



OPPORTUNITY KNOCKING

**IMPACT CAPITAL AS THE TRANSFORMATIVE AGENT
TO TAKE EMPLOYEE OWNERSHIP TO SCALE**

EXECUTIVE SUMMARY

Jessica Rose | Marjorie Kelly
with Sarah Stranahan | Michelle Camou | Karen Kahn

The Democracy Collaborative
January 2021



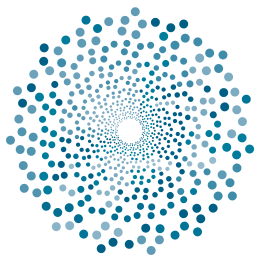
The complete *Opportunity Knocking* report, can be downloaded at www.fiftybyfifty.org/research

Authors

Jessica Rose and Marjorie Kelly, with Sarah Stranahan, Michelle Camou, and Karen Kahn

Credit, cover photo: Opportunity Threads/The Industrial Commons

This report was made possible through a Beyster Fellow award. Thank you to Mary Ann Beyster of the Beyster Foundation for Enterprise Development and the Rutgers University Institute for the Study of Employee Ownership and Profit Sharing for their generous support.



DEMOCRACY
COLLABORATIVE

democracycollaborative.org

1200 18th Street NW
Suite 1225
Washington, D.C. 20036

EXECUTIVE SUMMARY

As the COVID-19 pandemic sweeps through the global economy, the United States is suffering one of the worst economic crises in its history. Though fiscal policy is buoying the stock market, some 30 million workers are barely keeping their heads above water. People are waiting in hours-long lines at local food banks, and millions are behind on rent payments, leaving them vulnerable to eviction. With federal relief stalled in Congress, temporary business closures are becoming permanent, leaving Main Streets bereft of once-vibrant gathering places that produced the tax revenues crucial to municipal services. The downward spiral is accelerating.

In this paper, we propose that impact investors and other capital providers could be the agents to give this crisis a silver lining by catalyzing employee ownership buyouts at scale. COVID-19 is accelerating the “silver tsunami” of business sales and closures resulting from baby boomer retirements. According to Project Equity, as many as 1.2 million baby boomer-owned businesses with more than ten employees could be put up for sale or closed in the next decade, and many of these sooner than expected as a result of the current economic crisis.

Private equity and corporations are positioned to buy up the best of these businesses to benefit the 1 percent, further exacerbating wealth inequality. But there is an alternative: impact capital could become the lever used to redirect wealth into the hands of working Americans, creating a more just and equitable economy that is more resilient against future shocks. Investments in employee ownership buyouts could offer attractive midrange returns, while at the same time ensuring worker-owners are set to achieve long-term financial security.

Why Employee Ownership?

Americans have lost trust in our current form of capitalism. They know, as Senator Elizabeth Warren says often, “the system is rigged.” According to a May 2020 Just Capital/Harris poll, three quarters of Americans no longer believe that our system of capitalism is providing for the greater good of society.

There is another way. Decades of research, summarized most recently by Project Equity in *The Case for Employee Ownership*, demonstrates the substantial and widespread benefits that result from employee ownership, for businesses, workers, and communities.

As a result of deeper employee engagement and reduced turnover, the data consistently shows that business performance improves after conversion to employee ownership. Douglas Kruse and Joseph Blasi at the Rutgers Institute for the Study of Employee Ownership and Profit Sharing have documented gains in sales, employment and productivity, as well as greater resiliency, with employee-owned firms better equipped to survive recessions and less likely to make layoffs.

Worker-owners also earn better wages, and through profit-sharing and equity, are able to build greater financial security than their peers in non-employee-owned workplaces. Workers who participate in Employee Stock Ownership Plans (ESOPs), according to research from the Institute for the Study of Employee Ownership and Profit Sharing, have on average over \$130,000 in their retirement accounts. Moreover, among ESOP workers ages 28 to 34, employee-owners have 92 percent higher median wealth than similar workers at non-employee-owned

firms, according to a [study by the National Center for Employee Ownership \(NCEO\)](#). The household net worth of young worker-owners of color was [79 percent higher](#) than that of their peers.

