Collaborative, Democracy at Work Institute, The Working World, Project Equity, and Purpose, who have paved the way with longstanding experience in this space and detailed reports.[02] We are grateful for the many individuals who spoke with us, providing meaningful insight and sharing case-studies on their work, and for those who took the time to review a draft version of this publication.[03]

Some key definitions for the purposes of this paper include the following:

- *Employee-owned* and *employee ownership* refer to companies that have broad-based, majority employee ownership. For example, stock option and share purchase plans, which are not designed to result in majority employee ownership, are not included.
- *Employee* is used to refer to the company's workers, broadly defined, that are included in ownership. This can mean formal employees and workers who may be classified as independent contractors but are properly understood to be under the control of the corporation.
- *Ownership* is used broadly: it can be direct equity holdings by employees or indirect/beneficial ownership through a trust or other holding structure.

02 Andrea Armeni and Camille Kerr, "Investing in Employee Ownership: Financing Conversions Through a Private Equity Fund Model," November 7, 2019, http://transformfinance.org/briefings/investing-in-employee-ownership-financing-conversions-through-a-private-equity-fund-model; Jessica Rose et al., "Opportunity Knocking: Impact Capital as the Transformative Agent to Take Employee Ownership to Scale" (Washington, DC: Democracy Collaborative, December 17, 2020); Dorian Gregory et al., "The Lending Opportunity of a Generation: FAQs and Case Studies for Investing in Businesses Converting to Worker Ownership" (Cooperative Fund of New England, Project Equity, and Democracy at Work Institute, 2016), https://project-equity.org/wp-content/uploads/2019/11/LendingOpportunityOfAGeneration_updated-Nov-2019.pdf; Therese Detablan, Amanda Esteves, and Gemma McHardy, "Steward-Ownership: A Short Guide Book to Legal Frameworks" (Hamburg: Purpose Foundation, 2020), https://purpose-economy.org/content/uploads/purpose-guidebook-for-lawyers10022021.pdf.

03 Special thanks to Taylor Sekhon from Social Capital Partners, Alison Lingane from Project Equity, Jonathan Ward from Fund for Jobs Worth Owning, Zoe Schlaag from Common Trust, Greg Brodsky from the Equitable Economy Fund, and Astrid Schultz from Zebras United.

The research and ideas in this paper are limited to the following:

- **Businesses with material ownership stakes for workers:** The paper focuses on broad-based, majority employee ownership. While many of the same principles apply for companies open to sharing a small portion of their ownership with workers, majority employee ownership can result in more meaningful worker impact.
- **Start-up and conversion finance:** Start-up and conversion finance are the focus of this report because they both represent ways to *establish* employee-owned firms. Growth and expansion finance for existing employee-owned companies are not a focus of this report, given the clear parallels with conventional business lending and the existing literature available on cooperative lending.[04]
- **Primary focus on the US:** While the geographic focus for this paper is the US (where some of the models, such as employee stock ownership plans, are uniquely utilized), we hope that many of the approaches and conclusions in this report are of interest to the broader employee ownership community.

Finally, while this paper focuses primarily on ownership stakes for employees specifically, the general principals of broad-based ownership can be applied more broadly. Specifically, with some modification, these and similar financing structures can enable other essential stakeholders to participate in the benefits of ownership, such as local community members, customers/users, supply chains actors, and beyond.

04 Joe Marraffino, "Cooperative Financing Resource List," Co-op Cincy, accessed July 29, 2022, https://coopcincy.org/cooperative-financing-resource-list.

PART 1

Employee Ownership: A Critical Tool for Investors Seeking to Combat Inequality and Create Meaningful Work

To meaningfully address economic and societal inequality in the US, investors must address ownership. Concentrated, private corporate ownership is a driving force behind wealth inequality, racial and gender wealth gaps, and insecure workplaces, all of which undermine broader social and political cohesion.

ESG investors are increasingly declaring the need for urgent action on the issues employee ownership addresses: wealth inequality, racial and gender wealth gaps, and the quality of work. However, despite employee ownership's potential to significantly remediate some of the most pressing inequities of today, it is currently not part of mainstream ESG or "ethical" investing strategies. It is time for this to change. Investors should adopt the following strategies:

1. **Direct investment:** raising the levels of direct investment in companies and otherwise increasing the proportion of holdings in employee-owned companies within a portfolio (as explored throughout this paper)
2. **Disclosure:** demanding that metrics relating to employee ownership be disclosed by large companies and be part of key ESG indices
3. **Engagement and shareholder proposals:** engaging directly with companies and policymakers to propose and support greater levels of employee ownership

A. The Societal Value of Employee Ownership

1. A Direct Strategy for Fighting Economic Inequality

In the US, the wealth gap between the rich and everyone else has been increasing by every major statistical measure for more than thirty years. Income disparities are so pronounced that America's top 10% now receive nine times as much income as the bottom 90%.[05] All indicators suggest that inequality will continue to exacerbate: since the Great Recession in 2007, the richest 20% of families saw their wealth continue to grow, while the remaining 80% of families had their wealth contract.[06] This led to a doubling of the wealth gap between the US's poorest and wealthiest families between 1989 and 2016.[07]

A central driver of this inequality is the fact that business ownership is so uneven: in 2020, 87% of public stocks were owned by the top 10% of households, with 45% of Americans owning no stocks at all.[08] Private company ownership is even more exclusive, with only 13.4% of Americans owning equity in private businesses.[09]

05 Saez, Emmanuel. Striking It Richer: The Evolution of Top Incomes in the United States. 2020, eml.berkeley.edu/~saez/saez-UStopincomes-2018.pdf.

06 Juliana Menasce Horowitz, Ruth Igielnik, and Rakesh Kochhar, "Trends in Income and Wealth Inequality," Pew Research Center's Social & Demographic Trends Project (Pew Research Center, January 9, 2020), https://www.pewresearch.org/social-trends/2020/01/09/trends-in-income-and-wealth-inequality/.

07 Horowitz, Igielnik, and Kochhar.

08 Bob Pisani, "Wealth Gap Grows as Rising Corporate Profits Boost Stock Holdings Controlled by Richest Households," CNBC, August 27, 2020, https://www.cnbc.com/2020/08/27/wealth-gap-grows-as-rising-corporate-profits-boost-stock-holdings-controlled-by-richest-households.html.

09 Jim Wang, "What Percentage of Americans Own Stock? The Answer May Surprise You," Best Wallet Hacks (blog), February 10, 2020, https://wallethacks.com/stock-ownership-in-america/.

Equitable distribution of capital is fundamental to equitable distribution of wealth; addressing wages alone is insufficient. Indeed, since the 1980s, capital has been accruing a growing share of our economic output as labor's share declines, further exacerbating the wealth gap between workers and investors/owners.[10]

Studies confirm employee ownership's powerful ability to reduce wealth and income inequality. In the US, workers in majority-employee-owned employee stock ownership plans (ESOPs) report 2.2 times the savings of conventional workers.[11] Workers in employee-owned firms also tend to receive comparably higher wages.[12] A recent study into the effects of employee ownership on low and moderate income (defined as those earning less than $61,372), found that those working in ESOPs had ESOP accounts valued from $15,000 to $6,000,000 per worker, with a median value of $165,000.[13] By contrast, the typical American household at the fiftieth percentile median had just $17,000 in savings. In addition, workers close to retirement (ages sixty to sixty-four) had ten times more wealth compared with the typical American in same age group.

2. Significant Potential to Address Racial and Gender Wealth and Income Inequality

Exclusionary ownership has particularly adverse effects on female-identified people and people of color. Discrimination and intersecting structural barriers across race and gender have limited many people's access to the avenues through which wealth can be built—such as access to retirement savings, home equity, and business equity—as well as constrained income levels. This has led to significant race and gender wealth and income gaps: in 2018, for every dollar earned by a white man, Black women earned sixty-two cents and Hispanic or Latina women earned fifty-four cents.[14] In 2019, the typical white family had eight times the wealth of the typical Black family and five times the wealth of a Latinx family.[15] Similarly, on average, females in the US own just thirty-two cents for every dollar owned by males.[16]

Employee ownership has the potential to increase not just business and financial asset ownership, but also low levels of retirement savings.[17] This makes it a powerful tool for

10 James Manyika et al., "A New Look at the Declining Labor Share of Income in the United States," McKinsey Global Institute (McKinsey & Company, May 22, 2019), https://www.mckinsey.com/featured-insights/employment-and-growth/a-new-look-at-the-declining-labor-share-of-income-in-the-united-states.

11 "Research on Employee Ownership," NCEO, June 2022, https://www.nceo.org/article/research-employee-ownership.

12 "Research on Employee Ownership."

13 Janet Boguslaw and Lisa Schur, "Building the Assets of Low and Moderate Income Workers and Their Families: The Role of Employee Ownership," Curriculum Library for Employee Ownership (Rutgers School of Management and Labor Relations, March 2019), https://cleo.rutgers.edu/articles/building-the-assets-of-low-and-moderate-income-workers-and-their-families-the-role-of-employee-ownership/.

14 "Quick Facts About the Gender Wage Gap," Center for American Progress (blog), accessed August 26, 2022, https://www.americanprogress.org/article/quick-facts-gender-wage-gap/.

15 Bhutta, Neil, "Disparities in Wealth by Race and Ethnicity in the 2019 Survey of Consumer Finances," FEDS Notes, Federal Reserve, 2020, www.federalreserve.gov/econres/notes/feds-notes/disparities-in-wealth-by-race-and-ethnicity-in-the-2019-survey-of-consumer-finances-20200928.htm.

16 McCulloch, Heather, "Wealth, Not Just Wages, Is the Way to Measure Women's Equality," Los Angeles Times, 2017, www.latimes.com/opinion/op-ed/la-oe-reich-mcculloch-womens-wealth-gap-20170825-story.html.

17 "Race and Gender Wealth Equity and the Role of Employee Share Ownership."

addressing the economic precarity facing people of color and female-identified individuals. A study found that if all private companies had 30% employee ownership, the wealth of the bottom 50% of Americans and the median wealth of Black households would quadruple.[18] These findings are not just hypothetical: women and people of color in employee-owned firms have reported substantially more wealth than their peers in non-employee-owned firms (for example, in a study from 2019, the reported median wealth of Latinx ESOP employees was nearly twelve times the wealth of the national median for Latinx households, and the wealth reported by Black ESOP employees was approximately three times the wealth of the national median of Black households).[19] In addition, employee-owners of color have 30% higher wage income than regular employees, and female employee-owners have 17% higher wage income than their counterparts.[20]

However, systemic and structural racism—as well as a lack of awareness and knowledge of employee ownership models among business owners and leaders, workers, investors, and policymakers—have prevented communities of color from accessing employee ownership as a wealth-building strategy.[21] For example, 22.9% of adult working men in the US participate in some kind of employee share ownership program (not necessarily majority employee ownership) while only 16.4% of women do. There are also differences by race and ethnicity: 22.4% of all white workers in the US participate, compared to 17.3% of Latinx workers and 14.3% of Black workers.[22]

3. Improved Job Security and Job Satisfaction

Employee-owned firms tend to have more empowered workforces with more secure jobs. Only three in ten Americans believe their opinions count at work.[23] By contrast, nearly three quarters of Americans reported that they would prefer to work at an employee-owned company.[24] This makes sense: ownership means both more earning potential and a sense of meaningful workplace participation.

Data illustrates the difference employee ownership makes in day-to-day experience in the workplace. Both perceived and actual job security is higher in employee-owned firms, where layoffs are far less prevalent.[25] During the COVID-19 pandemic, employee-owned firms were

18 Dudley and Rouen, "Employee Ownership and Wealth Inequality."

19 Boguslaw and Schur.

20 National Center for Employee Ownership (NCEO), "ESOPs and Preferred-Status Certification: Challenges and Opportunities for Employee Stock Ownership Plans and Business Preference Programs," July 24, 2017, 3, https://www.nceo.org/assets/pdf/EO_Preferred-Status.pdf.

21 "Race and Gender Wealth Equity and the Role of Employee Share Ownership."

22 Weissbourd et al., "Race and Gender Wealth Equity and the Role of Employee Share Ownership." It is unclear in this report from which year or years of GSS data these statistics were calculated.

23 Gallup Inc, "Want to Change Your Culture? Listen to Your Best People," Gallup.com, March 6, 2019, https://www.gallup.com/workplace/247361/change-culture-listen-best-people.aspx.

24 Karen Kahn, "Three Quarters of Americans Prefer to Work for an Employee-Owned Company," Fifty by Fifty, June 3, 2019, https://www.fiftybyfifty.org/2019/06/three-quarters-of-americans-prefer-to-work-for-an-employee-owned-company/.

25 "ESOPs and Jobs," Employee Ownership Foundation, accessed July 29, 2022, https://employeeownershipfoundation.org/articles/esops-and-jobs.

3.2 times more likely to retain staff.[26] Workers at employee-owned companies also reported greater access to training (70% to 48%) and involvement in company decision making (36% to 26%).[27] In *Fortune Magazine's* annual hundred best places to work survey of over 230,000 workers, companies that offered equity compensation and profit sharing performed better on measures of employee satisfaction.[28]

4. Societal Benefits Without Impairing Business Performance

Beyond the societal benefits, employee ownership can produce improved company performance and thus strong financial returns for investors and lenders. Employee ownership addresses principal-agent tensions by aligning all stakeholders toward firm profitability. While there is limited research into these issues, the available research documents higher performance of employee-owned firms.[29] For example, one recent study found that comparable US employee-owned companies were significantly less likely to go bankrupt or close and had higher employment and sales growth than conventionally owned firms.[30] As a result of strong performance, employee-owned firms also tend to have lower default rates on loans. From 2009 to 2013, two studies found default rates of only 1.3% and 1.1%, respectively, on senior loans to companies with employee stock ownership plans.[31] These default rates occurred during the Great Recession, a time of significant financial uncertainty. By comparison, corporate bond defaults average approximately 3% annually and rose to 11% in 2010.[32] Another study found that employee ownership combined with employee involvement was associated with a 3.9% increase in return on equity.[33]

The productivity benefits of employee ownership are already recognized within parts of the conventional business communities. For example, the start-up community often grants around 20% of company equity as form of compensation to increase employee engagement and motivation. The performance value of broad-based ownership is also increasingly being recognized by private equity firms. KKR, for example, has granted all employees equity shares in some of their acquisitions and found that in those cases, broad-based employee ownership has substantially improved investment returns.[34]

26 "Race and Gender Wealth Equity and the Role of Employee Share Ownership."

27 Douglas L. Kruse, Joseph Blasi, and Maureen Conway, "Sharing Profits and Ownership with Workers Not Only Make Them Happier, It Benefits the Bottom Line Too," The Conversation, May 30, 2019, http://theconversation.com/sharing-profits-and-ownership-with-workers-not-only-make-them-happier-it-benefits-the-bottom-line-too-111803.

28 Kruse, Blasi, and Conway, "Sharing Profits and Ownership with Workers Not Only Make Them Happier, It Benefits the Bottom Line Too."

29 Joseph Blasi, Douglas Kruse, and Dan Weltmann, "Firm Survival and Performance in Privately Held ESOP Companies," Sharing Ownership, Profits, and Decision-Making in the 21st Century, 2013, 109–24, https://doi.org/10.1108/S0885-3339(2013)0000014006.

30 Blasi, Kruse, and Weltmann, "Firm Survival and Performance in Privately Held ESOP Companies."

31 "Default Rates on ESOP Loans, 2009-2013," NCEO, March 8, 2017, https://www.nceo.org/articles/default-rates-esop-loans-2009-2013.

32 Shannon Ward, "Corporate Defaults Have Tripled: What You Need to Know," Capital Group, August 22, 2020, https://www.capitalgroup.com/ria/insights/articles/corporate-defaults-triple.html.

33 Corey Rosen, Beyond Engagement: How to Make Your Business an Idea Factory (NCEOip, 2020), 6, https://www.nceo.org/publication/beyond-engagement-ebook.

34 Pete Stavros, "Incentivizing Employees Creating Value - KKR Investor Day 2018," KKR, July 9, 2018, https://www.kkr.com/global-perspectives/kkr-podcasts/2018-investor-day-incentivizing-employees-creating-value.

B. How Can Investors Integrate Employee Ownership into ESG and Other Impact-Oriented Strategies?

For investors committed to addressing wealth inequality, racial and gender wealth gaps, and quality of work, it is critical they begin supporting employee ownership. Disclosure, engagement, and direct investment are three priority strategies they can begin implementing. While this paper focuses primarily on direct investment, we briefly outline the other two strategies—increased disclosure and engaging with companies, policy makers, and private equity firms.

1. Direct Investment

The most immediate and direct opportunity to expanhd majority employee ownership is by investing capital that facilities employee ownership conversion or start-up. Investors can invest in conversion and/or start-ups through funds or directly through deals, as outlined in more detail in part 3 of this paper (see page 22). Mainstream financial firms, including Citi, JP Morgan, and Goldman Sachs, have recently made billion-dollar commitments to directly invest in building wealth for underrepresented Americans.[35] If just a portion of such funds were made available to employee ownership, this would significantly increase the existing amount of capital available for converting firms to employee ownership (see, for example, the A&H Capital Partners spotlight on page 41).

2. Disclosure

Corporate disclosure on employee ownership and governance is severely limited. While somewhere in the realm of 10% of Fortune 500 companies are thought to have broad-based minority employee share ownership or profit sharing, individual company percentages and information is highly opaque.[36] Basic metrics might include the percentage of ownership held broadly by employees (including ownership distribution and the share of all full- and part-time workers covered), and whether a company has worker-elected board representatives or other employee-governance and decision-making rights. If companies were required or even incentivized to disclose such information, it could help create a "race to the top."

Disclosure strategies can include the following:

- **Advocate for voluntary and mandatory disclosure frameworks to incorporate employee ownership metrics.** Investors should advocate for disclosure efforts to include employee ownership metrics. In 2020, the US Securities and Exchange Commission (SEC) mandated disclosure on "human capital" by all US publicly traded

35 "Goldman Sachs | Making Progress Towards Racial Equity," Goldman Sachs, accessed July 29, 2022, https://www.goldmansachs.com/our-commitments/diversity-and-inclusion/racial-equity/; "Racial Equity Commitment," accessed July 29, 2022, https://www.jpmorganchase.com/impact/racialequity; "Citi's Action for Racial Equity Initiative Invests $1 Billion to Address the Racial Wealth Gap in the US," November 9, 2021, https://www.citigroup.com/citi/news/2021/211109a.htm.

36 Joseph R. Blasi, Richard B. Freeman, and Douglas L. Kruse, The Citizen's Share: Reducing Inequality in the 21st Century (Yale University Press, 2014).

companies.[37] This has led to a flurry of proposals for the specific metrics that should begin to be disclosed, among them employee health and safety; diversity, inclusion, and engagement; and labor practices. However, none of the key initiatives advocating for standardized disclosure, such as Sustainability Accounting Standards Board, Workforce Disclosure Initiative, or the Working Group on Human Capital Accounting Disclosure, have yet included clear employee ownership metrics.[38] However, as new standard-setting initiatives continue to emerge, such as the Taskforce on Inequality-Related Financial Disclosures and the SEC's potential to release further guidance, investors are well-poised to leverage their influence and call for such metrics to be included. This could take the form of individual action or joint investor/coalition action.

- **Call for portfolio companies to disclose.** Investors should individually engage their portfolio companies to seek voluntary disclosure regarding employee ownership metrics. This can be done through closed door private engagement as well as more public approaches (see "[3] Engagement and Shareholder Proposals" below). In 2021, a record number of shareholder proposals demanded companies share workforce diversity, equity, and inclusion data.[39] Many received record support, including a proposal at IBM, supported by 94% of shareholders. Given the potential of employee ownership to address race and gender inequality, such proposals could be expanded to include employee ownership metrics (dedicated proposals could also be advanced, however it may be difficult to build adequate support for them).
- **Provide rankings and index investing options based on employee ownership disclosures.** Just as there are fossil-free funds, gender equality funds or environmental justice funds, there could and should be employee ownership funds, or economic justice funds (e.g., including employee ownership but also issues such as the ratio of worker to executive compensation, living wages, payment of fair taxes, etc.). Creating such funds and calling for adequate disclosure on key metrics to enable investment in them would be powerful actions for investors to take.

