Financing the Employee Ownership Transition

Part of undertaking an employee ownership transition is procuring financing for the process. The first step of any ownership transition is the same: the shares owned by the exiting owners need to be purchased by the employees. The two main ways to facilitate this purchase are seller/owner financing and external financing. This article will highlight the main features of both types of financing and expand upon the process of obtaining a loan.

Seller Financing

Before any employee ownership transition can occur a trust, or the company, must purchase the equity stake from the previous owners. There are many ways to do this, but a common way is seller financing. During this process, instead of the trust taking a loan from the bank, it takes a loan from the retiring owner (the seller). Usually, this loan will have a low interest rate, and often it is lower than rates offered from banks. Additionally, if the company is in too risky of a position to take out a bank loan, seller financing is a viable solution. Owner financing allows these companies to still proceed with an employee ownership transition and provides the owner with an exit in these scenarios.

Through seller financing, the trust will pay back the owner monthly pay-outs until the full value of the equity is repaid. NCEO Loan Default Study found that perhaps half of all ESOPs are funded in total or in part by this financing option.[1] Such an option is beneficial for companies transitioning to employee ownership (EO) because it circumvents the issue of finding traditional financing options, which can also have higher interest rates. Seller financing is particularly beneficial for employee ownership trusts (EOT) and worker cooperatives (Co-op) ownership models because it can allow them to exit the company and gain value from the exit.

ESOP External Financing

Another financing option is external financing, which is financing that is from an outside source like a bank to purchase the equity interest of retiring owners. Banks are often willing to give loans to companies implementing an employee stock ownership plan (ESOP). This is because the NCEO Loan Default Study finds that ESOPS have strikingly fewer loan defaults.[2] ESOPs also have the option of utilizing banking syndicates, which are a group of lenders that work together to provide credit to a large borrower, each sharing the lending risk.[3] One of the lenders is the managing bank and administers the loan on behalf of the other lenders. The total loan may comprise of different types of loans with different repayment terms negotiated separately between each lender and borrower. This has many potential benefits for business owners, including greater flexibility of loan terms and the ability to secure funding when they otherwise wouldn't be able to.

External Financing for EOT and Co-ops

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[1] January 2022." NCEO Study Finds S ESOPs Have Strikingly Fewer Loan Defaults."

[2] January 2022." NCEO Study Finds S ESOPs Have Strikingly Fewer Loan Defaults."

[3] February 2020. "Syndicated Loan." Corporate Finance Institute.

Companies that transition to employee owned trusts (EOTs) or worker cooperatives (co-ops) also often require external financing. Obtaining loans through traditional financing methods can be difficult for EOTs and co-ops because traditional institutions are not as familiar with these models. One possible solution is using Community Development Financial Institutions (CDFIs) which provide smaller loans to local businesses that big banks won't reach. CDFIs understand the benefits of employee ownership and will issue loans for the express purpose of assisting with successful transitions to worker co-ops and EOTs. Alternatively, Direct Public Offerings (DPOs) can provide financing by allowing community members to buy shares in the business. CDFIs and DPOs reflect the rise of patient capital, wherein "patient capitalists believe that you can achieve a commercial or quasi-commercial return and outsized social impact by betting on innovative entrepreneurs addressing underserved markets."[4] CDFIs and DPOs draw forth investors that are willing to wait to see returns are concerned with maximizing social benefits, making them a particularly viable solution for financing employee ownership models. Should other options not work, it is also possible for individual employees to finance the transition, but this isn't preferred because it puts employees at risk. Ultimately, internal financing remains the most popular financing method for EOTs and co-ops because of its minimization of risk and low interest rates.

Conclusion

Providing the capital to purchase an equity stake during employee ownership transitions can be a challenge, but it doesn't have to be. Using seller financing is the most common approach, because it includes a lower interest rate while also providing an exit option for the owner, but external financing can also be a successful solution. Traditional institutional financing like banks and bank syndicates are possibilities, but the best bet for employee ownership transitions are CDFIs and DPOs because of their "patient capital" approach. If seller financing, traditional external financing, and nontraditional external financing methods all fail, employees can finance the purchase of the equity stake themselves. This requires the cooperation of employees and their agreement to take on the increased risks, but it still remains a possible financing solution. Determining the best financing option for you depends on individual priorities and the current financial status of your company, but its clear traditional banks are far from the only option.

[4] June 2010. "Patient Capital in an Impatient World." Kauffman Fellows