Employee ownership also benefits the larger community. Firms owned by employees are more likely to remain committed to their local communities over the long run, keeping wealth circulating locally and contributing to civic life. As [Galfab CEO Jerry Samson said](#) when he was ready to retire, taking care of his employees and keeping his manufacturing firm in Winamac, Indiana, a town of 2,500, were key factors in his decision to sell to employees.

These benefits align well with the goals of impact investors, who seek to address growing wealth inequality and the damage of racial injustice, which remains a significant barrier to economic success for people of color. Investors do not necessarily need to find the perfect social enterprise or mission-driven business: every business that adopts robust democratic ownership and participatory management is building a different future for working Americans.

The Missing Agent for Scale: Capital

Despite the well-documented benefits associated with employee ownership, for three decades the number of employee-owned firms in the U.S. has stagnated. In 2018 the NCEO documented [6,400 firms with ESOPs](#), the most common form of employee ownership in the United States. The Democracy at Work Institute [estimates](#)

[there are around 465 worker cooperatives](#) in the country. Together, these businesses employ more than 10 million workers.

In part 1 of this report, “Solving the Agency Problem,” we argue that the failure to grow employee ownership is a problem of agency. An agent capable of transitioning asset ownership at the necessary scale has not yet emerged. For far too long, the field has assumed that owners ready to sell or employees, with the right information, could be that agent, but experience tells us that is not the case. We are, therefore, proposing a powerful, game-changing new direction for the employee ownership field.

Our thesis is that risk capital is the agent most likely to bring about desired change because it is already poised to capture firms as their ownership changes hands. Building on a 2019 report, [Investing in Employee Ownership: Financing Conversions through a Private Equity Fund Model](#), published by Transform Finance, we argue that to compete with the traditional mergers and acquisitions market—and to prevent businesses from closing when buyers are not readily available—the employee ownership field needs capital models that provide the same “knock upon the door” that traditional acquirers offer: capital with agency to initiate, structure, and finance transitions to employee ownership.

The entities most likely to catalyze change, we argue, are *impact private equity funds*, which are modeled after traditional private equity funds but use *worker-friendly value engineering* to improve productivity, and have guardrails in place to balance the interests of stakeholders and prevent over-extraction. We argue that this model, which