3. Engagement and Shareholder Proposals

There are a number of different ways that investors can engage influential actors—such as companies, policy makers, and private equity firms—to advance employee ownership. There are opportunities for experienced investor advocacy and coalition groups to begin exploring and collaboratively proposing agendas for action and change. The types of activities that could launch such a process include the following:

- **Lead and participate in sign-on letters and engagement campaigns to compel greater employee ownership at public and private companies.** Just as such campaigns and letters exist with respect to climate, racial, and gender justice, investors can

37 Sheri Wyatt and Brandon Yerre, "New Human Capital Disclosure Rules: Getting Your Company Ready" (PwC, October 8, 2020), https://viewpoint.pwc.com/dt/us/en/pwc/in_the_loop/in_the_loop_US/New-human-capital-disclosure-rules-Getting-your-company-ready.html.

38 "Human Capital," SASB Standards (website) accessed July 29, 2022, https://www.sasb.org/standards/process/active-projects/human-capital/.

39 Lydia Beyoud and Andrew Ramonas, "Shareholders Up Demands for Workplace Diversity Data Seen by Few," June 7, 2021, https://news.bloomberglaw.com/esg/shareholders-up-demands-for-workplace-diversity-data-seen-by-few.

begin and contribute to campaigns calling for employee ownership. While such campaigns could focus on disclosure (see above), they could also call for a specific portion of a given company or an investor's portfolio of companies to become employee owned.

- **File and support shareholder proposals calling for employee ownership and employee governance.** In 2020, there was a surge in investor shareholder proposals on worker governance representation.[40] As part of this effort, a shareholder proposal filed with Amazon received over 25% of the independent investor vote—a significant milestone particularly for a first filing.[41] Investors can build on the momentum, including proposals calling for worker input on boards by advocating for broader employee ownership and governance empowerment. There is a natural chemistry between the two efforts, given that ownership through shareholding confers the right to vote on and elect board representatives. For example, investors can encourage companies to follow the footsteps of Harley Davidson by granting factory workers equity stakes.[42]
- **Investors can engage with private equity fund managers to call for inclusive deal structures.** KKR, the world's third largest private equity buyout fund, expanded its program of minority employee ownership stock grants to drive performance and give employees a capital stake.[43] Building on this, KKR partner Pete Stavros launched the nonprofit Ownership Works, with the mission to "develop and implement innovative broad-based employee ownership programs."[44] While the details of this practice have not yet been disclosed and it does not look to be advancing majority ownership by employee, it represents an important opportunity to engage a broader range of investors—and the workers affected by their investments—with employee ownership. Asset managers and owners can play an important role in driving uptake of such practices.
- **Engage policymakers to advocate for policies that advance employee ownership.** Supportive policies, from loan guarantees to tax incentives, can unlock meaningful investment opportunities while also growing employee ownership.[45] Publicly backing and supporting such policies will help their chances of adoption and uptake.

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40 Ben Maiden, "Companies Face Proposals on Employee Representation," Corporate Secretary, February 1, 2021, https://www.corporatesecretary.com/articles/shareholders/32443/companies-face-proposals-employee-representation.

41 Oxfam America, "Oxfam: Notice of Exempt Solicitation" (SEC, May 26, 2021), https://www.sec.gov/Archives/edgar/data/0001018724/000121465921004454/f423210px14a6g.htm; Oxfam America, "Amazon, Listening to Workers Is Good Business," May 25, 2021, https://politicsofpoverty.oxfamamerica.org/amazon-listening-to-workers-is-good-business/.

42 "Harley-Davidson Revs Up Employee Ownership," *The Menke Group* (blog), accessed July 29, 2022, https://www.menke.com/esop-archives/harley-davidson-revs-up-employee-ownership/.

43 Stavros, "Incentivizing Employees Creating Value - KKR Investor Day 2018."

44 "Home" Ownership Works, September 28, 2021, https://ownershipworks.org/.

45 "Publications," *Ownership America* (blog), accessed July 29, 2022, https://ownershipamerica.org/publications/.

PART 2

Context: Employee Ownership Structures

There are three primary structures for majority employee-owned businesses in the US: the employee stock ownership plan (ESOP), worker cooperative, and the employee ownership trust (EOT).

1

Employee Stock Ownership Plans (ESOPs)

By far the most widely used employee ownership structure in the US, ESOPs are a tax-favorable way for workers to build retirement savings through ownership in their employer. In an ESOP, employees are granted company shares through a trust at no cost to the employee. The shares are held in trust and paid out when the employee leaves the company (i.e., when they quit, retire, or are fired). ESOPs have significant tax benefits that both incentivize sellers to pursue an ESOP conversion and enable operating ESOPs to pay lower taxes.

ESOPs are technically a form of benefit plan, rather than a distinct business entity or form in which all workers receive a deferred share in the ownership of the business as a benefit for working for the company. This legal structure—which is governed and regulated under the Employee Retirement Income Security Act (ERISA) of 1974 and by the Internal Revenue Service (IRS) of the Department of Treasury and Department of Labor—is unique to the United States. The DOL's regulation today is focused on areas including, but not limited to, ensuring ESOP transactions occur at fair market value, that employees participate on fair terms, and that the financing used does not exceed market rates. As a result, regulation creates some constraints on how ESOPs can be structured.

ESOPs are not required to have democratic governance, and as such ESOPs often provide employees with beneficial economic ownership without necessarily having the governance rights often associated with equity ownership.

2

Employee Ownership Trusts (EOTs)

EOTs are similar to ESOPs in that they acquire shares through a trust on behalf of employees. However, whereas an ESOP is limiting to holding the value of the shares earned by workers, an EOT permanently holds all the assets of the company and governs them in the interests of employees. In addition, whereas ESOPs are highly prescribed and defined by statue, EOTs are instead simply an innovative application of the usage of conventional perpetual purpose trusts (an existing form of trust that can be used to hold any form of business or entity). In this case, their purpose is to hold the assets of a company in perpetuity for its employees.

While EOTs are very common in the UK (where there are over one thousand employee-owned trusts and the top fifty businesses in this sector employ 180,213 people), they are only a handful of examples in US.[46] There are no regulatory or legal impediments to EOTs in the US since most states allow for trusts for business purposes, but Congress has not provided to EOTs the tax incentives that ESOPs currently enjoy.[47] Several state-level bills have been introduced in the past few years that strengthen and provide incentives for EOTs (and other employee ownership vehicles) in Michigan, Wisconsin, and New York.[48]

Although there is significant freedom and flexibility in designing an EOT, in practice they have been designed such that current employees receive payment on their shares in the form of annual profit sharing, rather than receiving payment for their ownership stake upon leaving the firm. EOTs can be designed to include non-employee stakeholders as owners, have a specific mission or purpose beyond profit generation (e.g., to act sustainably), and can place structural barriers to a third-party sale—such trusts are sometimes referred to as "steward owned." Majority EOTs generally form through the conversion of an existing private business.

3

Worker Cooperatives ("Co-ops")

Worker cooperatives entail both worker ownership and governance. This worker-centric governance is sometimes misperceived as requiring consensus decision-making. However, all that is required is that workers rather than passive investors elect the board of directors on a one-worker-one-vote basis (as opposed to one-share-one-vote). The board of directors are then accountable to workers and not investors when overseeing the governance of the organization. As owners, workers hold shares in the cooperative, with most non-wage worker payments in the form of a payment of "patronage" (a concept similar to dividends; however, the calculation of patronage is more flexible and might be calculated based on the time or inputs of a worker rather than the number of shares held).

Worker cooperatives have some tax benefits, but they are less significant than those of ESOPs. Worker cooperatives often initially require external technical assistance in structuring their governance. While in practice they tend to be smaller in scale than the other employee ownership structures, there are numerous examples of large worker cooperatives, including Mondragon

46 "What The Evidence Tells US," Employee Ownership Association (website), accessed July 28, 2022, http://employeeownership.co.uk/resources/what-the-evidence-tells-us/.

47 Michael, Christopher, "Employee Ownership Trusts: A New Model Of Employee Ownership?" Employee Ownership Trust Advisors (blog), accessed August 22, 2022, https://eotadvisors.com/employee-ownership-trusts-eot-a-new-model-of-employee-ownership.

48 Michael, "The Employee Ownership Trust, an ESOP Alternative."

in Spain, with over eighty thousand workers, and Cooperative Home Care Associates in New York, with over two thousand workers.[49]

Some states, such as Colorado and Wisconsin, have statutes specifying the rules of incorporating as a cooperative. Other states do not recognize cooperatives as a dedicated legal entity; in these states, cooperatives simply form as a regular limited liability company but with bylaws that mandate that workers elect the board of directors. This has also allowed for flexibility and growth of the model. For example, multi-stakeholder cooperatives, where workers have ownership and governance rights alongside other groups (e.g., investors, consumers, suppliers, etc.) can be structured under this model. Similarly, "platform cooperatives" are now increasingly being formed to challenge tech and gig economy giants—where the workers who "gig" for the company (e.g., drivers, delivery people, etc.) are also the owners and thus share in the economic benefits (see The Drivers Co-op spotlight on page 53 as an example).

Hybrid models that combine advantages of multiple structures are possible. For example, there is a trend toward "ESOPoperatives," where an ESOP is created with all the tax benefits but is structured to be governed as a cooperative—that is, the workers elect the board of directors. For example, Sun Light and Power, a California-based solar energy company, is an ESOP with cooperative governance that is also a certified corporation.[50] Similarly, it is possible to combine the EOT form with an ESOP, since an "EOT can be used for both minority and majority ownership of a company, and nothing precludes the combination of a majority EOT (for perpetuity) and a minority ESOP (for tax benefits)."[51]

A. What About Profit Sharing or Other Plans that Allocate Equity/Shares to Workers?

Workers are sometimes offered compensation or benefits through the allocation—or option to buy—company shares. This can be done through a number of ways, including stock options, stock warrants, restricted stock, employee stock purchase plans, phantom stocks, or stock appreciation rights. For example, KKR, the private equity firm, grants stock options to all employees in some acquisitions, and most start-ups include a small ownership pool for employees.[52] Some of these schemes do enable workers to actually share in the ownership of the company. However, they are sometimes limited to a particular event (such as an IPO,

49 "Informe Anual 2020/2021" MONDRAGON (website), accessed June 2, 2022, https://www.mondragon-corporation.com/urtekotxostena/datos-basicos.php; "About CHCA," CHCA (website) accessed July 14, 2022, https://www.chcany.org/about.

50 Martin Staubus, "The ESOP-Erative," Fifty by Fifty: Employee Ownership News (blog), August 17, 2017, https://medium.com/fifty-by-fifty/the-esop-erative-daaa98c1174f.

51 Christopher Michael, "The Employee Ownership Trust, an ESOP Alternative," Probate & Property Magazine, February 2017, https://static1.squarespace.com/static/589d740229687f17d2da0bb7/t/601216c7bb9bdd745962589f/1611798242878/Michael.+2019.+Introduction+to+EOTs.pdf.

52 Stavros, "Incentivizing Employees Creating Value - KKR Investor Day 2018."

sale of the company, or attainment of performance goals), may have constrained voting or economic rights (e.g., they may not include the value of the actual underlying shares themselves or only pay out the value of any increase in the company stock price), or be offered only a particular class of employees (e.g., managers).

By comparison, *profit sharing* refers to compensation plans and models that permit management to share profits on an annual basis with eligible employees.[53] These can be used to incentivize performance and share economic benefits with workers, but they do not shift *ownership* to workers. Instead, they are fully discretionary—at any point management can decide to terminate payments and the plan. Both profit sharing and conventional means of allocating corporate shares to employees rarely are used as the basis of majority employee owned companies. For this reason, they are not covered in this paper.

53 Will Kenton, "Profit-Sharing Plan," Investopedia.com, accessed October 28, 2021; Profit Sharing Plans for Small Businesses (US Department of Labor's Employee Benefits Security Administration and Internal Revenue Service: November 2020), pp. 2, 4; "Choosing a Retirement Plan: Profit-Sharing Plan," Internal Revenue Service, accessed October 28, 2021.

Table 1: Comparison of Major Employee Ownership Structures in the US

	Scale in the US		
	Firms	Workers	Trend
ESOPS that are Majority Employee-Owned	~4,000 majority employee-owned ESOPs	~1,500,000[a] in majority employee-owned ESOPs	Total number of ESOPs has been flat for the past 5–10 years. Flat growth trend in number due to counterbalancing new ESOP formation and ESOP sales to other businesses that are not employee- owned.[b] ESOP worker-owners and assets have been increasing as ESOPs grow and acquire companies.
Employee Ownership Trust (EOT)	~13 in US (>1,000 in the UK). There are also a handful of "steward owned" trusts that include employees as a stakeholder group along with other groups and have a broader societal or environmental purpose or mission.[c]	Unknown	Growing, through conversion
Worker Cooperative	~600[d]	~6,000	Growing, through conversion and start-up

a. "Employee Ownership by the Numbers," National Center for Employee Ownership (blog), November 5, 2021, https://www.nceo.org/articles/employee-ownership-by-the-numbers#Other-employee ownership; "Employee Stock Ownership Plan (ESOP) Facts," NCEOip, 2022, https://www.esop.org/#:~:text=Although%20other%20plans%20now%20have,employee%2Downed%20companies%20have%20ESOPs. Note: The NCEO estimates that nearly four thousand ESOP companies are majority employee owned. These figures exclude publicly traded companies with ESOPs, given that these companies are not majority employee owned.

b. Corey Rosen, "Why Has the Total Number of ESOPs Gone Down but Participation and Assets Gone Up? | NCEOip," NCEOip, February 2015, https://www.nceo.org/observations-employee-ownership/c/ESOP-numbers; "Employee Ownership by the Numbers.

c. Anna Jordan, "Pros and Cons of Employee Ownership Trusts (EOTs)," Small Business UK (blog), January 22, 2021, https://smallbusiness.co.uk/pros-and-cons-of-employee-ownership-trusts-eots-2552031/; "BTI Restructures as Employee Ownership Trust," Bicycle Retailer and Industry News, February 18, 2021, sec. Industry News, https://www.bicycleretailer.com/industry-news/2021/02/18/bti-restructures-employee-ownership-trust.

d. Olga Prushinskaya, "Worker Co-ops Show Significant Growth in Latest Survey Data," Fifty by Fifty (blog), February 18, 2020, https://www.fiftybyfifty.org/2020/02/worker-co-ops-show-significant-growth-in-latest-survey-data/.

Table 1: Comparison of Major Employee Ownership Structures in the US (continued)

	Tax Treatment	Employee Payouts
ESOPS that are Majority Employee-Owned	• Significant tax benefits in the US that accrue to seller and the company. • Sellers can use "Section 1042" to defer, potentially indefinitely, capital gains taxes on the sale. • S corporation ESOPs are not required to pay corporate income tax, and C corporation ESOPs have special deductions that decrease taxable income.	• Employees own company shares indirectly through a trust. Shares are annually valued by external firm. • Shares are granted at no expense to employees. • Employee shares are non-liquid, non-transferable. Employees shares are cashed out only after the employee leaves the company.
Employee Ownership Trust (EOT)	• Limited tax benefits in US • EOT sellers can leverage conventional trust law to achieve moderate tax savings under specific scenarios.	• Payment structure depends on trust terms. However, generally employees share in company's profits annually. Many EOTs announce an annual bonus as a percent of salary. • Employees only receive financial benefit from ownership while they are current employees; there is no cash out upon exit.
Worker Cooperative	• Corporate tax benefits accrue to cooperative and potentially to seller. However, cooperatives receive less favorable corporate tax treatment relative to S corporation ESOPs. • Like ESOPs, sellers to co-ops technically can use "Section 1042" to defer, potentially indefinitely, capital gains taxes on the sale. However, there are no documented cases of 1042 usage in cooperative conversions. Small deal size and limited technical advisory capabilities are cited as a prohibiting factor.	• Employees are entitled to share directly in company's profits annually through "patronage." • Worker members may be required to contribute small up-front "buy-in" to become owners. • Worker shares are generally non-liquid and non-transferable. Some worker cooperatives establish worker equity accounts that can be paid out upon leaving.

Table 1: Comparison of Major Employee Ownership Structures in the US (continued)

	Structure and Governance
ESOPS that are Majority Employee-Owned	• Existing corporate structure broadly remains, with the creation of a trust and appointment of trustee to oversee the ESOP. • Selling owner typically selects board, management, and trustee, with some constraints. • Most opt to continue traditional management structures, although can be structured to implement democratic worker governance. • Many ESOPs implement informal participatory management practices to include employee voice. • Trustee has an enhanced fiduciary responsibility to ensure ESOP is run for the financial benefit of employees. • Ownership stake in the ESOP is only available to employees. • Must conform to regulatory requirements.
Employee Ownership Trust (EOT)	• Company assets are entirely owned by a trust that is governed in the interests of employees (and sometimes other stakeholders). • Flexible governance structure enables governance structures customized to the needs of selling shareholders, workers, investors, and other stakeholders. • Governance documents and mandates can prioritize broad organizational purpose, including non-financial objectives. • Ownership and governance can include non-worker stakeholders, such as customers, investors, community members. • Many EOTs implement informal participatory management practices to include employee voice.
Worker Cooperative	• On a one-worker-one-vote-basis, workers are entitled to elect the cooperative's governance body (usually a board of directors). • Worker cooperatives can also choose to include external minority investor groups as part of governance. • While structures vary, worker cooperatives are generally run more like a republic, with elected leaders that have decision-making authority, than like a consensus-driven collective. • Most worker cooperatives implement informal participatory management practices to include employee voice. • Some states have cooperative-specific statutes. However, in many states, co-ops are formed by creating a limited liability company and establishing bylaws that enshrine cooperative principles.

Table 1: Comparison of Major Employee Ownership Structures in the US (continued)

	Formation and Exit Considerations
ESOPS that are Majority Employee-Owned	• Financial and legal structure is complex, relying on robust network of experienced service providers. Set-up fees generally >$150K. • Generally, >30–40 employees required to make it worth the complexity and up-front cost. • More legally susceptible to unwanted sale than other structures. Trustees generally follow board recommendation when board rejects acquisition offers; this can prevent most unwanted sales. However, ESOP trustees face potential legal liability based on the need to ensure decisions in financial interest of beneficiaries.
Employee Ownership Trust (EOT)	• Set-up fees for basic trust structure cited as ~$30K. • Flexible design enables use by companies of all sizes—no minimum or maximum generally cited. • There can be enhanced protections for EOTs against acquisition offers, providing legal protection to remain employee-owned long-term.
Worker Cooperative	• Required governance changes often require meaningful technical assistance to succeed. • Can be used by businesses of all sizes—no minimum or maximum generally cited. Although often small-scale, co-ops with as many as 80,000 worker-owners have existed for decades. • Worker cooperatives can be structured to reject acquisition offers, providing legal protection to remain employee-owned long-term.

PART 3

Strategies for Direct Investment in Employee Ownership

There are two distinct paths for establishing employee-owned companies, each of which entails tailored financing strategies. The first is to support an existing company to transfer ownership from its existing owners and shareholders (e.g., founders, investors, etc.) to its workers (the "conversion" pathway). The second is launch a company as employee-owned (the "start-up" pathway). The financing considerations of these two pathways are outlined below, with an emphasis on highlighting emerging and underexplored new funding strategies and models that new investors could help advance.

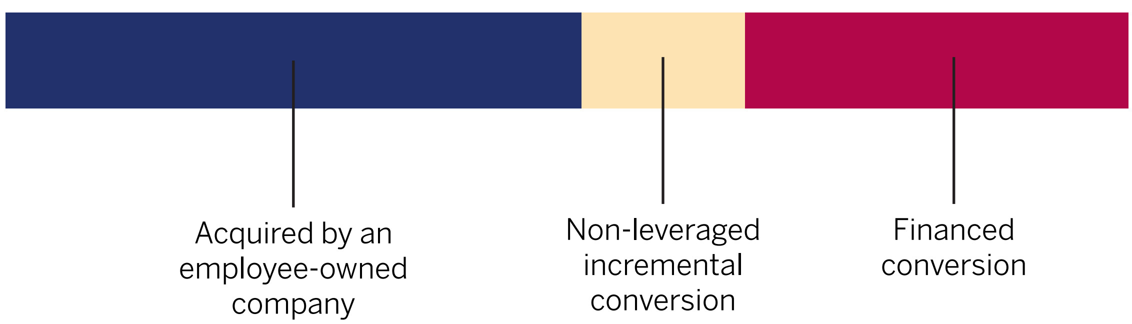
A. Conversions of Conventional Businesses to Employee-Owned Businesses

1. Key Approaches, Market Size, and Trends

In total, there are over 550 annual employee ownership conversions in the US.[54] Existing companies generally convert to employee ownership through one of three pathways:

a. An existing employee-owned company acquires and then converts the company to employee ownership
b. External finance is used to fund the conversion to employee ownership.
c. The company is incrementally converted to majority employee ownership without any external finance.

