7f. Proposition to the European Investment Bank to modernise SME lending

Promoting Employee Stock Ownership Plans (ESOPs) as a vehicle for business successions in SMEs

by Prof. Jens Lowitzsch and John D. Menke[1]

When the owner of an SME desires to retire and exit from the business, he generally has three alternatives. He can sell the business to a competitor (a strategic buyer), he can sell the business to his key employees (a management buyout), or he can sell to his staff through the mechanism of an employee stock ownership plan ("ESOP") buyout.

Promoting European ESOPs is particularly timely, as on initiative of Commissioner Michel Barnier in December 2012 the European Commission has placed the promotion of employee share ownership (ESO) on its Action Plan to reform European company law and corporate governance.[2]

In a parallel move the Commission has made business transfers one priority of the Entrepreneurship 2020 Action Plan.[3] The Small Business Act (SBA) and the 2011 Review of the SBA for Europe have specifically addressed the area of business transfers.

Modernising EIBs products while supporting long-term investment

In 2008 the EIB adopted an initial series of measures to boost SME lending aimed at modernising products. Among intangible investments eligible for financing were the costs incurred in the transfer of an enterprise enabling the continuation of economic activity (when financing the transfer does not exceed EUR 1m).

With regard to the COSME and the HORIZON program – both expressly supporting SMEs – promoting employee buyouts should be included as an option to finance business successions. Both offer equity and debt instruments building on the same platforms: COSME to all SMEs, Horizon 2020 to innovative SMEs and mid-caps.

On 25 March 2013, the Commission published a Green Paper on long-term financing in Europe. Private households are found to be the main source of funds for financing investment, although they generally prefer liquidity and easy redemption. Employees holding stock in their employer company have a different perspective; they tend to have a commitment to long-term investment. Therefore, promoting ESO contributes to achieving the Green Paper objectives.

Shifting the focus to business succession buyouts of mature firms by their employees

Based upon more than 30 years of experience in ESOP financing, we argue that the EIB should focus its efforts on providing senior and mezzanine capital for the transmission (buyout) of established, mature companies by their employees:

First, providing loans to established mature companies is by definition less risky than providing loans for start-ups and newer SMEs. “These businesses are 'going concerns' with established products, markets and customers and so have a higher probability of survival than new firms” (see p. 15 of the Entrepreneurship 2020 Action Plan).

Second, providing loans for the transmission of established mature firms would enable the EIB to invest larger sums of money. Loans for growth capital are usually quite small compared with loans for the transmission of mature firms where the new owner needs financing, not only for the purchase price, but also working capital loans and loans for further growth and expansion.

Third, “successful transfer of business preserves more jobs on average than those created by new start-ups. The transfer of business should therefore be given the same support as setting up a new business. Recognition of the special role of SMEs in Europe and in particular family-based firms, their typically local base, socially responsible attitudes and capacity to combine tradition with innovation, underpins the importance of simplifying the transfer of businesses” (p. 5, SBA).

A SME loan facility could be embedded, for example in the EIB’s JEREMIE programme.

1 The technical propositions of this text co-authored by John D. Menke, reflect over 30 years of broad experience in investment banking, mergers and acquisitions, and private equity transactions. Mr. Menke is the founder and president of Menke & Associates, one of the oldest and most prominent firms specializing in ESOP buyouts. He has supervised or participated in over 2,500 ESOP transactions, representing over 20% of the ESOPs in existence.

2 See „Action Plan: European company law and corporate governance - a modern legal framework for more engaged shareholders and sustainable companies“ 3.5. Employee share ownership, p 11 ff, COM (2012) 0740.

3 COM(2012) 795 final of 9 January 2013; see 3.4. Easier business transfers, 15 pp.

Annex – Overview of the ESOP concept

The sale of a business to its staff (ESOP buyout)

The sale of a business to its staff (ESOP buyout) is the one type of buyout that supports sound public policy, and it does so in a number of ways, including the following:

- ESOPs support the public policy of keeping companies small independent and local. Employee-owned firms are seldom "flipped" to large public companies and employee-owned firms are seldom relocated to a foreign country.
- Employee-owned firms tend to grow faster, and tend to withstand economic downturns better than non-employee owned firms.[4]
- Employee-owned firms help to broaden the ownership of capital rather than to concentrate the ownership of capital. ESOPs serve, better than any other technique available, to substantially increase the purchasing power of low and middle income workers, and this can be a major contributor to the growth and stability of a nation's economy.

Given the social and economic benefits of ESOP buyouts, providing financing for ESOP buyouts should become a focus of EIB lending. In fact, the EIB might announce to give preference to those who request loans for ESOP buy-outs over those who request loans for other purposes. An additional advantage to the EIB is the fact that the EIB will have little or no competition from regular commercial banks for this type of financing. Furthermore, loans made for ESOP buyouts will have a much lower default rate than is the case with other types of loans.

The U.S. experience – Interim balance in 2012

As of 2012 there were approximately 11,000 ESOPs in the U.S., covering around 10 million employees.[5] The vast majority of ESOPs are sponsored by privately-held firms, of which about 4,500 are majority and about 3,000 100% owned by the ESOP. An estimated 7,000 companies have ESOPs that are large enough to be a major factor in the corporation's strategy and culture. Only about 330 ESOPs are in publicly traded companies (employing just under 50% of the 10 million employee owners). Total assets owned by U.S. ESOPs were estimated to be $901 billion at the end of 2007. At least 70% of ESOP companies are or were leveraged, meaning they used borrowed funds to acquire the employer securities held by the ESOP trustee. An overwhelming majority of ESOP companies have other retirement and/or savings plans, such as defined benefit pension plans or 401(k) plans, to supplement their ESOP.

The ESOP is now a part of the social and economic fabric of corporate America. Over half of all the Fortune 500 companies now sponsor ESOPs. Over 40% of Inc. magazine's 100 fastest growing private companies sponsor ESOPs. Now that ESOPs have existed in the U.S. for over 30 years, there is a wealth of data to support the conclusions that:

- ESOPs have been more successful than any other technique of corporate finance in extending the ownership of productive capital to people who would otherwise remain non-owners.
- ESOPs have, on the average, provided a much higher level of retirement benefits than other types of pension and profit-sharing plans.
- ESOPs have helped to eliminate the "us versus them" attitude in the great majority of ESOP companies. ESOPs have, in fact, brought about an unparalleled reign of labour-management peace and cooperation.
- ESOPs have been successful in increasing employee productivity and company profitability.
- ESOPs have been very successful in providing for business succession and continuity.

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4 For a comprehensive overview of the positive economic evidence (esp. for ESOPs) see J. R. Blasi, D. Kruse, A. Bernstein, "In the Company of Owners", Basic Books, New York 2003; they find an average increase of productivity level by about 4%, of total shareholder returns by about 2% and of profit levels by about 14% compared to firms without EFP schemes.

5 Source: http://www.nceo.org/articles/statistical-profile-employee-ownership; according to a 2004 survey completed by the General Social Survey, out of 108 mln. private sector employees in the U.S., 21% own company stock, and the median value of the employees' company stock ownership is over one-fifth of their annual pay.