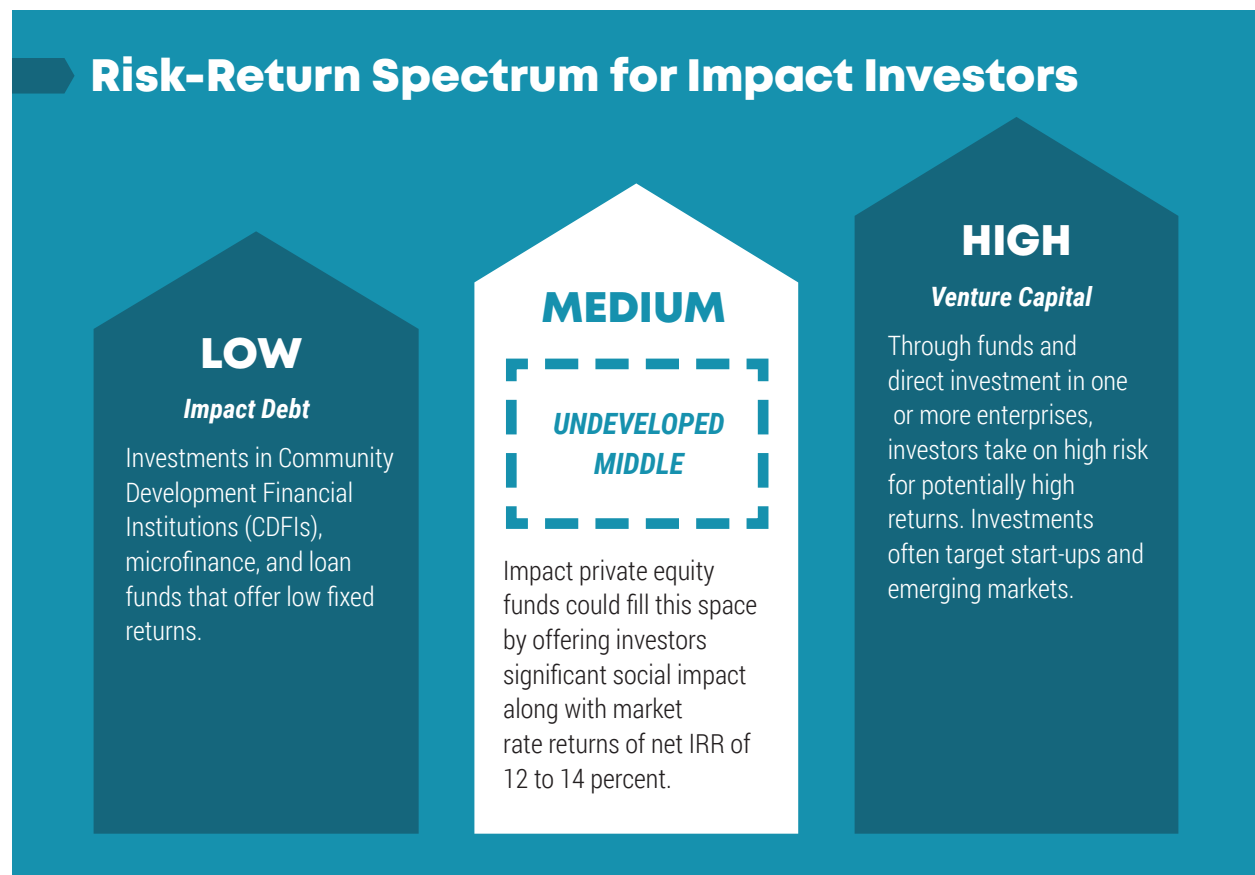
Our thesis is that risk capital is the agent most likely to take employee ownership to scale because it is already poised to capture firms as their ownership changes hands.

is similar to the one proposed by Transform Finance, is most likely to successfully take employee ownership to scale.

We emphasize *impact private equity* funds with an eye to the rapidly growing interest in impact investing around the world. The Global Impact Investing Network (GIIN) reports \$715 billion in impact assets under management. Additionally, women and millennials, who care deeply about their impact on people and the planet, are expected to inherit \$59 trillion from baby boomer spouses and parents. These investors have the opportunity to transform the largest economy on the planet through broad-based employee ownership.

Authentic Social Impact

The success of this type of investment, however, depends on its demonstrable social value. In part 2 of our report, “Ensuring Authentic Social Impact,” we explore more deeply how to constrain excess capital extraction to ensure employee ownership deals result in equitable outcomes. Taking lessons from the field of microfinance, which was undermined by an influx of capital, we make the case that capital must be appropriately channeled and restrained, through the use of guardrails and protections. We introduce the *Guidelines for Equitable Employee Ownership Transitions*, developed by our organization along with others in the field to outline how employee ownership deals can be structured to ensure



balanced and just outcomes. We also explore how beneficial outcomes can be encouraged and tracked, using frameworks such as the [U.N. Sustainable Development Goals](#). We propose developing *impact metrics* to assess the success of employee ownership transitions in three key areas: building wealth, establishing democratic and empowering workplace cultures, and implementing broader socially and environmentally responsible business practices.

An Employee Ownership Capital Ecosystem

In part 3 of our report, “Building an Employee Ownership Capital Ecosystem,” we address a gap in current impact investment vehicles, what we call the *missing middle*, by looking at the innovators and investment funds that have begun to fill that gap. Until recently, impact investment opportunities in employee ownership tended to be concentrated at opposite ends of the risk-return spectrum: high-risk/high-return investments in individual deals, or low-risk/low-return investments in worker cooperatives through community development finance institutions (see illustration on p. 5). Missing have been employee ownership-focused funds that can deliver risk-adjusted, mid-range returns—with real impact.