Figure 1: Pathways to converting a company to employee ownership: Approximate proportion of annual conversions



As a form of company sale, employee ownership conversions are a segment of the broader mergers and acquisitions (M&A) market. In volume and value, employee ownership conversions represent a small, but not insignificant proportion of the broader US M&A market. The U.S. M&A market sees approximately $2 trillion in annual transaction value, with over twelve thousand deals in 2020. Of these deals, 4,140 were "primary" private equity buyouts, in which a private equity firm buys a non-private equity-owned firm. These primary transactions are the most comparable benchmark to illustrate the potential scale of employee ownership conversions because companies privately owned by individuals, not private equity

54 Rosen, "Why Has the Total Number of ESOPs Gone Down but Participation and Assets Gone Up? | NCEO." This resource includes an estimate of more than three hundred ESOP acquisitions annually.

firms, are those most likely to pursue employee ownership conversions.[55]

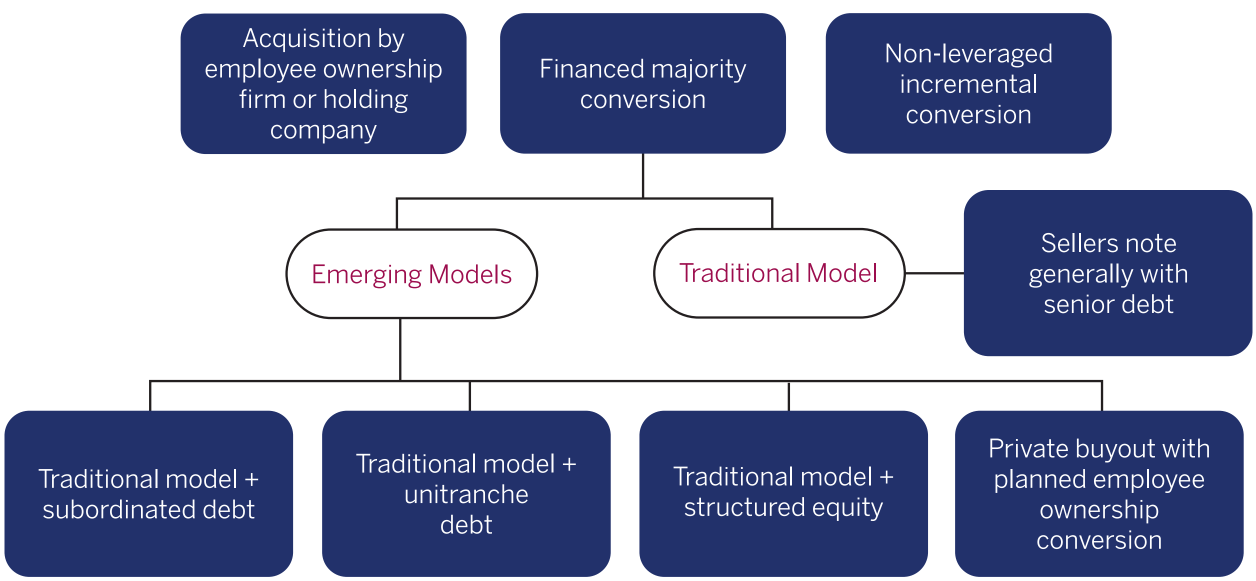
a. Acquisitions by Employee-Owned Firms

In an acquisition of conventional companies by employee-owned firms, the conventional firm becomes employee-owned as a result. **Experts estimate that roughly three hundred conversions to employee ownership per year are the result of acquisitions of conventional companies by employee-owned companies.**[56] Anecdotally, this number is growing alongside the growth in conventional M&A activity. While these acquisitions increase the number of employee-owners, they do not increase the number of employee-owned firms.

Employee ownership acquisitions have predominantly occurred through ESOPs, though several cooperative holding companies are also making acquisitions. ESOPs are an attractive acquisition vehicle, largely due to the tax benefits directed at the ESOP company and the selling shareholder. ESOPs can often pay competitive value for private companies and can receive tax benefits through the transaction. Like conventional acquirers, employee ownership acquirers often use a combination of external debt and cash reserves to finance a transaction.[57]

While acquisitions by individual US employee-owned companies are largely limited to ESOPs to date, some cooperative groups are developing holding company structures that can unlock synergies between businesses. These will be discussed in the following section on fund structures.

Figure 2: Common Pathways to Employee Ownership Conversion



55 Wylle Fernyhough and Rebecca Springer, "North American M&A Report: 2020 Annual" (PitchBook, 2021), https://files.pitchbook.com/website/files/pdf/PitchBook_2020_Annual_North_American_MA_Report.pdf.

56 Rosen, "Why Has the Total Number of ESOPs Gone Down but Participation and Assets Gone Up? | NCEO."

57 Michael Harden, Erin Turley, and Christopher McLean, "ESOP Companies Advantage in Making Acquisitions," The ESOP Association (Washington, DC, May 20, 2016), https://www.kaufcan.com/wp-content/uploads/2018/08/esop-companies-advantage-in-making-acquisitions-2016-tea-annual-confer-_.pdf; "Employee Ownership by the Numbers."

b. Incremental Non-Leveraged Conversions

Some companies decide to gradually arrive at majority or 100% employee ownership. Approximately one-third of new ESOPs were formed this way, an estimated eighty to eighty-five per year.[58] A gradual transition to employee ownership is often non-leveraged, which means that it is funded primarily from the company's cash reserves, not by borrowing.[59] ESOPs pursuing a non-leveraged incremental conversion strategy often save cash to meet the 30% employee ownership minimum requirements for tax benefits. Once that threshold is reached, the company can continue purchasing shares incrementally. Non-leveraged incremental conversions are led internally by selling shares; while advisors can manage the transaction, there is no opportunity for external catalytic capital deployment as a catalyst for the conversion. Incremental conversions can be appropriate in situations where only one major shareholder wishes to sell, where the company does not wish to or cannot take on external debt, and where the seller seeks a gradual exit from their ownership.

c. Financed Conversions

There are approximately two hundred financed conversions of companies to employee ownership per year. Traditional financed ESOP conversions are seller-organized deals that predominantly use seller notes and senior debt and represent the vast majority of financed conversions in volume and value. We estimate that the annual company value transacting in traditional financed employee conversions to be between $3–7 billion.[60] While significant, this represents less than 1% of the $2 trillion annual M&A market.[61]

Some sellers choose to finance an entire conversion exclusively with a sellers note, obliging the company to pay the seller 100% of the agreed valuation plus interest over time. However, most financed conversions also involve external finance.

In an externally financed conversion, a lender (or lenders) provides debt financing to a company, the proceeds of which go to purchasing shares from the current owners. As part of the transaction, ownership is transferred to the employees. While shares are generally granted to the employees for free, equity value often starts low and grows as the conversion debt is paid off. Externally financed conversions enable sellers to receive some value up front for their firm and convert a substantial—often 100%—portion of ownership to employees immediately. While there is a common traditional structure, financed conversions use an increasingly diverse set of deal structures.

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58 "Employee Ownership by the Numbers."

59 Ben R. Duffy, "ESOP Implementation Considerations: A Leverages ESOP versus a Nonleveraged ESOP," ESOP Installation Thought Leadership, Spring 2020, https://willamette.com/insights_journal/20/spring_2020_3.pdf.

60 Expert interviews with ESOP advisors and funds converged on an average ESOP conversion valuation between $20–40 million. We assume 168 financed ESOP conversions per year based on NCEO historical data "Employee Ownership by the Numbers," NCEO, 2021, https://www.nceo.org/articles/employee-ownership-by-the-numbers. The $3–7 billion estimate was validated by two disclosures. First, an NCEO study ("Default Rates on Leveraged ESOPS") found $12.8 billion in total outstanding debt (note: not annual debt issuance) to ESOPs from only three sample banks. Likewise, JP Morgan, a leading lender in ESOPs discloses at least $4.8 billion of ESOP loans (https://www.jpmorgan.com/commercial-banking/solutions/credit-and-financing/employee-stock-ownership-plan).

61 Fernyhough and Springer, "North American M&A Report: 2020 Annual."

Because they represent the most direct opportunity for external finance to grow employee ownership, financed conversions are the primary focus of this report. However, it is important to contextualize the role of financed conversions alongside employee ownership acquisitions and incremental conversions because these represent viable alternative pathways to employee ownership for private company owners.

Figure 3: Estimated Number of Financed US Employee Ownership Conversion Deals Per Year

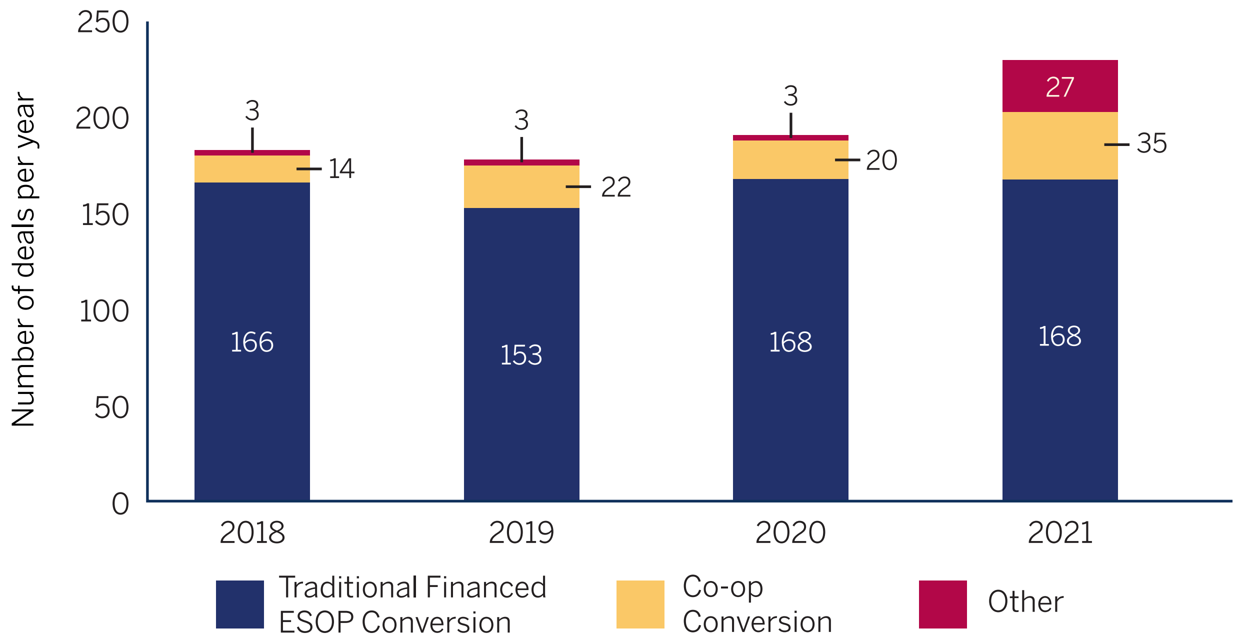


Fig. 3 illustrates trends in *financed* conversions.

- **Traditional financed ESOP conversions:** These traditional deal structures are discussed in more detail below. While they represent the vast majority of conversions, their volume growth has largely plateaued over the last decade. However, some practitioners are noting that deal size appears to be increasing, with several billion-dollar conversions in process in 2022. As mentioned above, traditional financed ESOP conversions account for $3–7 billion in estimated annual employee ownership conversion value.[62]
- **Worker cooperative conversions:** Worker cooperatives are meaningfully growing in volume and value. The growth in cooperative conversions is largely driven by members of the Workers to Owners Coalition, a group of organizations that shares data on their independent cooperative conversions. Cooperative conversions in 2021, captured in the Workers to Owners report, accounted for a total transfer of $14 million of company value.[63]

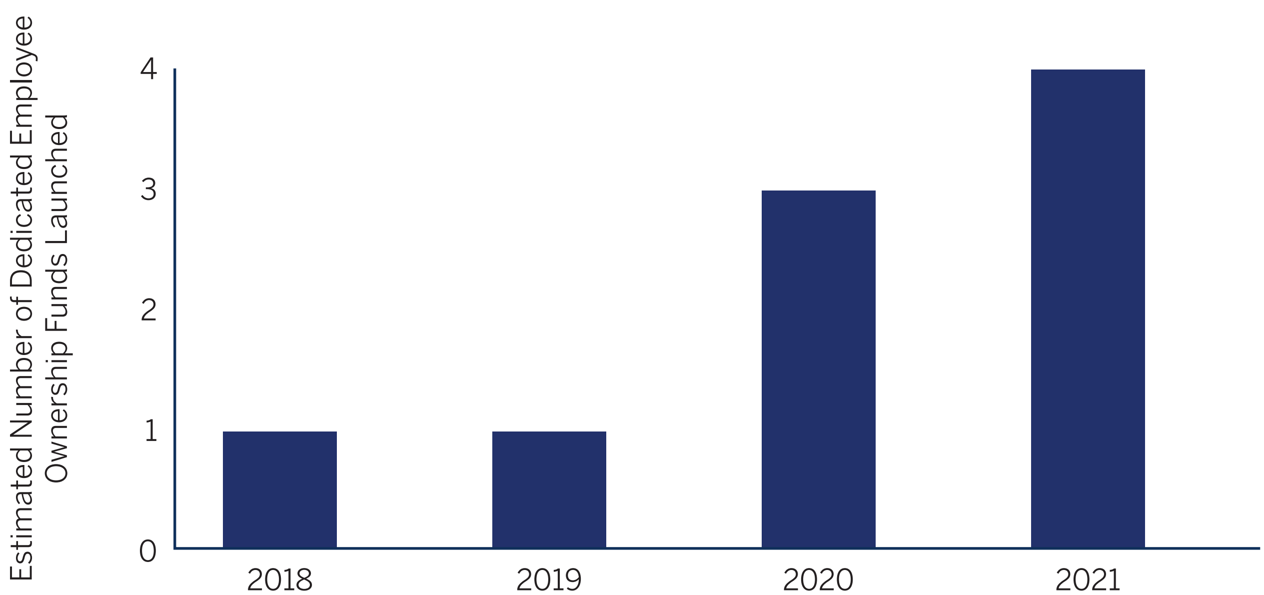
62 Expert interviews with ESOP advisors and funds converged on an average ESOP conversion valuation between $20-–40 million. We assume 168 financed ESOP conversions per year based on NCEO historical data "Employee Ownership by the Numbers," NCEO, 2021, https://www.nceo.org/articles/employee-ownership-by-the-numbers. The $3–7 billion estimate was validated by two disclosures. First, an NCEO study ("Default Rates on Leveraged ESOPS") found $12.8 billion in total outstanding debt (note: not annual debt issuance) to ESOPs from only three sample banks. Likewise, JP Morgan, a leading lender in ESOPs discloses at least $4.8 billion of ESOP loans (https://www.jpmorgan.com/commercial-banking/solutions/credit-and-financing/employee-stock-ownership-plan).

63 "Publications," Democracy at Work Institute, accessed July 29, 2022, https://institute.coop/publications; correspondence with DAWI staff for 2021 volume and value.

- **Other:** Conversions with emerging deal and fund structures are poised to grow significantly. The large spike in "other" conversions in 2021 is largely due to the rapid growth of Teamshares, a venture-backed employee ownership conversion start-up which made at least twenty-four acquisitions in 2021 and plans to make seventy acquisitions in 2022.[64] However, additional dedicated employee ownership funds using emerging deal structures are planning expansion, including Social Capital, which closed their first deal in 2021, and A&H Capital Partners, which had their first close in 2021 and plans to undertake several conversions in 2022. The number of annual US EOT deals is growing but remains in single digits. As of February 2021, there were thirteen EOTs in the US.[65]

The growth in non-traditional employee ownership conversions represents the beginning of a renaissance in the field. Increasingly, innovative employee ownership funds are presenting themselves as attractive alternative buyers for conversions, unlocking new deals with features ranging from attractive financial terms to management succession. As illustrated in fig. 4, within the last four years, at least eight new dedicated employee ownership funds have launched. Funds with first capital raised or deployed between 2018 and 2021 include Teamshares, Social Capital Partners, Obran Cooperative Capital, Common Trust, Apis & Heritage Capital Partners, Main Street Phoenix Project, the Equitable Economy Fund, and the Evergreen Fund for Employee Ownership.[66]

Figure 4: Estimated Number of Dedicated Employee Ownership Funds Launching by Year[67]



64 "For Brokers," Teamshares, accessed July 29, 2022, https://www.teamshares.com/.

65 "BTI Restructures as Employee Ownership Trust."

66 *Info pending on additional funds.

67 Expert interviews. Launching is defined here as receiving funds to invest.

While the current scale of employee ownership is limited, the expected wave of ownership transitions provides tailwinds for employee ownership conversions. $10 trillion of private business ownership value is expected to change hands by 2025.[68] Regardless of business size, there are 2.9 million businesses owned by baby boomers nearing retirement.[69] "Owner's retirement" was listed as a key reason for a sale in 50% of cases in a recent survey of middle-market companies (those with between $10 million and $1 billion in revenue).[70] While retirement is a clear driver of pre-planned sales, 45% of sales in the middle-market survey were reported as opportunistic as a buyer presented themselves.[71] Employee ownership practitioners are well positioned to capture this business sale activity.

2. Traditionally Financed Employee Ownership Conversions: Seller Financing and Senior Debt

The combination of seller financing and senior debt is the traditional and most common structure for a financed conversion, and it is a building block for other conversion structures. It is essential to begin with an understanding of how these conversions function.

Summary: In these transactions, external lenders generally provide a senior note that is repaid through the company's cash flows. The seller receives the cash proceeds of the senior note at close. In a 100% employee ownership conversion, the remainder of the value of shares not covered by the senior note is exchanged for an interest-bearing sellers note, which is subordinated to the external senior note. Seller notes are typically repaid to the seller after the senior note through the company's cashflow.[72]

Traditional employee ownership vs. private equity leveraged buyout: Fig. 5 compares a generic private equity leveraged buyout transaction and a traditional employee ownership conversion. In the private equity transaction, the seller receives approximately 80% of the after-tax valuation up front through the private equity fund's equity and the senior debt proceeds. The remainder is paid out as a seller note based on company performance.[73] In this example of traditional employee ownership conversion, the seller receives only 35% of the valuation at close and is paid the remaining 65% through a sellers note. The company is left with two lenders post-transaction: the seller and the senior debt provider. It is important to note that this example does not factor in the tax impact of selling to employee ownership versus selling to private equity. For an equivalent valuation, total proceeds to the seller would be higher for a sale to an ESOP with a 1,042 capital gains rollover than a sale to a private equity firm.

68 Fernyhough and Springer, "North American M&A Report: 2020 Annual."

69 "Small Business Closure Crisis," Project Equity, accessed July 29, 2022, https://project-equity.org/communities/small-business-closure-crisis/.

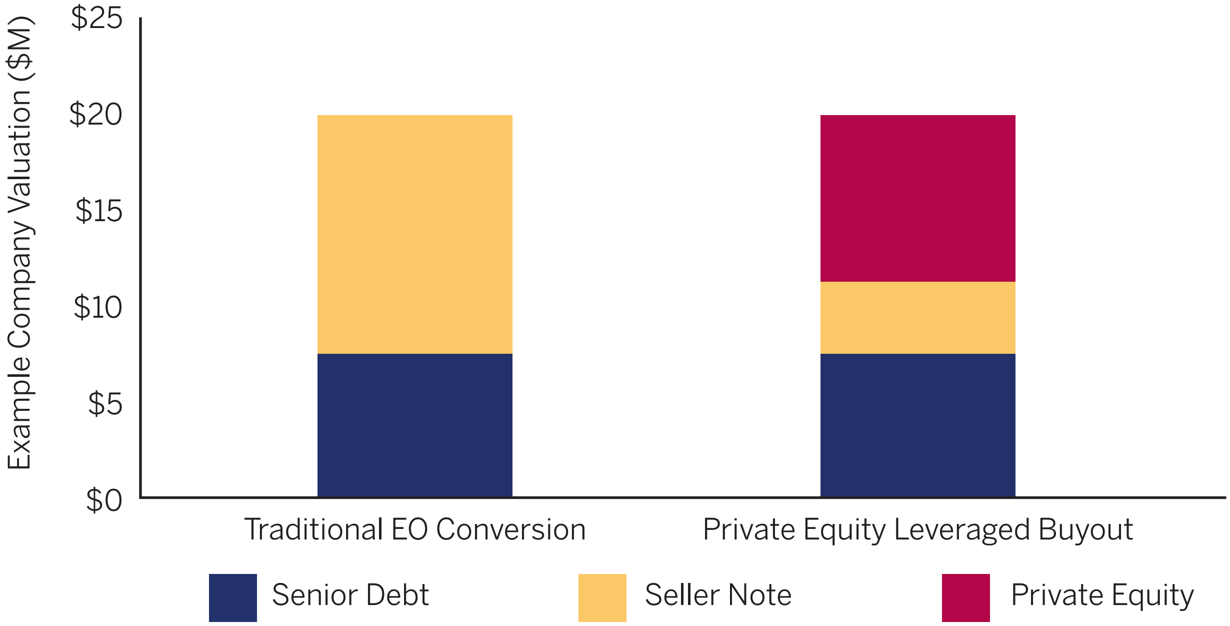
70 "Small Business Closure Crisis."

