Ownership Works !

Introduction

Shareholders have traditionally focused on aligning top managers' interests, neglecting the broader employee base. But things are changing, as we witness more and more private equity firms offer less skilled employees stock options plans (ESOPs) – a chance for them to own part of their company. Leading this transformation is Ownership Works, a non-profit created by KKR's legendary Co-Head of Global Private Equity Pete Stavros. In this article, we dive into the moving story of CHI Overhead Doors, a deal led by Stavros himself, that allowed KKR to not only decuple its investment, but also to distribute life-changing payouts as high as $800,000 to CHI's most-tenured hourly employees and truck drivers. In a second part, we dive into ESOPs' benefits and risks, and outline how this new trend will shape the private equity industry over the next decade.

To put you in the mood for this article, here is a very touching video filmed by KKR, of CHI employee's reactions to their payouts, and there gratitude towards Pete Stavros: https://www.youtube.com/watch?v=ZM_XaO9pGjs.

Ownership models

The rationale behind establishing ownership incentives is grounded in the agency theory, which suggests that in the absence of ownership, employees will pursue their interests to the detriment of the shareholders'. At its core, by providing workers with equity, they become owners, theoretically ensuring that their interests align more closely with the financial sponsors'. Additionally, these incentives are used to attract and retain top talent, who might otherwise be lured away by competitive offers from other firms.

Equity-based compensation plans are structured in many ways, including profit interests, stock options, phantom equity (right to receive a payment of cash that mirrors what the recipient would have received if he owned regular stock), or even restricted stock grants. Typically, these benefits are subject to repurchase rights on termination of contract, performance and vesting thresholds, and have specific tax treatment.

The allocation of equity incentives in private equity deals raises a series of debates between management and the broader employee base, especially over fairness and efficacy in keeping the company, as a whole, motivated. On the one hand, managerial stakes are fundamental for aligning leadership interests with those of shareholders, incentivizing the key decision-makers to guide the company's activities towards maximum growth and profitability. However, by concentrating bonifications in the hands of a few at the top of the pyramid, the rest of the workforce receives negligible treatment, potentially breeding a feeling of inequality that could otherwise drive unified progress.

From a psychological point of view, a paradoxical aversion to risk emerges as managerial compensation packages become increasingly tied to performance metrics. While these incentives are designed to make executives pursue growth and innovation, the personal financial stakes often foster a conservative mindset, where managers prioritize safer paths that ensure stable results and limit innovation. Furthermore, many argue that the incremental motivation for senior employees through more and more money quickly dissipates and that other people deep in the organization may never feel recognized in their jobs. In this case, granting them the opportunity to be equity participants and feel like partners may unleash a surprising productivity response.

About Ownership Works

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With this in mind, Peter Stavros, Co-Head of Global Private Equity at KKR, founded and now chairs Ownership Works, a nonprofit organization dedicated to advancing the employee ownership movement in corporate America. During the past 25 years working in leadership roles, Stavros observed a high turnover rate and low engagement levels of the skilled trades workers – which constitute 80 per cent of a regular industrial firm's workforce – with many seeking opportunities where they can find value and purpose for their work.

Reflecting on his family history, Stavros often recounts the story of his father, a construction worker in Chicago, whose experiences laid the foundation for his future ambitions. His father's struggles with the limitations of hourly wages, the battles between labour and capital for more hours, and the strikes that punctuated his career impressed upon Stavros the impact that incentive structures can have. "Out of conflict and incentive misalignment," Stavros recalls, "my father would say that the system cared more for hours than work efficiency. He believed in the potential of profit sharing to create alignment, often saying, 'Shouldn't I care about quality, cost, and doing the job right on time? But I don't.' This deeply personal connection was the early seed in Peter's mind of the importance of creating a workplace where everyone has a stake in the business's success.

What he initially implanted as an employee stock options plan (ESOP), which was a tax structure that the government came up with to provide tax incentives for sharing ownership broadly, ended up transforming into an initiative that has benefited, to date, 100,000 employees and shared $360m of wealth with an average payout of $101,000 to low-income workers.

Today, Ownership Works partners with companies to develop innovative broad-base ownership programs by structuring & implementing equity plans, developing a culture of employee engagement, creating a financially inclusive workforce, and producing insights with the data gathered after the programs are active. To do this, the foundation counts on a board of renowned executives, including Stravos; Thomas Naratil, Former Co-President of Global Wealth Management & President of Americas, UBS; Sarita Gupta, Vice President of U.S. Programs, Ford Foundation; Todd Sisitsky, President, TPG, Co-Managing Partner, TPG Capital; and ten other experienced leaders across all sectors. Ownership Works unites private, public and nonprofit sectors to expand shared ownership across the business community. Over 75 foundations and corporations have made unprecedented commitments to increase the adoption of this innovative strategy.

Ownership Works envisions a future in which broad-based employee ownership is the new norm, creating an environment where workers are invested in mutual success. At scale, employee ownership can help millions of lower-income workers and companies foster more dynamic, resilient, and successful businesses. By 2030, the organization hopes to create hundreds of thousands of new employee-owners and generate at least $20bn of wealth for low-income households. In 2021, the private equity industry alone employed almost 12 million people in the United States and, counting on the help of their founding partners to generate interest, OW foresees the potential of inspiring a long-lasting change in how ownership is shared at work.

