

The Quest for Permanence: The Non-Esop Employee-Owned Firm

There is a lot of promotional writing about employee ownership of private businesses through the use of the Employee Stock Ownership (“ESOP”) structure. This form of ownership succession has a lot to recommend itself to closely held or family businesses—it is a highly tax incented structure allowing the existing owners to sell their stock, effectively, to company employees and defer capital gains on the sale. The debt incurred by the company to fund the transaction also has very favorable tax treatment—the principal on the debt is fully deductible on the corporation’s tax return, thereby increasing the company’s debt capacity considerably. For all those benefits, however, there are a number of negatives to the ESOP structure and some owners shy away from it for those reasons.

An alternative succession option to consider is the direct sale of company ownership to a select group of employees. There is very little national data on how many companies have become employee owned this way, but some of the ones that have are extremely successful. There are three such companies in St. Louis and this paper describes how the employee ownership came about for each of these firms and how this form of ownership, properly managed, has created tremendous shareholder value.

A common thread among these three companies is their maniacal focus on their business and a very strong sense of purpose. Despite their size, and they are all multi-billion dollar enterprises, there is a conspicuous sense of purpose among all employees. They evidence what is called “strategic ownership” which is a sine qua non of longevity. This is the perfect alignment of the wants and needs of owners, the employees and the customers. It is no wonder that these companies are leaders in each of their respective industries.

There are several “predicates” or pre-existing conditions necessary for this form of ownership succession to work and are amply evidenced by the history of the firms profiled below. They are:

The Owner Subsidy | The existing owners must be willing to sell their stock to the employees on more favorable terms than they likely would get in a fair market value sale to a third party (via auction, for example). ESOPs share this characteristic to some degree as well, but in this instance there are no tax benefits accruing to the owners for the sale at less than fair market price. Likewise, the debt incurred by the employees or the company has no special tax status.

An Owner-Employee Culture | The employees involved in the purchase must have the leadership skills to run the company in the future and the capacity to incur the debt to fund the purchase. As important, the employees involved must have the confidence of third party lenders and other parties that the company relies on for not only borrowing capacity but working capital.

Appropriate Governance Structure | An appropriate governance structure needs to come into being quickly at the time of the sale—in most cases, this structure will be very similar to what was used by the incumbent owners. Will there be a Board of Directors? If so, will any non-employees be on it?

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Who will be in charge and what are the limits? What is the management succession plan?

Ownership Control and Succession Plan | The desire for employee ownership is typically accompanied by plans for controlling the equity for the benefit of future employees and the definitive terms upon which future purchases and sales will be effected. A voting trust or shareholder or partnership agreement among all employee owners will spell out all these details. It will cover, among other things, whether anyone other than a current employee can own the stock and the pricing formula and payment terms for purchases and sales by and among employees and the company.

Funding Mechanism for Purchases and Sale | The purchase of shares in a business in which you work is not an everyday event and, typically, the employee getting this opportunity does not have the financial resources to fund such a purchase. Employee owned companies address this challenge by creating an internal funding mechanism (i.e. a loan facility) or arranging loans for their employees with an external lender (often guaranteed by the company). Likewise, the re-purchase of shares from employees needs a funding source as well, ideally from internally generated funds. Repurchase payment terms usually provide for payment of the purchase price over a period of years, usually 3 to 5 years.

Graybar Electric

Graybar is a leading distributor of electrical, communications, and data networking products in the U.S. It also is a provider of related supply chain management and logistical services to the companies whose products it distributes. The company has a network of 290 locations and employs approximately 8,500 employees. The active and retired employees of Graybar own 100% of the stock of the company, and as of March, 2017, the company had 6,847 security holders.

Graybar had revenues of \$6.3 billion in 2016 and net income of \$93 million. It paid cash dividends of nearly \$50 million to its stockholders in 2016 and the reported return to the employee shareholders for the past 5 years exceeded 20% per annum, on average.

Graybar has a fascinating and colorful corporate history that mirrors the evolution of electricity and the communications industry in the U.S. The “Bar” part of the name comes from founding partner Enos Barton of Cleveland. The “Gray” part comes from Elisha Gray who was an inventor and professor of electrical engineering at Oberlin University. The origins of the firm date from 1869. The electrical equipment manufacturing business founded by Messrs. Gray and Barton, first known as Gray & Barton, then as Western Electric Company, ultimately became part of Western Union and then American Bell Telephone Company.

Western Electric decided to sell its subsidiary, Graybar, then the leading distributor of radio and telephone equipment in the U.S., in the late 1920's and was unable to find a buyer. The reason a third party sale could not be consummated is that Western Electric and Bell Telephone insisted that any purchaser of the company agree to honor all the benefits the Graybar employees enjoyed by reason of being part of the Bell System. In January, 1929, the employees bought the company and the New

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York Times, on a front page article, announced that “There is no case in financial records where a company of the importance of Graybar has changed ownership in such manner”.