71 "Small Business Closure Crisis."

72 Note: In cooperatives, worker financing often also plays a role in funding a small portion (less than approximately 15%) of the conversion deal.

73 Brett Adcock, "Leveraged Buyout Analysis," Street of Walls, accessed August 1, 2022, https://www.streetofwalls.com/finance-training-courses/investment-banking-technical-training/leveraged-buyout-analysis/.

Figure 5: Example Comparison: Traditional Employee Ownership Conversion and Private Equity Leveraged Buyout



Debt terms: The percentage of senior debt relative to seller financing used varies significantly depending on the company, its debt capacity, employee ownership structure, and the lender. For ESOPs, the percentage of senior debt is typically 30–40% of the total valuation, representing approximately 2.5–4 times a company's earnings before interest, taxes, depreciation, and amortization (EBITDA). For larger deals with higher valuation multiples, senior loans often cover less as a percentage of total valuation. By contrast, senior debt for cooperative deals can reach 70% of valuation.

Interest rates on senior debt also varies depending on a company's circumstances and size. For conventional ESOP transactions, interest rates are generally in the range of 2–3.5% above the market benchmark (5–6.5% total in 2021), whereas interest rates for cooperative conversions generally range from 4.5–8%.[74] The higher rates on cooperative conversions are also reflective of the fact that cooperative conversions are generally of smaller companies with a higher risk profile. The term on senior loans generally varies from three to seven years.

Seller notes and payout terms: Seller notes that represent a significant portion of valuation are often unique to employee ownership transactions. Because they are often in the most subordinated position in the capital stack, seller notes generally receive higher all-in rates of return than other lenders. These returns range from 8–14% depending on the position in the capital stack and whether the seller accepts a concessionary rate to minimize risks to the business post-transaction. Some sellers choose to provide very low rates on seller notes, as low as 3–5% projected returns. Sellers notes often generate returns through paid-in-kind interest and warrants but can sometimes receive cash interest as well. Paid-in-kind interest can offer the company payment flexibility, but warrants, particularly if structured poorly, can result in significant dilution for employees. Paid-in-kind interest allows the company to accrue

74 "ESOP Financing in Today's Economy," NCEO Conference Session. Verit Advisors, Bank of America, PNC. 2021

rather than pay out interest. Warrants give the holder the future right to sell equity shares in the future. The warrant holder's profit is the difference between the equity value and the initial pre-determined share value. As such, warrants let the seller benefit from any growth of equity value. Warrants are much more common in ESOP conversions because ESOP shares have an objective annual value. Warrant coverage, which reflects the percentage of the seller note that has warrants equivalent to their value attached, generally ranges from 10–20% when included in seller's notes. Projected returns on seller notes above 14% in ESOP conversions are more likely to attract scrutiny from the Department of Labor.

Sellers are generally considered "friendly" lenders; in instances of challenging financial circumstances sellers are often lenient on terms to ensure the company remains resilient.

In addition to seller notes, employee ownership buyouts are occasionally structured with earnouts (increases to) or clawbacks (decreases to) the ultimate value owed to the seller based on company performance post conversion.

100% seller financed conversions: Some sellers opt to receive the full value of their company in seller notes. In these cases, the company immediately converts to employee ownership and takes on no external debt. The seller receives no cash at close.

Sources of financing: The traditional conversion deal structure is used across employee-owned forms, including ESOPs, co-ops, and EOTs. However, the sources of senior debt often differ. Most large banks (e.g., JP Morgan, Bank of America, Bank of Montreal) have dedicated ESOP lending teams and large loan books. While some regional banks are active in ESOP lending, many do not have sufficient sophistication and expertise. This represents a potential gap in the reach of ESOP conversion support.

Cooperative conversions generally rely on a network of community development financial institutions (CDFI) with specific cooperative expertise or interest. For smaller employee ownership conversions, some non-profit groups, like Project Equity and Seed Commons, can combine the roles of technical advisory and senior lender.

Because of their small number, EOT conversions have been funded on a case-by-case basis, mostly relying on impact-oriented debt providers to fund the senior note in the conversion. However, EOT advisors are working on bringing in more conventional banks into EOT lending.

With few exceptions, broad-spectrum lenders that provide a variety of loan products, such as conventional CDFIs or traditional banks, view employee ownership loans similarly to conventional loans. Employee ownership loan pricing is based on debt capacity and projected ability to pay. However, there can often be two main points of contrast. First, loans to cooperatives can require additional diligence and technical assistance on governance. Second, conventional small businesses loans often require a "personal guarantee" against personal assets of owners. However, given the number of employee owners, this is not feasible or desirable for an employee-owned company. Instead, employee ownership conversion loans are guaranteed against the stock of the company, its future earnings, and/or the company's assets. As such, these senior employee ownership conversion loans are often not fully collateralized.

Groups using traditional employee ownership conversion structures include the following:

- ESOP conversion lenders: Bank of America, Bank of the West, Wells Fargo
- Shared Capital Cooperative: cooperative conversions
- Project Equity: conversions to ESOP, co-op or EOT
- Seed Commons: cooperative conversions
- Cooperative Fund of New England: cooperative conversions
- Capital Impact Partners: cooperative conversions

Spotlight: CFNE Helps Liberty Graphics Convert to a Worker Cooperative

"Liberty Graphics has operated for more than forty years, making and selling premium quality, environmentally friendly T-shirts with artist-created nature images. The fledgling business launched in an old farmhouse and barn in Liberty, Maine, and occupies the same site today (though greatly expanded). It serves regional, national, and international wholesale and retail markets, including well-known apparel companies, museums, and annual festivals, including the American Museum of Natural History and the Nature Company. Locally, the business operates retail stores in Portland and Camden and an outlet store in Liberty.

The owner and founder decided two years ago to retire. The company's brand reputation and ecological practices would have value to a buyer, but an outside acquisition would likely have resulted in production being relocated with a loss of employment for long-time employees. During the COVID-19 pandemic in 2021, twenty Liberty Graphics workers (mostly women who had worked at Liberty Graphics for more than twenty years)[75] bought the company and converted it to a worker-owned cooperative; this supported local jobs and created wealth among employees as part-owners. The workers were able to purchase the business with the technical support of the Cooperative Development Institute (CDI) and SBDC Maine and financing from the Cooperative Fund of the Northeast (CFNE). The seller also maintained an emeritus seat on the board of the new cooperative and carved out a T-shirt supply business that uses organic cotton t-shirts that Liberty Graphics uses, though not exclusively.

The selling owner provided over 80% of the sale value in financing at 2% for ten years and has a first lien on the real estate and buildings sold and a subordinated/second collateral position on "all business assets." The Cooperative Fund of the Northeast (CFNE) provided the cooperative the remaining financing at an interest rate of 5.5% with a term of five years and amortization of fifteen years. CFNE took a first lien on all business assets, including accounts receivable, inventory, and furniture, fixtures and equipment and a second/subordinated position on the building and real estate.

- $100,000 fixed note loan for $50,000 to the seller and $50,000 to pay off an SBA Emergency Injury Disaster Loan
- $300,000 line of credit with an immediate balance of $153,000 at closing to pay off the existing balance at a local bank

Post conversion, Liberty Graphics opened a third store in Camden and continued to increase sales on its web sales platform significantly. Despite the ownership changeover and COVID-19 still affecting wholesale sales, Liberty Graphics had the highest revenues it had realized in years in 2021.

75 Total employment ranges from twenty-five to forty workers, depending on the season.

CFNE is a forty-seven-year-old non-profit community loan fund dedicated to increasing capital access for the region's cooperatives. Over the past decade, CFNE has financed a couple dozen worker co-ops to acquire their businesses."

— CFNE

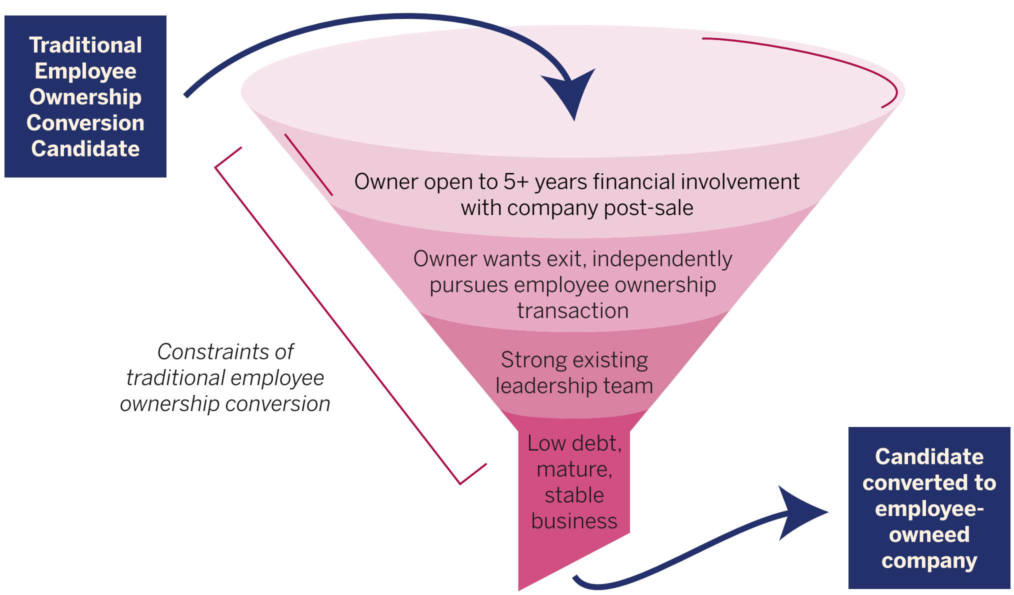
3. Opportunities to Build on Conversion Traditional Deal Structure

All else equal, many more business owners would prefer to sell their businesses to their employees than actually do. The reason is that "all else" often is not equal between most traditional employee ownership transactions and sellers' alternative exit options. Unlike conventional finance, which offers a wide range of options for corporate M&A transactions, the employee ownership space has generally relied on a single financed conversion structure: the traditional senior debt and seller note conversion. However, these traditional structures have limitations that constrain growth in employee ownership.

As illustrated in fig. 6, the reach of traditional employee ownership conversions is limited by constraints from seller awareness to company management. ESOP advisors typically will not work with companies that do not meet traditional conversion criteria, and sellers that do not meet the criteria typically do not seek out an ESOP. SES ESOP, a leading ESOP conversion advisory firm, for example, lists on its website five "sound reasons" not to do an ESOP:[76]

- It's complicated.
- It's got its ups and downs (i.e., ill-suited to companies without predictable profitability).
- It's lacking a successor.
- It's undercapitalized.
- It's incompatible with shareholders wishes (e.g., maximizing cash at close).

Figure 6: Expectations for Traditional Employee Ownership Conversions



76 James Steiker, "Five Reasons Why You Should Not Do an ESOP," SES ESOP Strategies, March 31, 2015, https://sesesop.com/five-reasons-why-you-should-not-do-an-esop/.

This leaves a meaningful opportunity for practitioners to design deal structures that meet diverse corporate needs. Understanding the nature of these opportunities is essential to inform and contextualize emerging employee ownership conversion strategies.

Emerging employee ownership deal and fund strategies aim to address the gaps in traditional conversion structures and unlock new conversions. To compete with conventional exit strategies more effectively, conversion practitioners are exploring five new opportunities to broaden the reach of employee ownership conversions:

- Increase awareness and decrease misconceptions
- Decrease process complexity
- Ensure competitive financial offer
- Provide succession leadership
- Invest in companies with diverse financial positions

Financing strategies that can address these opportunities are instrumental to growing employee ownership. Each opportunity will be discussed in more detail below.

A. Increase Awareness and Decrease Misconceptions

Many employee ownership professionals believe that the potential for conversions is significantly greater than actual conversions because many sellers simply do not realize that employee ownership is a viable exit for them or have misconceptions about the implications of such a transaction. Unfortunately, sellers, their accountants and legal advisors, and conventional business brokers tend to be uninformed about employee ownership. As such, sellers generally need to arrive at the decision to sell to employee ownership on their own and coordinate the process of selecting and managing advisors for a transaction. As explained in a recent paper by Democracy Collaborative, "In a strategy that relies on sellers to initiate a transaction, owners first need to know that employee ownership is an option. The problem: they don't."[77] Senior lenders, the only external capital provider in traditional employee ownership conversions, generally do not promote employee ownership loan products. Most banks provide and respond to what their clients are actively looking for rather than actively promoting adoption of a particular product.

Unlike traditional senior lenders, emerging employee ownership conversion funds may have greater capabilities to provide a "knock on the door" or to actively participate as bidders in competitive sale process. The conclusion of Democracy Collaborative's aptly titled "Opportunity Knocking" report is that mission-driven capital with an incentive to reach out to new potential sellers is a needed catalyst for scaling employee ownership.

B. Decrease Process Complexity

In a conventional sale, sellers have a limited set of decisions. They often pick the banker or broker, select the offer they prefer, and move on. By contrast, sellers generally must play a

77 Rose et al., "Opportunity Knocking: Impact Capital as the Transformative Agent to Take Employee Ownership to Scale."

highly active role in a traditional employee ownership conversion. That is because they are ultimately responsible for both selling the business and determining the post-transaction financing and structuring. While expert employee ownership advisors can facilitate this process, ultimately, the seller must actively make numerous decisions in a traditional employee ownership transaction.

Streamlining this process is critical to draw more sellers to employee ownership because many sellers are seeking a quick and clean sale. Many privately held business owners decide to sell or need to sell because of unforeseen life events referred to as the four D's: death, departure (of an owner), disability, or divorce.[78] These factors, or an attractive unsolicited offer, tend to result in a short-term transaction process with limited ongoing involvement for the former owner post-close. Many fund innovations seek to make deals compatible with the diverse needs of sellers.

C. Ensure Competitive Financial Offer: Valuation, Payment Terms and Timeline, and Tax Treatment

Many sellers want to receive a fair market value—or close to one—for their company. While company valuation is often loosely used as a proxy for value, it only tells part of the story. In practice, the payout terms and timeline and the tax treatment can often have as material an impact on how much sellers actually end up with in their pocket, and thus affect how sellers evaluate the value of a sale option. As such, the company's value should be viewed as a combination of sale price, payout terms and timeline, and tax treatment. These factors often differ significantly between an employee ownership sale and a conventional transaction.

The process of valuation differs between an employee ownership conversion and a conventional sale. In a conventional sale, external parties make an offer until the seller accepts. In an employee ownership transaction, independent third-party valuations often represent the first step in determining final sale price. In an ESOP transaction, the valuation process is highly regulated with an important negotiation between the seller and the trustee. ESOP valuation is legally required to be at or below fair market value. ESOP trustees risk being sued if the DOL views a deal as overvalued. In EOT and cooperative conversions, valuation is less regulated.

It is difficult to compare employee ownership sale valuations to those of conventional sales because there are no counterfactuals or controlled experiments; no company can simultaneously pick both paths. Thus, valuation must be viewed relative to the most likely conventional sale. Employee ownership practitioners offer divergent perspectives on the competitiveness of employee ownership valuation, with some claiming valuation often matches fair market value and others claiming it is often at a slight discount. Perspectives often differ based on the market segment that the practitioner is targeting. For companies that receive little to no external interest in a purchase, an employee ownership valuation often matches alternative offers; these companies tend to be smaller. For companies that receive significant interest from private equity or strategic buyers, employee ownership valuations often match or are at a slight discount to these alternatives; these companies tend to be

78 Christy Bieber, "The 4 D's Every Business Owner Needs to Plan For," The Motley Fool, August 14, 2018, https://www.fool.com/careers/2018/08/14/the-4-ds-every-business-owner-needs-to-plan-for.aspx.

larger. An acquisition by a competitor often values the company with a "synergy premium" based on the combined profitability of the companies post-merger. No "synergy premium" can be paid in an employee ownership transaction because the company is valued as a standalone entity.

Payout terms can differ significantly between an employee ownership conversion and a conventional transaction. In a private equity or strategic acquisition transaction, the selling shareholders often receive above 80% of the valuation at close. The remainder is often paid out as a seller note, equity rollover, and/or an earn-out. By contrast, traditional employee ownership conversions, particularly those of larger firms, often result in less cash at close. The remainder is paid out in the form of a subordinated interest-bearing seller note that may not be repaid in full for ten years or more.

Many ESOP transactions result in substantial tax savings for the seller relative to a conventional private equity or strategic sale. In environments with significant capital gains taxes, these savings can often make up for any potential valuation discount, resulting in comparable after-tax proceeds to a conventional sale. Unlike ESOPs, EOT and worker cooperative conversions do not generally result in more favorable tax treatment for sellers than conventional alternatives.

While many sellers prioritize valuation, payout terms, and tax treatment, there are still many who are willing to sell for a significant discount. Interviews with multiple employee ownership investment and advisory firms as well as with seller-owners who choose employee ownership confirm numerous instances of sellers choosing to accept a significantly discounted value from an employee ownership transaction relative to offers received from alternative bidders. For these sellers, employee ownership is the preferred exit strategy, and this preference has a financial value.

D. Provide Succession Leadership

Conventional buyers, whether private equity or strategic, are often structured to provide ongoing leadership immediately following a transaction. In fact, operational excellence—the ability to appoint and govern a highly competent management team—is often a main feature on which private equity firms attempt to distinguish themselves. In traditional employee ownership transactions, no external party is available to provide such leadership. Thus, either the seller remaining in leadership or a strong internal succession plan is often considered a prerequisite for conventional employee ownership conversions. This substantially limits conversions. Like conventional investors, employee ownership investment firms can provide leadership talent to enable conversions that might not otherwise be possible or appropriate.

While critically important for conversions of smaller firms, the succession constraint tends to be less relevant for medium and large firms that have a deeper bench of existing management talent and strong recruitment capabilities.

E. Invest in Companies with Diverse Financial Positions

For an appropriate price, many companies of all industries and all stages of growth or decline can find a willing buyer in the conventional market. However, most employee ownership conversion firms exclude distressed companies or rapidly growing companies and focus primarily on stable, mature businesses.

Companies experiencing rapid growth are often excluded because their need for growth capital can reduce the company's appetite to take on additional conversion debt and because employee ownership valuations tend to be conservative with respect to growth projections. Distressed companies are also generally excluded from employee ownership conversion due to concern over reputational and practical risks. While distressed companies represent a possibility for new conversions, most practitioners do not believe it should be a top priority for the employee ownership community and are skeptical about the impact of distressed conversions. Some potential lenders are concerned that distressed situations could result in negative publicity if the investor were to recoup their investment while the business shuts down and leaves workers unemployed. Furthermore, when ESOPs were emerging in the late 1970s, some distressed conversions ultimately resulted in arguably negative outcomes for workers as conversion terms cut pension benefits and other benefits in exchange for employee ownership participation; this legacy has continued to foster a negative perception of distressed employee ownership conversions, including among the union community.[79] It is possible for companies to convert and then perform poorly. However, if independent forecasts of performance suggest meaningful decline, conversion advisors are unlikely to proceed with the conversion and the conversion will have more trouble accessing financing.

4. Emerging Conversion Deal Structures

As demonstrated above, traditional employee ownership deal structures leave out numerous potential employee ownership candidates. Emerging deal structures offer terms that can attract new sellers to an employee ownership conversion. In particular, most emerging deal structures offer increased cash at close for sellers. By replacing a portion of the sellers note with various forms of external finance, investors can both take on more risk and achieve higher returns than a traditional senior loan. This more active investor role can create new incentives for dedicated funds to actively source deals and simplify the conversion process for the seller. This advantage of higher cash at close and investor incentives must be balanced with the risk that external debt can present to the company's long-term sustainable growth. It also increases the importance of ensuring that the investors' expectations of return are aligned with the long-term sustainability of employee ownership.