CHI Overhead Doors Deal

CHI Overhead Doors, a manufacturer of rolling steel garage doors and shutters, has been crafting products for homes and businesses since 1981. In 2015, KKR paid an aggregate price of approximately $700m for CHI in an auction, becoming the fourth private equity owner of the business. Pete Stavros, the Co-Head of KKR, pursued a plan of dramatic operational transformation for CHI, ranging from scrap reduction and improving efficiency of trucks load to labor productivity and net working capital optimization. As a result, in 7 years CHI added more than 400 new dealers and decreased the average delivery time down to 2-3 weeks, which is significantly lower than the competitors' figures. The company's EBITDA increased almost four-fold over a seven-year period, while EBITDA margin went up by more than 1,400 basis points from 20.5% in 2015 to 35% in 2022. Moreover, 120% revenue

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growth was enabled by investments in the existing manufacturing facility in Illinois and the construction of a second plant in Indiana. But most importantly, employees were given a pool of options, accounting for 3.5% of the company, meaning that all CHI's workers became owners of the business – the first step in a journey to overcome the generational mistrust between managers and workers. Firstly, employees were given a right to choose where the company should invest. All the claims addressed health and wellness, resulting in the investing in air conditioning system at the plants, building break rooms, opening a cafeteria with healthy food and medical clinic for workers and their families. As a result, both the rate and severity of injuries declined by more than 50% since 2015. Safety has also improved. Secondly, quarterly meetings and employee surveys were implemented to increase transparency of the business. And last, but certainly not least, workers received dividends four times throughout the 7-year period, accounting for $9000 per employee in total. Such kind of ownership has driven engagement and improved retention as workers were interested in doing their work well, and did not want to quit.

In 2022 KKR sold a very profitable business CHI Overhead Doors to Nucor Corporation in a transaction valued at $3bn. The sale represented one of KKR's largest returns in recent history, at 10 times the original equity invested – including all distributions. All CHI employees received a substantial cash payout on their equity in the Company. Ownership cheques to workers ranged from $20,000 for a new joiner to more than $800,000 for the most-tenured hourly employees and truck drivers. It was entirely free incremental benefit along with wage increases by 12.5% and 7% in 2021 and 2020 respectively. Moreover, all 800 employees received 12 months of pre-paid personal financial coaching and tax preparation services through Goldman Sachs Ayco Personal Financial Management and Ernst & Young. Pete Stavros emphasised that by joining forces with Nucor, CHI will continue to be part of an employee-centric organization that not only shares its growth ambitions but also provides all employees an opportunity to share in its success. Overall, passionate leadership team, meaningful wealth creation to workers and patient management played the crucial role in success of CHI Overhead Door case. As Pete Stavros once said: "We have seen first-hand the impact that the ownership mindset can have on individual owners and the business. When you invest in employees, positive results will follow".

Similar deals

KKR brought the shared ownership structure to many businesses. RBmedia, the largest producer of audiobooks in the world, is one of the most successful examples. At the KKR and RBmedia Owners Meeting, the sale of RBmedia to H.I.G. Capital in July 2023 was announced. RBmedia employees learned they would receive a cash payout through the company's shared ownership program, ranging from $5000 for new joiners to $100,000 or at least doubled amount of annual salary for the most long-term employees, who were talking of that payout as a life-changing experience. In the last 5 years under KKR's ownership, the company has doubled the size of its audiobook catalog and significantly improved the financial performance of the company. Shared ownership structure once again showed its ability to create economic opportunity for working families, enhance employee engagement, and build stronger companies.

Many other investors are also working to broaden ownership of their companies. Gardner Denver, the industrial machinery manufacturer, raised $826m in its IPO in 2017, sharing $100m in equity with 6100 employees, which equated to roughly a 40% of their base annual salary. In 2020 the company acquired Ingersoll industrial segment and gave $150m in equity to all 16,000 employees. Ingersoll Rand trained and educated workers to boost performance of the company. Over time, the company's quit rate has dropped from 20% to below 3% and safety incident rate decreased by 71%. Employee engagement scores from internal company data rocketed from the 20th percentile to the 90th percentile, reaching 91% participation rate in the latest survey. Shared ownership structure led to improvement in financials of the company. EBITDA increased from $380m to $1.185bn, stock price tripled in value since the IPO in 2017 and enterprise value rocketed from $3bn to approximately $27bn in 2021. Shared

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ownership in Ingersoll Rand has become a huge success as employees wanted to make a difference in the business and received an opportunity if true wealth creation.

Risks

Employee ownership is an American concept, and we can find evidence of it dating back as far as the Virginia Company's experiment with colonizing Jamestown. After a disastrous start, ownership was given to the settlers resulting in greater productivity and efficiency. After 400 years US leads the world in promoting employee ownership. In 1974, the details were laid out in the Employee Retirement Income Security Act (ERISA) for the establishment of a tax beneficial vehicle for the purpose of promoting employee ownership not just for management, but for all employees. The vehicle is known as an Employee Stock Ownership Plan (ESOP).