A year ago, Transform Finance profiled a half-dozen emerging investment funds focused on employee

ownership. We build on this work, offering an overview of 13 funds that have begun to fill the missing middle (see [Table, Sample Funds Investing in Employee Ownership](#)). But private market innovators, we argue, are not sufficient to get employee ownership to scale. *Catalytic capital*, from philanthropic investors and others, is crucial to seed intermediaries and create demonstrable successes. A [\\$24 million investment from the Kendeda Fund](#) in 2019, for example, seeded several new finance vehicles that are already catalyzing new conversions. Additionally, government action will be needed, including direct public financing and the establishment of policies and risk-reduction strategies, such as loan guarantees, to facilitate private financing.

If it is done right, capital could indeed be the missing agent that takes employee ownership to scale. The pipeline of potential businesses for sale is promising. The basic tax incentives and technical-assistance infrastructure are largely in place, although other policy frameworks are necessary to make broad-based employee ownership a public policy priority. Public awareness of and enthusiasm for employee ownership are rising. What is needed now is the growth of the underdeveloped supply side: employee ownership investing vehicles that are built in employee-friendly ways and also deliver real value for investors, while limiting potential abuses. This report explores some of the most promising approaches.



What is needed now are employee ownership investing vehicles that are built in employee-friendly ways and also deliver real value for investors.

Recommendations for Scaling Employee Ownership through Finance

This report argues for a set of approaches that could drive significant momentum in new employee ownership transitions in the near term. Summarized here as a set of recommendations, the approach combines supply-side (expanding opportunities to invest) and demand-side (strategies that make investments more attractive) features in order to create a range of employee ownership investment products aligned along the full risk-return-impact spectrum. We hope these recommendations will incentivize investors whom we believe will reap rewards, social and financial, from being early adopters.

- 1. Develop new investment funds for employee ownership.** New opportunities for employee-ownership investing must be created. To create the ease of investment that investors require—and the ease of ownership transition that sellers need—depends on the continued creation of new intermediary funds targeting employee ownership conversions. Many of these intermediaries will resemble today's private equity funds but will be designed to attract impact investors and generate beneficial, authentic social impact. In addition to developing new investment funds, existing lenders and other players could also deploy capital toward more “knock on the door” investments.
- 2. Ensure employee benefit through common metrics and deal guidelines.** A flood of capital into a new area can promote excessive capital extraction, as happened with microfinance. To guard against this and attract impact investors, new employee ownership-focused funds will need robust deal guidelines and metrics. The *Guidelines for Equitable Employee Ownership Transitions* provide a pilot version of impact metrics and guidelines for constructing beneficial conversion deals. It will be up to the employee ownership field to refine and further develop common metrics and deploy them consistently to demonstrate social impact.
- 3. Use employee-friendly approaches to value engineering.** Rather than creating investor value through traditional private equity practices such as downsizing, impact private equity can create value through employee-friendly practices, such as profit sharing, open communication, open-book management, participatory governance, inclusive planning and budgeting, and the solicitation of input in the appointment of managers or supervisors. These practices contribute to building a strong, collaborative team culture, which has been shown to increase productivity.
- 4. Grow the market by supporting this developing ecosystem with catalytic capital and take it to scale through government policy.** To find its place in a competitive market, this new field of employee ownership investing needs philanthropy to catalyze early-stage activity. As proof of concept is demonstrated and scaling begins, approaches like credit enhancements (for funds, firms, and senior lenders) can continue to point capital in the direction of employee ownership. Ultimately, government action will be needed to fully develop this capital ecosystem and take the field to scale, via direct public funding, the provision of incentives, the de-risking of investment, and the encouragement of new institutions.



A project of The Democracy Collaborative, Fifty by Fifty advances employee ownership as a vital component of a democratic economy. We are part of a movement that aims to create 50 million employee-owners by 2050. Learn more at <https://www.fiftybyfifty.org>

The Democracy Collaborative is a research and development lab for the democratic economy. Learn more at www.democracycollaborative.org