Emerging deal structures broadly fit into four categories:

a. Subordinated debt: Debt priced higher than senior debt and paid back as principal and interest over time. It is used in combination with senior debt and seller notes.

79 Karla Walter and Danielle Corley, "Mitigating Risk to Maximize the Benefits of Employee Ownership," Center for American Progress, October 2015, https://cdn.americanprogress.org/wp-content/uploads/2015/10/28102559/MitigatingRiskReport.pdf.
Following the passage of legislation in 1972, many early employee ownership conversions focused on employee buyouts in distressed companies. Often these conversions resulted in meaningful worker wage and pension concessions in exchange for an ownership stake. Some were successful, while others were not. In unsuccessful cases, workers could be unemployed and left with depleted pensions. The shift in employee ownership conversions to focusing on stable businesses is in part a result of this legacy.

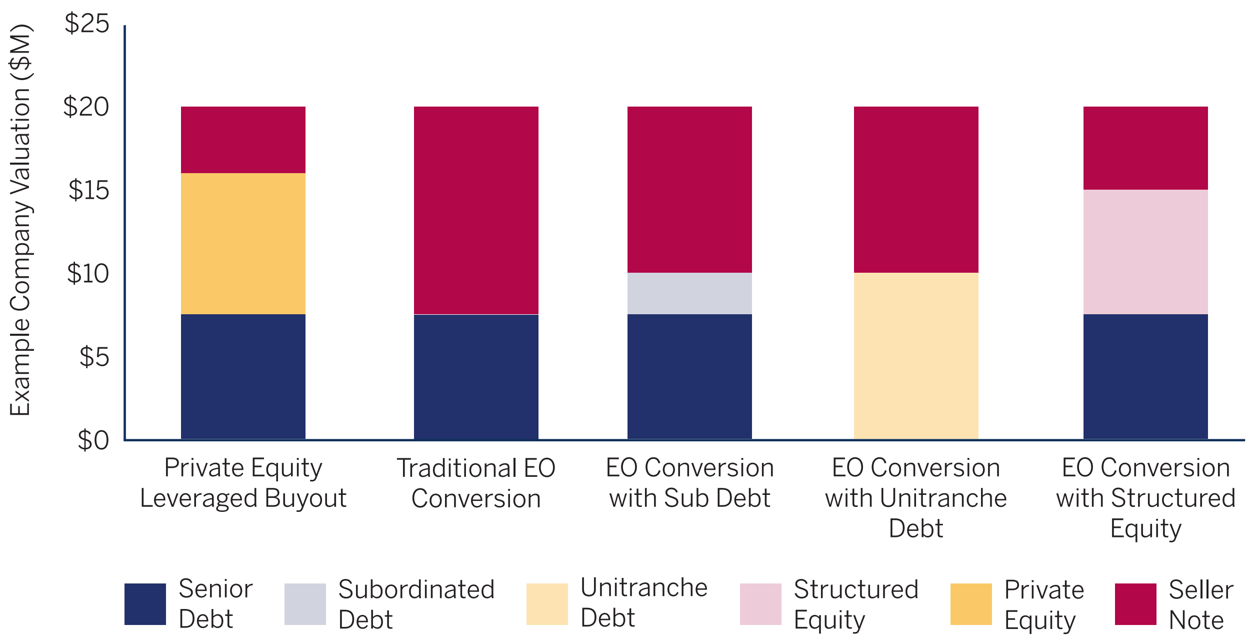
b. Unitranche debt: Combination of senior and subordinate debt in one loan. The terms of unitranche generally reflect the blended value.

c. Structured equity: A form of subordinated debt with warrants. Structured equity enables investors to receive upside from company performance and likewise obligates investors to assume the risk of poor performance.

d. Private acquisition followed by planned employee ownership conversion: Investors can also buy companies in a conventional acquisition with the intention of later converting them to employee ownership. The secondary employee ownership conversion can use any appropriate deal structure, whether traditional financed conversion, incremental conversion, or acquisition.

Each of these structures are discussed in more detail below and the position of debt in the capital stack are illustrated in fig. 7.

Figure 7: Example Share of Valuation Across Employee Ownership and Private Equity Deal Structures



a. Subordinated Debt

Summary: Subordinated loans from an external lender can effectively replace portions of the seller note in a conversion, increasing the cash at close for sellers. When subordinated notes are used in conjunction with senior debt and seller notes, the seller notes generally remain subordinated to the third-party subordinate note's position. Many subordinated notes in employee ownership conversions are structured with paid-in-kind interest, which offers the borrower flexibility on when interest is paid. This can reduce the default risk of the debt to the borrower in case of short-term poor performance.

Employee ownership expansion opportunities addressed: Given the origination capabilities of some subordinated debt lenders, they may be more capable of providing a "knock on the door" and supporting the company post-transaction. Furthermore, focused subordinated debt providers with employee ownership expertise could help lead a transaction from sourcing to conversion, coordinating all parties and simplifying the process for the seller.

Sources of finance: A variety of groups provide or can provide subordinated debt in employee ownership conversions. Groups that invest primarily in worker cooperatives generally focus on senior loans but are often structured with the flexibility to be subordinated when they lend in syndicates with others.

Current usage in ESOP conversions: ESOP advisors interviewed estimate that fewer than 5% of financed ESOP conversions use some form of external subordinated debt; this typically occurs in deals where cash at close is important to the seller and where the deal size is large enough to enable large private debt investors to engage. The loans can either be from traditional mezzanine debt firms that are accustomed to investing in private equity deals at relatively high interest rates or from institutional investors with long time horizons. Many ESOP advisors attribute the limited usage of subordinated debt in ESOP transactions to several factors: added deal complexity, a limited group of subordinated lenders with terms and knowledge specific to ESOPs, and historically higher interest rates for subordinated ESOP conversion debt than comparable loans in the traditional market. However, new market participants are seeking to re-evaluate the appropriate returns and terms for subordinated debt in employee ownership conversions, which is beginning to increase their utilization.

Groups using this approach include the following:

- Social Capital Partners provides unitranche or subordinated debt in large ESOP conversions.[80]
- Project Equity has primarily provided senior debt to date but is open to providing unitranche or subordinated debt in ESOP, EOT, or cooperative conversions.
- The Fund for Jobs Worth Owning has primarily provided senior debt to date but is open to providing unitranche or subordinated debt in ESOP, EOT or cooperative conversions.
- Purpose Evergreen Capital provides unitranche or sub-debt (in addition to senior) in EOT conversions. PEC led the ESOP to EOT deal of Organically Grown Company.
- Common Trust is an emerging EOT conversion funder focused on providing subordinated debt and using innovative profit distribution structures to benefit workers.

b. Unitranche

Summary: Unitranche debt bundles subordinated and senior notes in one loan, generally providing the same overall average terms and cash at close. This can be attractive in circumstances where the company prefers the simplicity of a single lender but where a seller wants more cash at close than what a traditional senior note alone would provide. Unitranche deploys more capital from a single source and has higher rates than senior debt, which may make it more appropriate for institutional investors with high minimum deal size thresholds. Historically, lenders have primarily considered using unitranche debt for larger deals; however, smaller employee-owned non-profits and CDFIs have been considering deploying unitranche debt for the smaller businesses with which they work.

80 The ESOP Podcast, "146: Social Capital Partners & Taylor Guitars Financing," accessed August 1, 2022, https://www.theesoppodcast.com/post/146-social-capital-partners-taylor-guitars-financing.

Groups using this approach include the following:

- Social Capital Partners provides unitranche or subordinated debt in large ESOP conversions.[81]
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- The Fund for Jobs Worth Owning has primarily provided senior debt to date but is open to providing unitranche or subordinated debt in ESOP, EOT, or cooperative conversions.

Spotlight: Taylor Guitars ESOP Conversion with Unitranche Debt

"In January 2021, Taylor Guitars announced their employee ownership transition after the sale of the company to an ESOP. The transaction was in part a result of the work of Social Capital Partners (SCP), who has been working with pension funds on ESOP co-investments since late 2019. It was the first known direct investment by a pension fund into an ESOP conversion and the first ESOP that was designed to include a Mexican workforce.

Bob Taylor and Kurt Listug founded Taylor Guitars in 1974 and built the business into an iconic market leader with over twelve hundred employees and $122 million in revenue (as of 2019). They continued to own the company through 2020 but had been actively developing a succession plan. While they had many options, including a strategic sale to another guitar company or a sale to a private equity firm, they ultimately chose the ESOP as the best option for the company long-term.

Instead of a traditional senior debt and seller financed deal, Taylor's owners chose a unique financing offer from SCP. SCP partnered with the Healthcare of Ontario Pension Plan (HOOPP) and worked with Taylor's ESOP financial advisor, Chartwell, to structure a long-term unitranche loan with the following features:

- Ten-year term
- Competitive, fixed interest rate with no warrants
- More cash at close for sellers than a traditional senior debt offering
- Flexible repayment terms to allow the company to reinvest in growth
- Accelerated payment of sellers note in strong performance periods

Taylor's owners found that this structure better fit their objectives than a traditional ESOP conversion funded by bank debt. In particular, the financial terms, flexibility, and long-term structure of the unitranche loan and alignment of SCP and HOOPP to preserving employee ownership long-term differentiated this offering from traditional options in the market. The deal closed in December 2020, and since then the company has been making more guitars than ever.

In designing a conversion structure that meets the needs of both company owners and large pension funds, SCP paved the way for more groundbreaking deals. Pension funds have a long-term investment horizon which aligns with the needs of a company undergoing a 100% employee ownership conversion. However, with minimum check sizes well above $100 million, many pension plans generally can only directly invest in larger conversions. Going forward, SCP believes a closed-end fund structure would best enable them to replicate the success of Taylor Guitars' conversion many times over."

— Social Capital Partners

81 The ESOP Podcast, "146."

c. Structured Equity

Summary: Structured equity offers elements of both equity and debt. While conventional structured equity ranges from convertible notes to preferred shares, subordinated debt with warrants is the structured equity tool generally used in employee ownership conversions. Structured equity generally replaces a portion of the seller's note and unlocks an equity-like upside for the investor and maximize the cash at close to the seller. This is generally only used in ESOP conversions. Some structured equity providers seek to retain a sellers note junior to their position. However, others effectively eliminate seller financing altogether by seeking another debt provider subordinate to their position, filling out the capital stack entirely with external lenders and providing 100% of the value at close to the seller.[82] While structured equity investments are designed like seller notes, some providers tend to pursue higher return targets through both higher coupon rates and higher warrant coverage. Warrant coverage in structured equity generally ranges from 20–40% of the equity. Structured equity providers can target conventional private equity returns of 15–25%.

Employee ownership expansion opportunities addressed: Structured equity providers tend to act like private equity firms in transactions. Because structured equity offers the possibility for robust returns, structured equity providers can actively source both banked and proprietary deals, manage the conversion process, and even manage corporate leadership and governance post-conversion. Structured equity has the additional advantage of increased cash at close for the seller, making the offer comparable to a private equity deal; this lets structured equity providers participate in competitive brokered sales. As such, investors using structured equity can play a meaningful role in catalyzing new conversions.

Long-term durability of companies converted with structured equity: Most structured equity providers underwrite the expectation that the target company will pay them back through a re-leveraging event once a significant portion of the senior loan has been retired. This re-leveraging keeps the company employee-owned. However, in practice, some ESOPs that have been highly leveraged with structured equity and have experienced meaningful share price appreciation choose to sell to a third-party buyer—effectively ending employee ownership—in order to pay back the warrants. Usage of warrants does not necessarily trigger the pressure to sell. Warrants are a common feature of sellers notes, generally at up to 20% of value, and they are commonly exited through re-leveraging. However, as warrant coverage increases, it can become increasingly attractive for investors to lead the company toward an external sale at a premium, particularly if re-leveraging cannot occur during the investor's time horizon due to insufficient debt paid back.

Relative to a conventional initial private equity transaction, an external sale can be immensely positive for workers; they often receive significant proceeds from the second sale. However, if the longevity of employee ownership is a priority, structured equity needs to be designed with that objective in mind. Strategies to increase the sustainability of structured equity include reducing warrant coverage and ensuring a sustainable coupon rate. Investors should also include event protection that ensures that warrants are valued against the full value of all ESOP shares (instead of just the allocated share amount) in the event of a sale. This ensures

82 Mosiac Capital Partners, "Employee Ownership Buyout Primer," https://www.mosaic-cp.com/wp-content/uploads/2020/03/2-_Buyout_Overview.pdf.

that investors do not end up with an outsized share of the company's value. Companies can also use other approaches, such as implementing a distribution waterfall in which investor proceeds decline once a target return is achieved.

Target market: Relative to subordinated notes and unitranche alone, structured equity may be more appropriate in smaller deals where valuation to EBITDA (earnings) multiples are lower. In these deals, with multiples of four to eight times EBITDA, the company can often afford to take on a higher cost of debt because the level of debt to earnings is lower. Cash at close is often more meaningful to owners of smaller companies where the dollar value of proceeds is lower.

Groups using this approach include the following:

- Apis & Heritage Capital Partners focuses on converting businesses with essential workers of color to ESOPs using structured equity. Their position in the capital stack is generally above the senior note but below seller notes.
- Mosaic Capital is a private equity firm that uses structured equity for ESOP conversions. Their position in the capital stack is generally above both the senior loan and additional mezzanine debt; seller financing is not always required in their deals.
- Long Point Capital is an investment firm that performs structured equity ESOP conversions alongside traditional private equity transactions.
- American Working Capital utilizes long-term structured equity positions in ESOP conversions.

Spotlight: A&H Capital Partners

"Apis and Heritage Capital Partners (A&H) is an impact private equity firm focused on using employee ownership to close the racial wealth gap. A&H specifically targets lower middle-market firms where at least one-third of the workforce are people of color and a majority are low-income workers. A&H announced a first close of $30 million on Juneteenth 2021 and is currently concluding the fundraising of its inaugural fund. A&H investors include a blend of foundations, high net-worth individuals, and institutional investors, and the firm seeks appropriate risk-adjusted returns for its investors.

A&H looks for businesses with $1–6 million of EBITDA and long operating histories. A&H primarily seeks out founder-led companies and approaches owners with a value proposition that is competitive with other potential buyers or exit options, both in terms of pricing and structure. While A&H, a firm that is owned mostly by people of color, believes it provides an attractive proposition for owners of color, its targets are not limited to those owners. A&H's focus is also not restricted to owners who have previously considered or are considering an employee ownership conversion, though there is a natural synergy in those circumstances. The firm is squarely focused on having employee-owned conversions, which it calls an employee-led buyout (ELBO), be a standard option for consideration in connection with owner exit transactions.

A&H's employee ownership conversion tool for its inaugural fund is the ESOP, as the ESOP provides significant tax advantages to the company. In a traditional leveraged ESOP conversion, a senior lender sourced by the seller provides a portion of the capital and the seller provides seller financing for the remainder of the purchase price. The seller financing portion is often 60–70%. This creates a barrier for owners who wish to transition away from the business and/or those that are relying on cash proceeds from the sale to support their retirement. A&H leads the arrangement of the capital needed for the employee ownership conversion (including bringing the senior lender to the transaction) and subsidizes the senior lender and trustee costs. This removes a major barrier for owners who would otherwise prefer to transfer their companies to the employees who have helped build them as the sellers now receive an amount of cash on closing that is on par with more traditional buyout structures.

A&H uses structured notes. A&H's notes generally have the following terms:

- Five- to seven-year term
- Interest only with a balloon payment
- Competitive subordinated interest rate composed of cash interest and paid-in-kind, or deferred, interest
- Warrants aligning A&H with the employee-owners on company growth
- No closing cost and no prepayment penalties
- Unsecured (to obtain equity treatment from senior lenders where desired) or second lien

A&H's goal through the investment is to pay off the majority of or all of the senior debt through increased cash flow from the ESOP tax benefits and employee ownership generally and to, subsequently, exit the investment through a refinancing of A&H's notes to a senior lender. From a social impact, worker productivity, and wealth generation perspective, it is important that A&H companies are not forced into a sale to facilitate A&H's exit. As such, A&H's underwriting is focused on allowing for a refinancing. This translates to lower senior leverage at the close of the transaction, an appropriate warrant level that will not create undue burden for the Company and A&H's own flexibility to ensure the long-term viability of the ESOP.

Another important part of A&H's proposition is its governance and employee ownership training design. In its structure A&H holds board seats alongside an independent director and a director chosen by employees. A&H also partners with The Democracy at Work Institute for direct employee training and resource support around employee ownership. A&H suggests that while the technical conversion to ownership takes place immediately on completion of the conversion, the real training and learnings around owning your business happen over time with focused efforts.

A&H believes that employee ownership is a proven wealth building tool that must be explicitly aimed at communities of color and the businesses that employ them. A&H's capital not only enables more small to medium companies to convert to employee-owned companies, but in focusing on companies with significant workers of color it also helps to shrink the racial wealth gap."

— Apis and Heritage Capital Partners (A&H)

d. Private Acquisition Followed by Planned Employee Ownership Conversion

Summary: A "buy and sell back" strategy involves acquiring a company with equity in a conventional transaction on the condition that it will be exited to employees once pre-determined conditions are met. The initial transaction can look like a conventional acquisition or private equity deal. The secondary employee ownership exit transaction can have any of the deal structures described above, including senior debt, incremental conversion, or acquisition by an employee-owned firm. Some practitioners, such as Teamshares and Seed Commons, are using or exploring an approach where they would aim to maintain a minority shareholding in the majority employee-owned company for perpetuity.

Employee ownership expansion opportunities addressed: This strategy has the potential to address many existing barriers to employee ownership. To the initial seller, a "buy and sell back" model has the potential to effectively match the terms of a competitive bidder, particularly on cash at close. In addition, valuations can approach conventional bids, though the limited exit options may require a discount. According to several ESOP lawyers, as long as the initial investor is an LLC and not a C corporation, the investor can be eligible for the 1042 tax deferral upon the secondary exit to an ESOP or worker cooperative, which can increase up-front valuation.[83]

Because the investment firm would become the equity owner, they have significant incentives to source deals and provide succession leadership. They also can offer a relatively simple process to a seller. Furthermore, this structure might enable an investor to acquire riskier or struggling businesses, which generally are not considered appropriate for employee ownership conversions.

Challenges to implementation: This approach requires very patient capital. The investor may need to stay invested in the firm for a long time, first as an equity holder and then, after the secondary employee ownership conversion, potentially as a sellers note holder. Furthermore, some experts have mentioned that particular care that needs to be taken to ensure full legal compliance if the exit is to an ESOP. While the employee ownership exit transaction may look like any other employee ownership sale, some ESOP advisors are concerned that the Department of Labor may apply additional scrutiny if the selling shareholder is an investment firm.

Groups using this approach include the following:

- Seed Commons uses gradual worker cooperative conversions where equity converts to worker ownership as performance and repayment hurdles are met.
- Long Point Capital is an investment firm that bought a company from the previous seller in a traditional leveraged buyout and exited through a 100% ESOP. There was no up-front commitment to an ESOP exit, but Long Point determined it was the best exit option.
- Southeast Acquisition Partners is considering traditional leveraged buyout followed by a sale back to employees, gradually, or 100%.
- Teamshares is a venture-backed start-up that is actively converting small businesses to employee ownership. Their target businesses are service businesses, many of which may be too small for use of ESOPs. They use a combination of equity and sellers notes to structure a conversion, and gradually grant employees shares over an approximately twenty-year period if performance hurdles are met. While they start with a significant majority of equity and only grant a small portion to employees up front, Teamshares aims to keep a minority equity position in their companies long-term.

83 Regina Carls et al., *Leveraged ESOPs and Employee Buyouts*, 7th ed., 2020, https://www.nceo.org/Leveraged-ESOPs-Employee-Buyouts/pub.php/id/20.

- Tim Rettig is an Ohio businessman who sold a software company to an ESOP and has used some of the proceeds to acquire another company. He plans to improve company performance with technology and then exit to an ESOP again. If successful, Rettig believes the process can be replicated many times.[84]

Spotlight: Tim Rettig's Acquisition of Staffanation

"In February of 2020, I purchased a company called Premium Personnel in Fairfield, OH. The purpose of the acquisition was to modernize operations, scale the company, and to exit the company via an ESOP by 2030. The company was rebranded as Staffanation, and all of its operations were modernized. I chose the company specifically because its operations were antiquated and would benefit from my thirty years of experience in information technology. The company purchase was financed with a ten-year SBA loan, and I also had two silent partners join in the deal. Because I own other companies, including majority ownership in an ESOP, I need to own less than 80% of any new company to prevent ERISA control group issues. For instance, if I owned more than 80% of Staffanation, it would require ESOP stock from Intrust IT to be distributed to employees of Staffanation. The two companies are not related operationally or financially, so any cross-company requirements like that would disrupt each company's ability to operate independently of the other.