If shared ownership helps workers and shareholders alike, why isn't it already widespread? The answer partly lies in the risks of implementing the model. First of all, deploying the structure requires a concerted effort, and it takes a long time to see results. For example, the outcomes for Ingersoll Rand took place over nine years. There are also often deeply held misconceptions about the workforce. Pete Stavros said he had heard a lot of excuses from owners and their advisors why it would not work for them or their company. Many owners are afraid of giving capital to workers as they might not value the equity and ownership and might make wrong decisions about the business. However, all these excuses are grounded in lack of knowledge and mistrust between workers and managers.

Pete Stavros said in one of his interviews: "Shared ownership cannot be implemented in exchange for wages or other benefits — this is not about shifting risk on to the workforce". Indeed, in the case of KKR and CHI Overhead doors there was a free, incremental benefit for each worker, and it was not in exchange for benefits, wages or wage increases as wages there increased by 12.5% in 2021 and by 7% in 2020. However, employees still bear some risk. First of all, payouts are linked to the company's performance which means that if the company does not grow and create value, workers will not receive additional payouts – no matter how hard an individual employee worked. Overall engagement and high contribution of all workers is required to make the model efficient. Moreover, ESOPs carry inherent risks which are not present in other retirement plans: since ESOPs don't diversify investments, employees' retirement accounts are tied to the performance of the company, and large amounts of employee layoffs can cause the ESOP to spiral. This risk is amplified in privately traded ESOPs. An ESOP is privately traded when its stock is not available for public purchase and not valued in the stock market. The stock in the privately traded ESOP is valued by a third party who performs a yearly valuation. If the third party is biased, or trying to produce a valuation that pleases the shareholders, it may overvalue the stock, which allows the shareholders, when exiting the company, to receive more money for the privately traded stock than it may actually be worth. Many ESOPs take on loans to purchase the privately traded stock from the shareholders, so called leveraged ESOPs. The risk to employees' ESOP accounts comes when the ESOP takes on too much debt. An ESOP that takes on significant debt has little room to survive financial downturn of the sponsoring company, which is now owned by the employees.

Regarding risks for the portfolio companies and the financial sponsors, they had to put a lot of effort to make employees believe them, to educate them and to invest in different facilities to make the environment better. And still, it might not work out and the company might simply lose money by paying huge dividends to employees and investing in different facilities for workers if they will not believe in the potential of the business and will not put much effort on a daily basis, or even worse, will quit the job quickly. There are many examples of unsuccessful ESOPs, one of which was the Chicago Tribune Company, when Samuel Zell, the real estate billionaire came up with an idea of a leveraged buyout of Tribune and converting it from C to S corporation, so as to avoid paying income taxes. The new Tribune had only one shareholder, an ESOP and Zell had no shares, but he did have a

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warrant to buy a lot of shares for virtually nothing. Robert Willens, a longtime tax analyst said: "It would have been probably the greatest tax avoidance structure ever devised, had they earned income." Zell probably would not have exercised his warrant until he was ready to cash out. Then he would have either sold the warrant to someone or exercised it and immediately sold the stock. However, there was one loophole to the taxation of S corporations. A company that converts from C to S status could still be subject to capital gains taxes if it would sell assets within 10 years after the conversion. If that happened, it would owe taxes on the gain in value that occurred before the company converted. That was the case with Tribune as it indeed had sold assets. That is why I.R.S. stated that the company should have paid $190m tax plus a 20% "accuracy related penalty", when it sold the Long Island newspaper Newsday to Cablevision in 2008. After that Tribune released its 2012 financial statements with a footnote explaining its tax problems on the Cablevision deal and adding that it might face an additional $225 million in taxes — plus interest and penalties — when the I.R.S. completes its audit of its 2009 return. That was when Tribune sold the Chicago Cubs baseball team in a transaction with the same structure. Afterwards, the company was converted back to the normal C status as it had more than 100 shareholders. Creditors were given stock when Tribune came out of bankruptcy at the end of 2012, and the company, not its shareholders, was responsible for the tax bill. That is how the cleverest corporate tax strategy failed at the Tribune Company. That case showed many pitfalls of ESOPs. Some companies that make poor candidates for an ESOP often have one or more of the following attributes: consistently weak earnings, weak management succession plan, poor internal controls and poor relationship with lenders.

On the other hand, ESOPs give a lot of benefits to financial sponsors and portfolio companies. Firstly, if a corporation stock is sold to an ESOP, the capital gains tax can potentially be avoided as now employees own the company. Secondly, income attributed to shares of a corporation stock held by an ESOP is not subject to tax, meaning that portfolio companies do not pay income taxes if they have given 100% of common shares to employees.

Conclusion

Broadening the ownership structure through ESOPs is both the smart, and right thing to do : it allows for a fair allocation of the surplus value created by more motivated employees. Over the next decade, this philosophy will most certainly impact the way Private Equity firms structure their deals, and companies their ownership.

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