There are two provisions in the operating agreement that we inserted specifically in preparation for the company to become an ESOP. These provisions are not required, but they make it easier to undertake an ESOP and ensure that the silent partners are aware of the future direction of the company to be sold to an ESOP. The first provision is about converting from an S-Corp to a C-Corp in preparation for sale. That conversion is not required for an ESOP, but it carries with it some tax benefits to the sellers. The second provision ensures that the silent partners must participate in the majority stock sale to the ESOP. These provisions include the following language:

- **Conversation to C corporation.** It is anticipated that the Corporation may convert the Corporation from an S-corp into a C-corp for the sale of the Corporation to an ESOP. The parties agree that the Corporation's Subchapter S election may be converted upon the affirmative vote of a majority the Shares of the Corporation's stock . . .

- **Tag-along right.** Notwithstanding the provisions as otherwise set forth in this Agreement, if a majority owner of Shares proposes to enter into a Control Transfer (as hereinafter defined) with a purchaser or related group of purchasers, in a single transaction or a series of related transactions (a "Majority Seller") then as a condition precedent to such transfer, the Majority Seller shall permit the other Shareholders to sell on equivalent terms and at an equivalent price as established in the Control Transfer. . . ."

— Tim Rettig, Staffanation

5. Conversion Fund Structure

The structure of the firms deploying capital in employee ownership conversions matters. Beyond the terms of individual employee ownership conversion deals, the structure of the firms deploying capital in employee ownership conversions affects their ability to drive scale and impact.

84 Chris Cooper and Michael Palmieri, "Building the Future with Employee Ownership," *Fifty by Fifty* (blog), May 14, 2020, https://www.fiftybyfifty.org/2020/05/building-the-future-with-employee-ownership/.

Many firm structures used in conventional finance can be used directly, "off the shelf," by employee ownership conversion firms. However, employee ownership finance does present some unique dynamics. Four primary structures are being employed for employee ownership conversions, each of which is explained further below:

a. Committed capital fund structure
b. Holding companies and shared services
c. Fundless sponsor
d. Search funds

a. Committed Capital Fund Structure

Summary: Few, if any, modifications on fund structure are necessary to utilize traditional committed capital private equity or debt fund structures for employee ownership conversions. A main structural difference between an employee ownership focused fund and a conventional private equity firm can be the time horizon. Debt positions using structured equity or subordinated debt in employee ownership conversions can exceed the average private equity holding period of five years. Employee ownership fund managers can either choose to fundraise with a conventional fund life and underwrite for a required exit through debt re-leveraging within that window of time (thus getting paid back sooner) or can pursue a longer-term fund lifetime.

Employee ownership expansion opportunities addressed: Committed capital fund structures are appropriate for catalyzing a variety of employee ownership conversion deal structures and are by far the most common structure used today. There is meaningful room for growth in utilizing these structures.

Approaches to balancing fund and worker returns: Private equity-like employee ownership conversion funds can modify fee structures to balance fund and worker returns. As mentioned above, structured equity or a buy-and-sell-back approach can approach traditional private equity returns. However, some firms may pursue returns below traditional private equity rates by changing the fund fee and return structure. Innovative distribution waterfalls can reduce the carried interest fees charged when portfolio businesses perform well. For conventional private equity structures, the fund typically receives 20% of all returns above the preferred return rate of 8%. In contrast, Purpose built a distribution waterfall for Organically Grown Company in which investors receive a declining share of returns relative to the company itself if the company outperforms.

Groups using this approach include the following:

- Seed Commons utilizes conventional debt fund structure with decentralized loan decision making that empowers local organizations to source and structure loans.
- Project Equity employs conventional debt fund structure.
- Apis & Heritage Capital Partners uses conventional private equity fund structure.
- Shared Capital Cooperative utilizes a committed capital debt fund structure, funded both by debt and preferred shares.

- Mosaic Capital Partners is a private equity-like firm using structured equity in employee ownership conversions.
- Conventional ESOP banks include Bank of America, Wells Fargo, JP Morgan.

Spotlight: Blended Capital Approach of the Employee Ownership Catalyst Fund

"The Employee Ownership Catalyst Fund is a capital vehicle, co-managed by national nonprofit Project Equity and impact investment firm Mission Driven Finance to support more small and medium businesses across the United States in transitioning to employee ownership. The Fund is open to new commitments from accredited investors.

Many of Project Equity's key findings on obstacles to employee ownership revolve around access to flexible capital.

- Location: Transition financing is often geographically restricted based on funder preferences.
- Amount of employee ownership and timing: Some financing programs are contingent upon the business transitioning to 100% employee ownership, but that does not always make financial sense for the seller or the business, or at least not as the initial step.
- Responsiveness to a rapidly changing economy: Small business owners face a veritable funhouse of challenges with something new popping up around each corner, even when they're on an exciting path to employee ownership.
- Employee ownership feasibility: Analysis for a multi-party ownership transition is time consuming and typically an expense outside the planned operating budget.

Capital from the Employee Ownership Catalyst Fund can support transitions of at least 30% ownership for businesses across the United States. Recognizing the enormous diversity of business circumstances, revenue models, seller positions, and workplace cultures, the fund meets businesses where they are. Just as Project Equity recommends different forms of employee ownership for different businesses, the Employee Ownership Catalyst Fund uses a suite of financial tools to be responsive to each business case.

Centering the purpose of being responsive to diverse business needs, the fund needed to have a flexible structure. Like most vehicles Mission Driven Finance designs and manages, the Employee Ownership Catalyst Fund has a blended capital structure to leverage the different strengths of different kinds of investors for even more power together.

Most of the target $20 million fund comes in the form of notes, in both senior and junior positions. Mission Driven Finance has found that especially when allocating to emerging impact fund managers, investors like the increased cashflow visibility from a debt note structure over the deeper trust and/or higher return required for a limited partner position.

Especially catalytic was a $1 million grant to Project Equity to launch the fund. While grants are often used for programs (still an excellent use case!), the granting foundation gave Project Equity discretion on how best to leverage this risk-tolerant, risk-absorbing commitment to unlock capital and opportunity.

Project Equity invested the grant proceeds as equity in the Employee Ownership Catalyst Fund, which is, by definition, subordinate to the outside noteholders. Essentially a general partner (GP) stake, the fund equity can be used for fund expenses, cushioning potential losses, and absorbing tails from portfolio companies still repaying the fund when investor notes reach maturity.

One way that a grant-funded GP stake gets extra mileage is by tapping into the state-backed small loan guarantee program run by the California Investment Bank (IBank). Project Equity has raised additional grant dollars to enable the fund to tap IBank loan guarantees for some or all of its California loans. Approved Employee Ownership Catalyst Fund loans to businesses in California can get up to 80% of the principal guaranteed against losses for just a few percentage points—paid by the fund, and specifically grant proceeds. This provides other investors additional protection without burdening transitioning businesses with higher costs of capital or asking sellers (who have already put their blood, sweat, and tears into growing their businesses) to further expose themselves with personal guarantees and personal collateral requirements.

Of note, by having a grant-funded GP stake, the Employee Ownership Catalyst Fund has a wider suite of capital tools available to support small businesses transitioning to employee ownership. Where other investors are note holders with fixed, albeit extendable, maturity dates, the equity slug in the fund has flexibility on timing. With patient capital in the fund, Project Equity and Mission Driven Finance can originate loans and revenue-based investments but also equity purchase agreements. Noteholders could be made whole at maturity and remaining equity payments from portfolio companies would be allocated to repaying the grant-funded GP stake. In this way, the capital parallels the employee ownership forms—many tools available in the toolbox to be able to meet businesses where they are.

Lastly, returns for the GP stake function more like a performance incentive. Reduced fund losses directly translate into returned GP capital which can be repurposed or reinvested at Project Equity's discretion."

— Mission Driven Finance

Figure 8: Mission Driven Finance's Blended Capital Structure

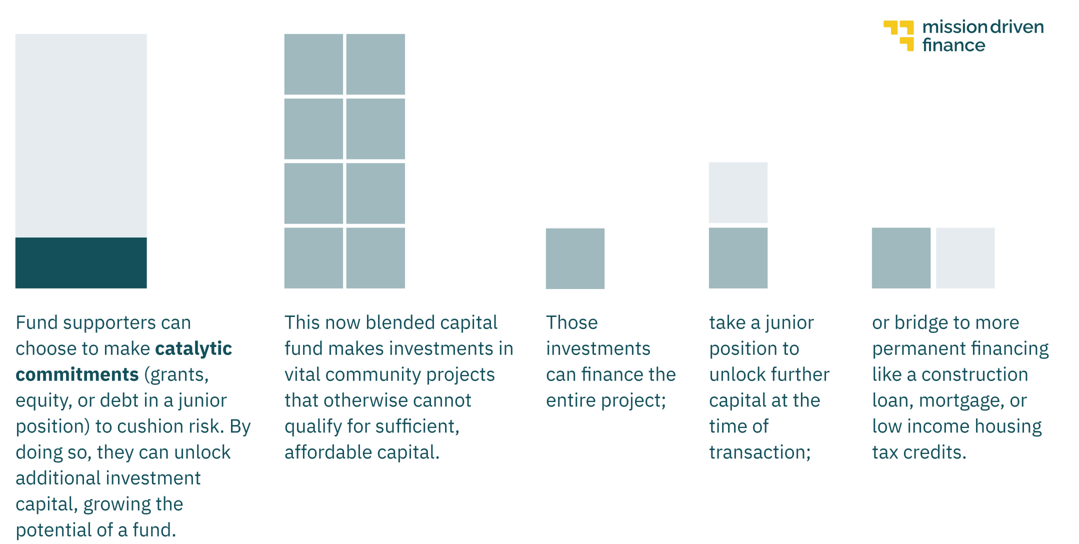

Image courtesy of Lauren Grattan and Mission Driven Finance

b. Holding Companies and Shared Services

Summary: Holding companies focused on employee ownership conversions streamline conversion processes and capture synergies across businesses. Holding companies can achieve meaningful economies of scale in administration, including the management of employee ownership structures themselves. As mentioned above, Teamshares focuses on adding value through providing shared services, such as accounting, IT, and forecasting, for its portfolio of small businesses, and TeamShares achieves many of the benefits of a holding company through its internal operational practices. Holding companies also provide risk diversification, which can help stabilize cash flows and direct investment to productive uses.

Employee ownership expansion opportunities addressed: Like a strategic corporate acquirer, holding companies can actively source deals, simplify a transaction for a seller, put in place management leadership talent, and/or use a variety of financing sources that increase cash at close.

Groups using this approach include the following:

- ESOP Holding Companies include Empowered Ventures (IN), Empowered Ventures (Midwest), Alliance Holdings (PA), Employee Owned Holdings (TX), EQ Holdings (MN), Foliance (IA), Houchens Industries (KY), Kocolene Development Corp (IN), OwnersEdge (WI), Tri HoldCo (CA), Unity Holdings (ND).
- Main Street Phoenix Project uses a building holding company structure to buy out restaurant owners and build an efficient shared services platform for restaurant management.
- Obran is a cooperative holding company that seeks to use platform and bolt-on acquisitions in strategic industries.
- Mondragon (note: not US Based) is a ninety thousand-worker cooperative in Spain that effectively functions as a diversified conglomerate holding company. While it is not dependent on growth through acquisition per se, it has acquired and started new businesses with capital generated from its existing portfolio.
- Teamshares focuses on providing shared professional services to a portfolio of converted small employee-owned businesses.
- Co-op Cincy is a network of cooperatives. Converted companies become part of their network, contribute 10% of profit, and jointly decide how those funds are spent.
- Industrial Commons is a cooperative holding group in western North Carolina.
- Evergreen Cooperatives is a network of cooperatives in Cleveland, closely partnered with academic and medical "anchor institutions" to identify and source new worker cooperative company members within anchor institution supply chain.

Spotlight: Empowered Ventures Expands as an Employee-Owned Holding Company

"Empowered Ventures evolved from TVF, a textile distributor that converted to an ESOP in 2010. After a decade of growth and building a strong balance sheet, we saw an opportunity to bring employee ownership to more businesses using a relatively innovative model: a diversified ESOP holding company. Through TVF, Empowered Ventures was launched to acquire and convert diverse businesses to employee ownership. We believe that this model provides numerous advantages for sellers and for the companies post-transaction.

Like a conventional ESOP sale, sellers receive the peace of mind and legacy benefits of selling their business to employees. However, unlike an independent ESOP conversion, our payment terms and process are generally much more favorable. To date, our two acquisitions have been all in cash from internal sources, providing cash at close comparable to, if not better than, a private equity transaction. Furthermore, we greatly simplify the ESOP conversion process. Our ESOP is at the holding company level and employees of the acquired company join the existing ESOP on day one. Being able to avoid all the steps involved with forming an ESOP eliminates much of the cost, complexity, and risk associated with a traditional ESOP transaction. We have found this to be especially appealing to many business owners.

Our holding company also gives our businesses a competitive advantage post-conversion. While the cultural shift of becoming employee-owned is a powerful boost to performance, the opportunity as a holding company is even greater. We add value as a holding company by providing strategic leadership, supporting leaders, and building internal capabilities from finance to analytics to operations. We have no intention of selling our businesses, and we don't put debt on their balance sheets, enabling truly long-term oriented strategic actions and investments. Being diversified also insulates our long-time employee-owners from the wealth concentration risk of a single-company ESOP.

In the future, we are interested in evaluating how mission-aligned institutional capital might help us further expand our model."

— Empowered Ventures

Spotlight: Evergreen Cooperatives Fund for Employee Ownership

"In May 2021, Evergreen Cooperatives' Fund for Employee Ownership (TFEO) added to its growing portfolio of employee-owned businesses with the acquisition of Intellitronix, an industry-leading producer of LED automotive aftermarket digital and analog gauges. The manufacturing facility is located near Cleveland, Ohio.

The deal represents the fourth transaction by the Fund for Employee Ownership to provide loans from both TFEO ownership and the exiting owner to finance the acquisition. The Fund also provided operating capital to the new worker cooperative by taking a preferred share position in the new cooperative, Ohio INTX Cooperative (INTX). To date, INTX has thirty-five employees of which fourteen are employee-owners who have participated in decision-making and profit sharing since the acquisition.

The Fund's mission is to acquire, convert, and support new cooperatives by creating a network where Evergreen Cooperative Corporation is a shareholder in addition to the new employee owners. Evergreen's mission is to create living-wage jobs in disinvested communities around Northeast Ohio, while providing wealth-building opportunities for employees through employee ownership.

A critical piece of The Fund's social impact is to provide support to the new cooperatives, providing guidance on governance, training, and educational tools, and post-acquisition support for new employee-owners. Education and training are provided on bylaws, membership agreements, financial literacy, and open book management among other worker-owner topics. We provide expert technical assistance to transitioning employee-owners and the executive staff.
The Fund continues to raise patient capital and invests in small and medium sized businesses where owners are looking to exit their company while continuing their legacy, keeping jobs local, and creating wealth building opportunities for their employees."

— Evergreen Cooperatives' Fund for Employee Ownership

c. Fundless Sponsor

Summary: To date there are over four hundred conventional fundless sponsors operating in the US.[85] Fundless sponsors do not have committed capital. Instead, they are structured to source deals and fund them individually through their network of potential limited partners. While fundless sponsors fund individual deals at a time, they typically invest in multiple companies. As such, their role is more parallel to that of a private equity fund.

Employee ownership expansion opportunities addressed: Fundless sponsor principals are often active in operations and governance. Fundless sponsors can be active in sourcing proprietary deals but generally do not participate in auctioned sale processes. This is because they often focus on lower middle market and have the capacity to do deep outreach, but also because they may not be competitive without committed capital in traditional processes. The key advantage of independent sponsorships is the flexibility they offer. Each deal can be customized to meet the needs of LPs and sellers, without a predetermined deal structure. Many fundless sponsors offer emerging fund managers an opportunity to build a track record on which to raise a more traditional fund; several employee ownership-oriented independent sponsorship fund managers explicitly are working toward that goal.

Challenges: The core challenge of the fundless sponsor structure is simultaneously aligning deal terms across the seller and the capital sources. In a traditional fund, the manager has capital available to deploy, so the firm engages in a one-way negotiation, not as a deal-maker between two parties. This has been a challenge for employee ownership fund managers. Social Capital Partners addressed this challenge by bringing in single investors as partners early on in a deal so that they can get comfortable with the terms and the process. Other groups using fundless sponsor models generally explicitly state their intent to use it as a steppingstone to other structures.

Groups using this approach include the following:

- Social Capital Partners uses independent sponsorships that focus on bringing in single

85 Carmela Mendoza, "The Case for Independent Sponsor Deals amid Covid-19," Private Equity International (blog), October 27, 2020, https://www.privateequityinternational.com/the-case-for-independent-sponsor-deals-amid-covid-19/.

large institutional investors in joint diligence for deals. They are exploring raising a committed fund.

- Southeast Acquisition Partners seeks independent sponsorship, with no deals closed to date.
- Torana Group seeks independent sponsorship, with no deals closed to date. They are working with family offices to build a committed fund.
- Common Trust is an EOT conversion fund, using independent sponsorship structure to build toward a committed fund.

d. Search Funds

Summary: Conventional search funds enable entrepreneurs to acquire, lead, and grow a business. The number of search funds is growing, and conventional search funds closed over twenty-five investments in 2020.[86] In a conventional search fund, an entrepreneur will generally aggregate commitments from twelve to twenty individual or institutional investors to fund the search phase. These commitments generally cover the searcher's salary while they source a deal. Once a deal is found, the searcher will invite these limited partners to fund the deal itself. Searchers take an equity stake in the company alongside their limited partners. Adapting a conventional search fund model to employee ownership is relatively straightforward. An employee ownership leader simply sources a deal and becomes part of management post-conversion.

Employee Ownership Expansion Opportunities Addressed: The key advantage of search funds is their ability to enable transactions with sellers who do not have a strong succession plan. In fact, searchers often can become preferred acquirers because some sellers prefer to leave their company in the hands of an experienced searcher rather than a financial firm or a strategic buyer.

Challenges: Search funds have a similar dynamic to that of independent sponsorships: there is no committed capital, and both the seller and the investors must align on terms simultaneously.

Groups using this approach include the following:

- Obran has launched a cooperative search fund accelerator program. The program offers a stipend for business leaders to source, gain equity in, and lead gradual cooperative conversions.[87]
- Co-op Cincy runs a cooperative leadership development program that is designed to train business leaders of color to source and lead a newly converted cooperative in Cincinnati.

86 "The Search Fund Model Explained," WSC & Company, accessed August 1, 2022, https://wscandcompany.com/search-fund-model/.

87 "Cooperative Search Fund Accelerator," Obran, 2021, https://www.obran.coop/search-fund-accelerator.

B. Start-Ups

New businesses need capital to grow. The type of capital needed can differ depending on the business's objectives. Some start-ups are businesses that aim to reach stability as a small business, while others aim to grow rapidly to gain meaningful market share in a particular industry. For small business finance, the pre-profitability phase is often financed by personal assets of owners. In the US, venture capital is the primary vehicle by which start-up companies that have potential to rapidly scale receive funding.

The start-up space presents an open opportunity for employee ownership. Many start-up founders are looking for alternatives to the conventional venture capital path and are seeking to reward the teams that make a business succeed. This section explores the challenges, opportunities, and emerging practices for employee ownership start-up finance.

1. Market Size and Trends

The conventional venture capital industry has grown rapidly over the last decade, peaking at nearly 15,500 deals and $330 billion in investment dollars in 2021.[88] By contrast, the value of investments or loans in pre-profitability employee-owned start-ups is below an estimated $2 million annually.[89] The vast majority of employee-owned start-ups are worker cooperatives. While many traditional cooperative lenders do offer start-up loans, these loans generally reflect a small part of their portfolio. Large cooperative lenders, like the National Cooperative Bank, do not generally invest in worker cooperative start-ups.

2. Opportunities for Employee Ownership Start-Up Finance

Through conversations with practitioners, three major opportunities for start-up employee ownership finance to address have been identified:

a. Mainstream employee ownership-specific requirements for personal guarantees, collateral, and track record
b. Provide equity-like capital that allows for investments in growth
c. Develop an investment ecosystem to overcome tradition of pooled venture investing

a. Mainstream employee ownership-specific requirements for personal guarantees, collateral, and track record

Banks often require both a track record of profitability and a personal guarantee by the owner for small-business start-ups. Cooperative start-up businesses generally have neither a record nor worker members willing or able to provide a personal guarantee. Furthermore, with the growth of technology-oriented start-ups with limited physical assets, many start-ups lack the collateral

88 Priyamvada Mathur, "Six Charts That Show 2021's Record Year for US Venture Capital" PitchBook, January 19, 2022, https://pitchbook.com/news/articles/2021-record-year-us-venture-capital-six-charts.

89 Pending additional information; information assumed based on disclosures from cooperative lenders, including Start.Coop, Shared Capital Cooperative.

required for a traditional loan. As such, cooperative and employee-owned start-ups struggle to meet the requirements for loans from traditional banks. Flexibility around guarantees, track record, and collateral are critical to funding employee ownership start-up deals.

b. Provide equity-like capital that allows for investments in growth

While conventional early-stage start-up loans can be a useful structure for businesses with modest growth expectations, they are not designed to support rapid growth. Loans can require early payments to the lender regardless of performance, which directly competes with the resources a company has available to invest in its growth.

For this reason, conventional equity from venture capital generally funds start-ups with more ambitious growth expectations. Venture equity holders expect be paid back benefit when their equity is purchased by other third-party investors at a premium to the price they paid, generally within at most ten years from the initial investment. This design enables the start-up to direct its initial resources toward growth, not toward paying back its early investors. In many venture-backed start-ups, the ultimate target buyers of start-up equity are larger companies in the same industry or the broader public through an IPO.

Investing with the intent to ultimately sell to a non-employee-owned company or do an IPO is not an option with employee ownership start-up finance. Thus, investors in employee ownership start-ups face difficulties in generating returns from growing equity value and then selling ownership. Instead, employee ownership start-up investors need to structure vehicles to "harvest" their investment through the long-term financial performance of the business itself. As such, employee-owned start-up finance requires deal structures that provide equity-like flexibility to focus on growth in the short-term and offer investors long-term returns while maintaining employee ownership.

c. Develop an investment ecosystem to overcome the tradition of pooled venture investing

Unlike private equity investors, who tend to invest individually in deals, venture capital firms tend to invest in groups and in multiple rounds, with a single venture firm leading each financing round and setting the basic terms. This enables venture investors to spread their investments across more deals and diversify their portfolio risk. For this approach to be replicable in employee ownership, an entire ecosystem of employee ownership-oriented investors may be required to support multiple rounds of joint funding.

3. Start-Up Deal Structures

While the volume and value of transactions remains low, organizations are innovating new ways to provide start-up capital to employee-owned businesses. Employee-owned start-ups generally receive funding in three primary ways: grants, loans, and equity or equity-like investment. Financial innovation is primarily occurring with equity and equity-like investments.

a. Grants

While grants are not technically a form of financial investment, they are often critical catalysts in founding worker cooperatives.[90] Grants can both help a cooperative establish a track record to find additional capital and can increase other investors' confidence and willingness to invest.

Groups using this approach include the following:

- Capital Impact Partners are a community development financial institution with broad focus, providing annual start-up grants for cooperatives.
- Shared Capital Cooperative occasionally provides grants to support cooperative development.

b. Loans

Some cooperative development groups offer loans to start-ups. Start-up loans are generally used for new worker cooperatives that aspire to become successful small to medium-sized businesses, not rapid-growth technology businesses. Start-up loans to cooperatives also generally delay the borrower's payment of principal and, occasionally, interest. This allows the borrower to focus initially on growth rather than debt repayment. They do not require personal guarantees and can have significantly reduced collateral requirements. Depending on the time horizon of the lender and borrower characteristics, the loan can be underwritten to be paid back gradually or can have the principal paid back through a refinancing transaction involving the company raising additional capital.

Groups using this approach include the following:

- Local Enterprise Assistance Fund's (LEAF) portfolio includes start-up debt with delayed payment terms to small cooperative start-ups.
- Shared Capital Cooperative's portfolio includes start-up debt with delayed payment terms to small cooperative start-ups.
- The Fund for Jobs Worth Owning's portfolio includes start-up debt with delayed payment terms to small cooperative start-ups.

Spotlight: The Fund for Jobs Worth Owning Loan to Heartsong

"The Fund for Jobs Worth Owning (FJWO) recently provided a $30,000 flexible term loan to a worker-owned home care agency start-up in western Washington state. Supported by the Northwest Center for Cooperative Development (NWCDC), Heartsong Homecare Co-op was eager to begin serving clients in Skagit and Island counties. Heartsong is actually the fifth home care cooperative developed in Washington, the newest member of the local worker-owned community. Heartsong came to FJWO with a strong business plan, management team, and core group of caregivers ready to serve the community. The workers only needed start-up capital to get off the ground, providing those early-stage funds to pay caregivers, staff the office, and invest in marketing to build the business.

90 To our knowledge, grants have not been used to establish ESOP or EOTs.

FJWO partnered with Shared Capital Cooperative, a national co-op-focused CDFI, in addition to NWCDC's own loan fund and a local investor to complete the transaction. Since equity was limited, all lenders stepped up to offer payment flexibility. The other lenders were able to offer six to twelve months interest-only payments. FJWO did as well and added an extra element of flexibility to the loan by giving the borrower the option to defer all payments of principal and interest for a number of years. Heartsong has the option to lower their interest rate by up to 2% by beginning principal payments early, but exercising that option is entirely up to them. This aspect of the loan gives Heartsong leaders the ability to manage their cash flow and make necessary investments in their business. There were no personal guarantees on the loan. Instead, ongoing reporting on key business metrics were put in place to keep the lenders updated.

As beneficial as employee-owned businesses are for their workers and communities, they remain difficult to finance. Low-wage workers do not typically have the wealth to purchase stock or offer collateral themselves, and service-sector industries have very little hard collateral to offer a traditional lender. Loans from FJWO are flexible and tailored to fill this gap, providing a crucial part of the financing needed to stabilize and grow worker cooperatives and transition conventionally owned businesses to employee ownership. Learn more at www.jobsworthowning.org.

Heartsong is now up and running, providing excellent, client-focused, and worker-empowered care to their community: www.heartsong.coop."

— Jonathan Ward, The Fund for Jobs Worth Owning

c. Equity and Equity-Like Financing

Emerging employee ownership investment venture term sheets by definition avoid a dependence on repayment through third-party acquisition or IPO. These structures find other means of achieving the upside for investors while providing the flexible financing needed by start-ups in periods of rapid growth. Five common structures are summarized in Table 2.

Table 2: Start-Up Equity Investment Approaches

	Description
Revenue-Based Financing	• Investor paid back as a fixed share of company revenue • Returns generally capped as multiple of initial investment (e.g., 1.2–4 times) • Can be structured as equity or debt • Can constrain company investment in growth because of pre-profit payback requirements; investor returns also constrained relative to conventional venture*

Note: while Indie.vc attempted to popularize these revenue or profit share-based investment approaches for conventional, non-employee-owned venture capital, they ultimately were unsuccessful in raising money. Many experts believe the primary explanation is that traditional venture investors see higher returns from structuring their returns primarily based on a third-party exit. As such, using these approaches in employee ownership represents a constraint on conventional capital availability.

Table 2: Start-Up Equity Investment Approaches (continued)

	Description
Profit-Based Financing	• Investor paid back a proportional share of profit • Returns generally capped as multiple of initial investment (e.g., 1.2–4 times) • Shared earnings agreements are a common structure for profit-based financing • Can constrain company investment in growth because of early payback requirements; investor returns also constrained relative to conventional venture
Convertible Note	• Debt that converts to equity, generally at a capped (discounted) price in a future funding round • Can be designed to be exited to community or workers
Redeemable Shares	• Equity ownership that can or must be repurchased by the company at a predetermined valuation • Repurchase can come from refinancing, or follow-on equity, and thus can be designed for an exit to community • Allows company to invest in growth without early payments—ideal for risker endeavors
Preferred Shares	• Equity ownership that often entail a target annual dividend (often 4–10%) • Ideal for established, expanding, and profitable companies • Can be designed to share additional upside with other parties in years of outperformance

All these structures can be designed to maintain worker governance. Where it is used, external equity can be structured as non-voting.

These equity and equity-like financing approaches can be used either to fund the growth of existing employee-owned start-ups or to enable a conventional start-up to scale and ultimately convert to an employee ownership structure. The growing "Exit to Community" movement believes that early-stage investments that pre-determine a conversion to employee ownership provide the "best of both worlds—the risk and dynamism when founders need it, and the loyalty and accountability when the community needs it."[91] A number of publications provide additional detail on employee-owned start-up terms, including Purpose's Online Course, the "Exit to Community" primer, a recent article series from Start.coop, and sample term sheets from Jason Weiner.[92]

91 Malene Alleyne et al., "Exit to Community: A Community Primer" (Boulder: Media Enterprise Design Lab, August 31, 2020).

92 Alleyne et al., "Exit to Community: A Community Primer"; "AltCap Self-Paced Online Course + Strategy Workshop," Purpose, Altcap Fundraising Accelerator, accessed August 1, 2022, https://altcap.podia.com/altcap-self-paced-online-course; Jason Wiener, "Limited Cooperative Associations and Early Stage Financing," jason wiener | p.c., June 9, 2018, https://jrwiener.com/limited-cooperative-associations-and-early-stage-financing/; Greg Brodsky, "How to Invest in Cooperatives (Part One) [OM #5]," June 29, 2021, https://ownershipmatters.net/newsletter-item/greg-brodsky-on-how-to-invest-in-cooperatives-part-one/.

Groups using this approach include:

- The Equitable Economy Fund provides initial and follow-on financing for growth-oriented start-ups that have participated in the Start.coop accelerator program.
- Purpose Ventures deploys flexible venture investments for EOT structures within growth-oriented start-ups.
- Shared Capital Cooperative participates in equity-like debt investment for scalable cooperatives.

Spotlight: The Drivers Cooperative – Reflections on Start-up Finance for Cooperatives

"We at The Drivers Cooperative decided to pursue a regulation crowdfunding so that we could capitalize on public support and include our members, who are non-accredited investors. When designing the terms, we sought to achieve the following:

- Alignment of investors on revenue growth
  - Any dividend-based payment involves investor feedback on costs, whereas paying out 2.5% of revenues to investors in the round organizes focus on top-line growth. Compared to term debt with fixed principal and interest payments, revenue-based financing makes the cooperative's debt obligation variable based on its success.
- Extended grace period so that funds could be used to grow the business rather than immediately repay investors
  - Most term-debt agreements only have six to twelve month interest-only periods, whereas this agreement had a three-year grace period before payments began.
- No voting rights to retain driver control of the cooperative
  - Given this was debt, there were no voting rights associated with the investment.
- Return that acknowledged the risk but capped the return
  - With distributions of 2.5% of revenues and a cap of 2.5 times the investment, the aim was to target an IRR above what an investor would receive in public markets but below what an investor would receive in venture, with payments ending after ten years.

The Drivers Cooperative had both funds and individuals participate in the $1.46 million round on the same terms. With last year's change in SEC regulations, companies can now raise $5 million annually via regulation CF campaigns. The challenge, of course, is identifying and convincing a large number of investors on terms that honor the spirit of cooperatives.

A primary challenge of raising capital for cooperatives is that the impact investors, who have roughly $715 billion under management, are expecting to invest in C corporations in a way that is largely indistinct from commercial venture investing or give grants to nonprofits. Debt agreements or terms involving capped returns are generally difficult to get through their investment committees, many of whom are accountable to limited partners.

Organizations that are used to fund cooperatives, such as CDFIs, typically offer debt based on existing cash flows (e.g., conversions) or reliably projected cash flows (e.g., development costs for housing cooperatives or inventory for grocery cooperatives). Given that they are charging 4–10% APR on loans, their expected return makes it challenging to take on significant risk in new businesses with uncertain future cash flows. Furthermore, the size of these funds are dwarfed by commercial venture funds (e.g., Shared Capital Cooperative, our earliest debt investor, has a loan portfolio of $13 million, compared to Andreesen-Horowitz's $9 billion raise). This means that a $2 million seed investment has dramatically different implications on the health of the total portfolio for smaller funds focused on cooperatives than a $2 million seed investment does on the total portfolio of a venture fund. Lastly, CDFIs can ameliorate their risk through the Small Business Administration guarantee, but most start-up loans require a personal guarantee, which is an untenable risk for an individual to take when the organization is collectively owned.

Normalizing larger funds and revenue-based investments with capped-returns among impact investors and CDFIs would do a lot to grow the start-up platform cooperative movement."

— Alissa Orlando, Co-founder of The Drivers Cooperative

4. Start-Up Fund Structure

Employee ownership venture fund structures generally parallel three conventional structures: conventional debt or equity funds, accelerator/incubators, and internal venture from a parent company. These structures are often used in conjunction with one another, such as an internal incubator or a debt fund accelerator. In addition, many employee-owned cooperative start-ups are leading their own fundraising efforts, pulling together many diverse groups in custom transactions.

a. Conventional Debt or Venture Fund

Most funders that make worker cooperative venture loans do so out of their broader debt funds. They borrow capital and generally charge interest rates that can pay back their lenders, cover expected losses, and, if necessary, cover transaction costs and staff. Start.coop accelerator start-ups receive equity and equity-like investment from Equitable Economy Fund.

Groups using this approach include the following:

- Equitable Economy Fund raises capital from accredited investors and is associated with Start.coop accelerator companies.
- Shared Capital Cooperative sources capital as debt and preferred shares equity.

b. Accelerator/Incubator

Accelerators and incubators combine investment with start-up technical and strategic assistance.[93] Accelerators tend to provide support to existing start-ups, while incubators generate concepts internally and provide the support that enables them to grow.

Groups using this approach include:

- Start.coop is an accelerator program for cooperatives. Participants are not limited to worker cooperatives (platform cooperatives, among other models, are included).

93 Liz Enochs, "How Co-op Accelerators and Incubators Are Supercharging a Worker-Owned Economy," *Shareable* (blog), July 9, 2019, https://www.shareable.net/how-co-op-accelerators-and-incubators-are-supercharging-a-worker-owned-economy/.

- Co-op Cincy offers training, development, and capital assistance programs for cooperative start-ups.
- Green Worker Cooperatives offers training, development, and capital assistances program for cooperative start-ups.

c. Internal Venture Fund from an Employee-Owned Parent Company

Conventional corporate venture capital funds have grown in popularity, with companies ranging from PepsiCo to Cargill launching their own internal venture funds. This structure can be and has been adapted for employee ownership. Mondragon, the eighty thousand-person worker cooperative behemoth based in Spain, pioneered an internal venture capital approach to cooperative investment.[94] The organization has a centralized financing arm that incubates and finances internal start-up cooperatives. Inspired by Mondragon's success, The Industrial Commons in North Carolina is building a cooperative group with the goal of founding new cooperative members. The Industrial Commons has a debt fund, "Capital for the Commons," that enables start-ups to borrow at zero percent interest and only pay back the loan once profitable.

Groups using this approach include the following:

- The Industrial Commons employs an internal grant-funded investment fund to support new cooperative start-ups.[95]

94 Christina A Clamp, "The Evolution of Management in the Mondragon Cooperatives" (Manchester, NH, 2003), https://community-wealth.org/sites/clone.community-wealth.org/files/downloads/paper-clamp.pdf.

95 "Capital for the Commons," The Industrial Commons, accessed August 1, 2022, https://theindustrialcommons.org/capital-infrastructure.

PART 4

Maximizing Catalytic Impact through Employee Ownership Investment

4

Any properly structured investment in meaningful employee ownership is inherently an impact investment. However, employee ownership practitioners tend to be deeply thoughtful about how they can design their efforts to maximize their impact. Employee ownership impact strategies and the theories of change behind them are the focus of this section.

To provide greater clarity on investment strategies, this section defines and references the role of conventional, impact, and catalytic capital in employee ownership. The three classifications can be defined as follows:[96]

- **Conventional capital:** seeks market-rate risk adjusted returns without additional effort to increase impact.
- **Impact capital:** generally seeks market-rate risk adjusted returns and achieves measurable, targeted impact.
- **Catalytic capital:** a subset of impact capital that achieves targeted impact and/or enables additional investment by accepting concessionary returns or disproportionate risk.

In employee ownership finance, most ESOP conversion loans could be considered conventional, since there is no additional targeted effort to achieve impact. Many new market-rate employee ownership funds are both impact and catalytic; by innovating on new approaches with less of a track record, they aim to build replicable models that can grow employee ownership. Catalytic capital has been used for decades to support cooperatives and is increasingly used to support early-stage, less proven market-rate ESOP funds and EOT conversions.

A. Theories of Change

Employee ownership funders using deal terms and strategies designed to increase impact generally converge on several theories of change behind their work.

First, impact and catalytic capital can directly fill capital gaps, unlocking employee ownership deals that would simply not be possible with traditional employee ownership finance. By making new deals possible, catalytic and impact capital is meaningfully additional to alternative capital sources. As previously discussed, impact and catalytic employee ownership funds are often able to offer deal terms that make employee ownership more viable (e.g., a company that cannot find alternative lenders), more attractive to sellers (e.g., more cash at close), or more appropriate for a given business (e.g., succession leadership) than traditional employee ownership finance sources. These sources are also often able to source off-market or banked/brokered deals that would not otherwise convert to employee ownership. In addition, funds with concessionary terms are often able to fill capital gaps, specifically smaller conversion deals (less than roughly $3 million), and cooperative conversions and start-ups that require significant technical assistance. Many impact and catalytic capital providers also prioritize business with underprivileged worker populations, targeting worker ownership in communities where it can have the most impact. Many practitioners view the gaps that impact and catalytic capital fill as important not just because of their incremental ability to add to the number of employee-owned businesses, but because the depth of impact is generally greater, from the communities affected to degree of worker participation in governance.

96 Christine Leijonhufvud et al., "Catalytic Capital: Unlocking More Investment and Impact" (Tideline, 2019), https://tideline.com/wp-content/uploads/2020/11/Tideline_Catalytic-Capital_Unlocking-More-Investment-and-Impact_March-2019.pdf.

Second, beyond direct impacts on affected workers, many practitioners believe that their work is creating "lighthouse businesses" or even "lighthouse funds" that serve as a replicable model for others.[97] This can not only grow the volume of transactions beyond what one firm can achieve, but it also can expand the boundaries of what practitioners—and the public—imagine as possible in workplaces. Many cooperative developers understand the practical limits to scaling cooperatives within our current economic rules and structures. However, they believe that by providing examples of working alternatives, they can mobilize the political will and cultural momentum to change economic rules and structures themselves.
Lastly, catalytic early investments in strategies with limited track records can serve to facilitate scalable innovation in the field, whether around business structures (e.g., EOT development), governance (e.g., workers on boards of ESOPs), members (e.g., centering underprivileged groups), and financial and fund terms that can unlock new deal types.

B. Techniques to Maximize Impact

Beyond their core deal and fund structures, impact and catalytic capital providers in employee ownership have used targeted techniques designed to increase impact across their portfolio. Some of the key techniques that are being deployed to maximize impact in employee ownership transactions, which are each outlined in more detail below, are as follows:

1. Concessionary rates of return
2. Early investment in new funds or business with limited track record
3. Subsidized transaction costs and technical assistance for deals not served by traditional capital providers
4. Governance and management structures for worker voice and impact
5. Loan guarantees

1. Concessionary Returns and Terms

Capital and grants from impact and catalytic investment firms, foundations, high-net-worth individuals, and subsidized government programs have enabled some employee ownership capital providers to offer concessionary terms. Concessionary terms enable impacts that are not possible for market-rate investments, such as allowing more financial benefit to accrue to employees, enabling conversions or start-ups to happen that would not otherwise be possible, and attracting market-rate capital by shouldering additional risk.

In practice, interest rates on many catalytic employee ownership conversion loans do not appear substantially discounted from those of commercial loans from traditional banks. For example, Seed Commons, LEAF, and CFNE—leading cooperative conversion lenders—tend to provide senior financing in cooperative conversions at around 4.5–8% interest, with deal-specific variability. These organizations often borrow at approximately 0–3%, which leaves 1.5–8% to cover expected losses and non-subsidized operational expenses.[98] While on the

97 "What's Steward-Ownership?," Purpose, accessed August 1, 2022, https://purpose-economy.org/de/whats-steward-ownership/.

98 Expert interviews with three leading cooperative finance groups.

surface these interest rates parallel the conventional market for senior loans, the loans are made to organizations that often do not have comparable access to conventional financing because of perceived risk level and higher transaction costs. Thus, for the type of business being lent to, the capital provided is concessionary.

While interest rates on conversion or start-up loans are the most widespread use of concessionary returns, firms are innovating on other concessionary terms to increase impact. For example, in the conversion of Organically Grown Company (OGC) into a perpetual purpose trust, investors were granted non-voting preferred shares with a base and a concessionary upside dividend. The base dividend was 5% annually, and returns above this value had a unique distribution waterfall. Unlike traditional equity investments that accrue all financial upside, OGC's upside dividend was structured to require additional payment to non-investor stakeholders should the company experience strong performance.[99] This concessionary approach to a distribution waterfall was designed to strike a balance between appropriate returns for investors with long-term benefit to all the company's stakeholders.

Seed Commons uses a similar approach in non-extractive conversion loan structures.[100] Only if the borrower achieves sufficient profit, Seed Commons generally expects annual principal payments as a percentage of profit and annual profit-sharing payments of 7% of outstanding principal. As such, Seed Commons actively shares upside with worker-owners. By conditioning payment on a borrower's ability to pay, Seed Commons implements a core non-extractive finance principal: "no repayments greater than profits." This approach requires an agreed-upon definition of "profit" in order to ensure alignment around accounting procedures and wages. For that reason, Seed Commons and their borrowers define profit as "special net income," revenue minus cost of goods minus operating expenses; wages included in operating expenses are set at pre-determined levels, with any wages in excess counted toward special net income.

Lastly, subordination can be an important tool to attract additional lenders. Some experienced cooperative lenders will take a concessionary subordinated position with only a slightly higher interest rate to enable a senior loan from a group that has lower risk tolerance.

In addition to concessionary strategies that increase impact, it is also important to emphasize baseline deal structuring "guardrails" that many in the employee ownership community believe essential to ensure an employee ownership deal is a net positive and a "fair deal" for workers. This can include mandating that workers are expected to give up nothing in exchange for a deal (e.g., no 401K shifting in ESOP transactions). It also includes designing debt levels that enable continued success of the company and continued operation as an employee-owned company. A recent Democracy Collaborative report provides in-depth recommendations on guardrails in employee ownership finance.[101]

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99 "The Nitty-Gritty on Alternative Equity," Alternative Ownership Advisors (blog), accessed August 1, 2022, https://www.alternativeownershipadvisors.com/blog/nitty-gritty.

100 "Seed Commons' Approach to Non-Extractive Finance," *SEED COMMONS* (blog), accessed August 1, 2022, https://seedcommons.org/about-seed-commons/seed-commons-approach-to-non-extractive-finance/; Brendan Martin, Ed Whitfield, and Marnie Thompson, Integrated Capital Investing | Seed Commons, June 22, 2021, https://iciaptos.com/seed-commons/.

101 Karen Kahn, "Investor Guidelines for Shared Value Creation in Employee Ownership Transitions Unveiled," The Democracy Collaborative, May 7, 2020, https://democracycollaborative.org/learn/blogpost/investor-guidelines-shared-value-creation-employee-ownership-transitions-unveiled.

Spotlight: Common Trust's Approach to Ensuring Early Employee Benefit from Employee Ownership

"Common Trust is a financing platform that offers a streamlined process for small business owners to design, customize, and form an EOT, develop a financing structure that supports an equitable employee ownership transition while providing liquidity to the sellers, and finances the transaction with mezzanine debt.

One of the design challenges we set out to overcome was a trend of historical financing structures for employee ownership that would result in employees not being able to realize the value of their newfound employee-owner status until several years down the road, even while investors were earning a return. This problem is doubly difficult to accept for those small businesses that have a long history of distributing a portion of profits to employees—in many cases the best candidates for an employee ownership conversion—because while the employees may now be employee-owners, the terms of the financing may be such that those employees do not experience that value for several years. When workers are not able to experience the tangible benefits of employee ownership, this can all but nullify the performance benefits that come with it.

To address this challenge, we designed a unique loan product that balances across distributions made to investors and distributions made to employees, while ensuring long-term company health. We finance EOTs buying out 30–100% of small businesses using a capital stack composed of senior debt, mezzanine debt provided by Common Trust, and seller financing structured as a seller note or seller earnout. Our loan product is designed to incorporate base-level payroll enhancements demonstrated to influence employee performance, while adequately balancing across cash reserves, company reinvestment, and paying back lenders. The effect of this is that employees see a significant take-home pay increase in year one of the conversion, as opposed to several years down the road after investors are paid back, while investors are paid back over a five to ten-year time horizon, depending upon their position."

— Zoe Schlag, Common Trust

2. Early Investments

Several investors have used loans or investments to help early-stage employee ownership funds or businesses position themselves to raise additional capital. For example, A&H Capital Partners, which targets a 15% net IRR from financing ESOP conversions, raised much of its first fund capital from impact driven foundations such as Ford, Rockefeller, and Skoll.[102] Likewise, LEAF makes occasional investments in start-ups, like Drivers Seat Cooperative, with the expectation of getting paid back out of later rounds of investment. Several lenders also facilitate grants to enable cooperative start-ups to take off. Examples include Capital Impact Partners' initial $50,000 grant to ChiFresh Kitchen and Co-op Cincy's accelerator program that facilitates grants to local cooperative start-ups, both of which helped worker cooperatives establish themselves and attract additional capital.

102 Abby Schultz, "Private Equity Fund Launches to Close the Racial Wealth Gap," Barron's, June 23, 2021, https://www.barrons.com/articles/private-equity-fund-launches-to-close-the-racial-wealth-gap-01624478005.

3. Subsidized Transaction Costs and Technical Assistance

Subsidized transaction costs and technical assistance are often a central catalyst in conversions or start-ups of worker cooperatives. Worker cooperatives often require significant legal and financial support to establish themselves as well as worker training on cooperative governance, administration, and finance.

These transaction costs and technical assistance requirements are prohibitively expensive for some businesses. As such, while grants are not a form of capital, they can be a prerequisite to deploying it. Many leading cooperative finance groups, such as Project Equity and The Fund for Jobs Worth Owning, have grant funding to support their work. In larger cooperative conversion transactions (generally greater than $1 million) that may require multiple investors, financial institutions with less experience in employee ownership often rely on these grant-funded employee ownership-focused groups to do the technical legwork and post-transaction support. CDFI groups, such as LEAF, CEI, and Capital Impact Partners, have deployed parts of their portfolio to worker ownership in part because they have been invited to invest by grant-funded cooperative-focused development groups. Leadership from non-profit cooperative development groups has given larger CDFIs the confidence to invest.

Some non-profit cooperative developers believe that it may be impossible to become fully funded from returns on investment alone, and aspiring to do so may detract from these groups' ability to drive impact. According to these practitioners, targeting smaller investment sizes with significant transaction costs simply requires a level of support that investment returns and/or loan interest may not provide. Thus, a continued subsidy for technical assistance and transaction costs is required in order to fill this market gap. Seed Commons is one cooperative developer aiming to be fully supported by its own investments. However, the group relies on a wide network of non-profits to source and support its deals. With the exception of Project Equity, which provides subsidized technical assistance in democratic ESOP conversions, the ESOP community is largely for-profit and supported by high transaction fees and large loans to profitable companies.

4. Governance and Management Structures for Worker Voice and Impact

Most conventional equity and some debt inherently entitles the financier to actively participate in portfolio company governance. However, many employee ownership capital providers are proactively structuring deals to build out worker participation and voice. For example, A&H Capital Partners plans to allow workers to appoint board members to build more democratic decision-making structures. While these actions can be viewed as governance or management concessions designed for impact, research has shown that the combination of ownership stake and meaningful participation can also drive greater performance.[103] Financial performance, not worker impact, is most likely the reason why KKR, the third largest private equity fund in the world, has begun instituting employee ownership and participatory management practices in portfolio companies.[104]

103 Rosen, *Beyond Engagement: How to Make Your Business an Idea Factory*.

104 Stavros, "Incentivizing Employees Creating Value - KKR Investor Day 2018."

5. Guarantees and Down Payments

The use of loan guarantees in employee ownership conversions is currently relatively scant. However, there is enormous potential for the US government and private foundations to serve as sources of guarantees. Government funding opportunities exist at both the state and federal level. At the state level, some institutions already provide small business loan guarantees that could be expanded to employee ownership conversions. For example, California's Infrastructure and Economic Development Bank has a program aimed at guaranteeing loans for small businesses in low to moderate income communities that struggle to access capital.[105] Project Equity is among the groups working on accessing these guarantees for employee ownership conversions.

At the federal level, the Small Business Administration (SBA) could adapt their guarantee program for employee ownership, and the creation of a new guarantee program for middle-market companies could further broaden employee ownership's reach. Through the 7(a) program, the SBA already provides loan guarantees to an estimated 70% of conventional small business acquisition loans below $5 million.[106] This credit enhancement exists to help small businesses access capital that would not otherwise be available. However, several barriers constrain the use of SBA guarantees in employee ownership transactions, including personal guarantee requirements, down payment requirements, and a cumbersome individual approval process for ESOP loans. While the Main Street Employee Ownership Act of 2018 required the SBA to find alternatives to personal guarantees in employee ownership loans, the SBA has not proposed a viable alternative at the time of this writing. Under the proposed "Build Back Better" agenda, a $100 million fund would be available for employee ownership loans without personal guarantees.

In addition to personal guarantees, the SBA requires a 10% equity down payment that is only paid back after the SBA loan is fully repaid, typically ten years after issuance. This provision prevents most employee groups, who generally cannot provide the capital, and sellers, who are selling to get liquidity, from using SBA guarantees in employee ownership conversion loans. The SBA could address this barrier by waiving the down payment requirement for employee ownership conversions, enabling seller finance to count as a down payment, and creating a fund that would support Small Business Investment Corporations in funding employee ownership down payments. These changes would enable third-party investors to catalyze employee ownership conversions with the backing of the SBA.[107]

Guarantees could also be used for businesses where conversion loan size exceeds $5 million. Bruce Dobb proposes lifting the cap to $30 million, and Richard May and others argue that the Department of Treasury should set up a $100 billion loan guarantee fund that investors can use to back larger conversion loans.[108] The US has enacted similar guarantees around housing loans through Fannie May and Freddie Mac and trade through the Export-Import Bank.

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105 State of California, "Loan Guarantees," California Infrastructure and Economic Development Bank, accessed August 1, 2022, https://ibank.ca.gov/small-business/loan-guarantees/.

106 Ted Lauer, "SBA 7(a) Guaranteed Loans Helping Promote Employee Ownership," Blue Ridge ESOP Associates, February 9, 2017, https://news.blueridgeesop.com/blog/sba-7a-guaranteed-loans-helping-promote-employee-ownership.

107 Bruce Dobb and Tomás Durán, "Bruce Dobb & Tomás Durán: Overcoming the 'Equity Injection' Obstacle to Employee Ownership," *Fifty by Fifty* (blog), June 22, 2021, https://www.fiftybyfifty.org/2021/06/bruce-dobb-tomas-duran-overcoming-the-equity-injection-obstacle-to-employee-ownership/.

108 Dobb and Durán, "Bruce Dobb & Tomás Durán."

Spotlight: Project Equity's Efforts to Use Government Loan Guarantees in Employee Ownership Conversion

"Loan guarantees are an important tool for opening up more capital for employee ownership. The SBA runs loan guarantee programs that open up over $20 billion in lending capital for small businesses each year.[109] Unfortunately, there are some significant barriers for employee-owned businesses to access those loan guarantee programs in their current forms, most notably the requirement of a personal guarantee. The Capital for Cooperatives Act is the most current legislative effort (at the time of writing this report) aimed at removing these barriers for the cooperative form of employee ownership.[110]

California operates a small business loan guarantee program run through its Infrastructure and Economic Development Bank (the California IBank) that serves hundreds of businesses each year. In the 2020–2021 fiscal year, it guaranteed 363 loans that totaled $229 million.

Project Equity has begun to utilize the IBank guarantees for its California loans, with the dual goals of (1) showcasing how state guarantees can be used for employee ownership transitions and (2) de-risking its portfolio. By creating and sharing new examples, they hope to inspire more lenders to provide loans for employee ownership transitions and increase familiarity among the lending partners in the IBank program. Though the IBank guarantee has been used in a few prior cases for employee ownership, including both ESOPs and cooperatives, for most lenders, lack of experience with employee ownership introduces perceived risk that a loan guarantee can help bridge.

Specific to Project Equity's Employee Ownership Catalyst Fund, use of the guarantee may enable Project Equity to create a more standardized set of loans and open up the potential to re-sell seasoned loans to mission-aligned financial institutions, thereby freeing up capital within its fund for new loans.

Currently there are numerous opportunities to expand available capital for employee ownership through loan guarantees. Alongside the SBA 7(a) loan program, the State Small Business Credit Initiative (SSBCI) is foremost among them. SSBCI began as part of the emergency response to the Great Recession of 2008–2009 and has now been renewed with $10 billion in total resources (nearly seven times the earlier allocation). The State Small Business Credit Initiative Capital Program Policy Guidelines, released November 10, 2021, affirmatively name employee ownership transitions as an eligible use of SSBCI funds, even though other business purchases are disallowed. Project Equity and other employee ownership advocates are currently working to ensure that state SSBCI program managers are aware of this fact and advocating for proactive education about employee ownership for agencies, lenders and businesses that are involved in, or could utilize, SSBCI funds."

— Project Equity

109 In FY19 (pre-pandemic), there were about 52,000 SBA 7(a) loan program loans made, totaling $23.17 billion. "SBA Small Business Lending Reflects Strong Economic Trends," SBA Small Business Lending Reflects Strong Economic Trends, accessed August 1, 2022, https://www.sba.gov/article/2020/mar/04/sba-small-business-lending-reflects-strong-economic-trends.

110 Anca Voinea, "Capital for Cooperatives Act Introduced to US House of Representatives," *Co-op News* (blog), January 6, 2022, https://www.thenews.coop/159347/topic/politics/capital-for-cooperatives-act-introduced-to-us-house-of-representatives/.

Conclusion

There are more potential employee ownership conversions and start-ups than there is institutional capacity to source, fund, and support these deals. Thus, impact and catalytic capital is poised to play an immediate role in increasing the number of employee-owned companies and the depth of their impact.

These employee ownership investment opportunities exist across the risk and return spectrum and with a variety of strategies, priorities, and expected impacts. The diversity in firm strategies and investment opportunities reflects the diversity of the market needs in employee ownership conversion and start-up finance. Some practitioners perceive a tension or tradeoff between depth and scale of impact, either questioning the scalability of deeper impact subsidized models or the depth of impact of highly scaled models. However, overall, there is a broad spirit of collaboration and transparency among practitioners and a widespread belief in the value of a diverse ecosystem of practitioners addressing unique challenges. This constructive attitude reflects both the fact that the size of employee ownership opportunity is far greater than the scale of the active participants and that diverse employee ownership funds meet different market needs and are often not in direct competition. There is no "silver bullet" strategy for growing employee ownership. As such, it is important to recognize the ways in which diverse strategies meets specific impact priorities and market needs.

In broad terms, as outlined in this paper, the match between impact theory of change and market needs can be summarized as follows:

Concessionary capital provided for deals that require high transaction costs (small size, worker cooperative structure, etc.)

- Often plays an instrumental role in making specific types of deals happen that conventional or market-rate impact capital would not enable,
- Often achieves deep impact in terms of participatory governance and ownership, and inclusion of underprivileged worker populations; these converted companies can create "lighthouse" models that can inspire broader cultural, political, and economic change that reinforces employee ownership, and
- Can present scalability constraints, as grant funding for outreach and subsidized technical assistance, not access to capital, is often a limiting resource. (Some non-employee ownership focused CDFIs noted that capital is available for employee ownership conversions as long as dedicated groups can provide the technical support).

Firms that aim to provide scalable deal terms and structures that could compete with non-employee ownership conventional exits

- Can unlock scalable growth in employee ownership by broadening the number of sellers or founders who would consider employee ownership and the scale of capital available for employee ownership conversion and start-up,
- Can increase impact by incorporating worker governance, building ownership culture at converted firms, and ensuring a financial structure that enables long-term firm sustainability and fair distribution of returns from company performance, and
- Need to ensure that deal structures match the needs of target firms (e.g., structured equity in lower to middle-market deals, and subordinated debt in larger deals with higher valuation multiples).

The diversity in approaches means that catalytic and impact investors have powerful opportunities to support firms, funds, and strategies in their infancy. These early investments pave the way for meaningful growth.

Beyond bolstering individual firms and their strategies, building the financial ecosystem requires common investments in technical assistance and policy change. Technical assistance gaps exist both at smaller commercial banks, which largely have left the ESOP market to larger banks, and within the cooperative advisory community, which often has less expertise regarding tax benefits. This cooperative technical assistance gap may be one reason why the 1042 seller tax rollover has never been used in a cooperative conversion. Policy changes, such as guarantee funds, can drive what one practitioner calls a "quantum leap" in employee ownership by incentivizing more firms to participate and more companies to convert.

With political changes, continued innovation, and additional mission driven investment, the employee ownership space is poised for dramatic growth and impact.

Appendix

Interviews included individuals from the following organizations:

ORGANIZATION NAME	TYPE OF ORGANIZATION
Capital Impact Partners	CDFI
Coastal Enterprises	CDFI
Shared Capital Cooperative	Coop Finance Fund
Upside Down Consulting	Cooperative Advisor
Jason Weiner	Cooperative Advisor
Fund for Employee Ownership / Evergreen Cooperatives	Cooperative Conversion Holding Company
Main Street Phoenix Project	Cooperative Conversion Holding Company
Obran Cooperative	Cooperative Conversion Holding Company
Seed Commons	Cooperative Finance Fund
Cooperative Fund of New England	Cooperative Finance Fund
Local Enterprise Assistance Fund (LEAF)	Cooperative Finance Fund
National Cooperative Bank	Cooperative Finance Fund
Co-Op Cincy	Cooperative Finance Fund and Advisor
Industrial Commons	Cooperative Holding Company / Non-Profit
Start.coop	Cooperative Start-up Accelerator
Ownership Associates	Employee Ownership Advisor, Ownership Culture
Praxis	Employee Ownership Advisor, Ownership Culture
Ohio Employee Ownership Center	Employee Ownership Advisory and Advocacy Non-profit
NCEO	Employee Ownership Association
Fund for Jobs Worth Owning	Employee Ownership Conversion Fund
Social Capital Partners	Employee Ownership Conversion Fund
Torana Group	Employee Ownership Conversion Fund
Project Equity	Employee Ownership Conversion Non-Profit
Zebras Unite	Employee Ownership Ecosystem Advisor/ Convener
Kachewa Impact Fund	Employee Ownership Fund of Funds
Ownership Matters	Employee Ownership Media Source
DAWI	Employee Ownership Non-Profit
Ownership America	Employee Ownership Policy Advocacy Organization
EOT Advisors	EOT Advisory Firm
Purpose Foundation	EOT Advocate and Advisor
Common Trust	EOT Conversion Fund
UBS ESOP Group	ESOP Advisory Firm

ORGANIZATION NAME	TYPE OF ORGANIZATION
Verit ESOP Advisory	ESOP Advisory Firm
Ambrose Advisors	ESOP Advisory Firm
BDO	ESOP Advisory Firm
Beyster Institute	ESOP Advisory Firm
Chartwell Financial Advisors	ESOP Advisory Firm
ESOP Plus	ESOP Advisory Firm
Menke Group	ESOP Advisory Firm
Prarie Capital Advisors	ESOP Advisory Firm
SES ESOP Services	ESOP Advisory Firm
American Working Capital	ESOP Conversion Fund
Apis & Heritage Capital Partners	ESOP Conversion Fund
Mosaic Capital Partners	ESOP Conversion Fund
Southeast Acquisition Capital	ESOP Conversion Fund
Long Point Capital	ESOP Conversion Fund
Tim Rettig	ESOP Conversion Individual Investor
Empowered Ventures	ESOP Holding Company
Greenburg Traurig	ESOP Law Firm
Mission Driven Finance	Impact Investment Advisor
Wells Fargo	Traditional ESOP Lender
UBS ESOP Group	Traditional ESOP Lender
Bank of the West ESOP group	Traditional ESOP Lender
Fifth Third Bank	Traditional ESOP Lender
Equal Exchange	Worker Cooperative