The sale terms to the employees was a bargain. The purchase price for the company was \$9 million, which represented six times annual earnings compared to the 19x price earnings ratio for the Dow Jones Industrials at the time. In addition, Western Electric agreed to refund at any time in the next 5 years the full purchase price, plus 6% interest, to any employee who bought the stock and wanted to sell it for any reason. The payment terms for the initial sale allowed the employees to buy the stock via payroll deduction over four or five years. Over 72% of Graybar’s then 2,300 employees participated in the sale.

Today, Graybar’s shares are predominantly held (over 80%) in a voting trust to which employee owners voluntarily subscribe. The trust was established under New York law and has a limited ten year life, requiring the company to re-establish the trust every 10 years pursuant to an employee subscription. Participation in the trust is voluntary, but is irrevocable during its term. The Company has the option to purchase shares of any shareholder who ceases to be an employee for any reason other than death or retirement on a company pension and on the first anniversary of a holder’s death. All shares are purchased and sold at the price of \$20 per share.

Graybar is a reporting company under the Securities Exchange Act of 1934 and therefore files regular quarterly and annual reports with the SEC. Its governance regimen appears similar to that of a publicly traded company, with the exception that the Board is made up entirely on insiders, all current employees.

Since 1929, employee ownership has been at the heart of Graybar’s business. As an employee-owned company, Graybar’s employees and retirees have a vested stake in the success of the organization. This mindset shapes not only how employees work, but it also helps build a sense of pride throughout the organization.

Edward Jones & Co., L.P.

Edward Jones (“Jones”) is a registered broker-dealer and investment advisor which does business in the U.S. and Canada. Its primary business is the retail brokerage business which it conducts through over 13,000 branch offices. Jones is best known for its one-financial advisor per office branch system. At December 31, 2016, Jones had approximately 14,919 financial advisors, \$963 billion of client assets under its care and over 43,000 employees.

Jones history dates back to 1922 when the firm was founded in downtown St. Louis by Edward D. Jones Sr. At that time, it was a typical “stock and bond house”, of which there were dozens in cities like St. Louis. Mr. Jones took on partners from time to time and had what could best be described as an unexceptional retail brokerage business. The firm became a member firm of the NYSE in 1941.

After WWII, Edward D. (“Ted”) Jones, Jr. joined his father and things began to change. The mutual

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fund industry was just getting started and the firm expanded its business by selling funds to retail investors throughout Missouri and Illinois. Ted encouraged his dad to hire a number of his friends and they each would drive around the states neighboring Missouri and sell mutual funds out of the back of their cars. In those days, mutual funds were sold on a monthly installment basis and orders were processed in the home office based on wires from local Western Union offices on the road.

Ted was a farmer at heart and, much to the disappointment of his father, maintained his home at his farm in central Missouri and started to come in to the office in St. Louis less frequently. He ultimately convinced his father to open an office in Mexico, Missouri so he could work closer to home. This would be the first of thousands of branch offices that Edward Jones would eventually open.

Ted Jones by appearance was a simple man. He was short, slightly plump, sported a farmer's tan and bore no resemblance to the cigar smoking, stuffy appearing big city stock and bond brokers of the day (like his father). He always looked you in the eye when he spoke and as the conversation proceeded, he would edge closer and closer to your face just to make sure you were getting his point. Among other traits, he had an uncanny "sense" for human behavior and what motivates people to succeed. He was very adept at identifying the personal and character qualities that would make for a successful Jones broker.

By reason of his experience selling securities to individual investors in a small town, he discovered what until very recently was thought to be preposterous...that is, there is a vast and completely ignored market for investment products in every town in America, not just in the big cities. He also figured out that the best way to serve that market was through offices located in those towns, such as he had established by serendipity in Mexico, Missouri. He insisted on putting only one broker in each office to eliminate competition among brokers and make measurement of success (or failure) very simple. He established a rule, still honored today, to never put a broker in an office a town where he grew up. (Give some thought to why that is important!) Door to door, face to face personal solicitation of business from individuals was the model for success, ruthlessly enforced by Ted.

Ted Jones' approach had modest success while his father was alive, but following Sr.'s death, the concept took off. This occurred because Ted, self-less as he was, decided that having a small piece of a giant pie was better than owning all of a small one. He sold the bulk of his 100% interest in the firm to his other top salesmen. The sale was effected at "book value", and the purchase and sale of interests in Edward Jones to this day is done on the same basis—in and out at book value.

In 2016, Jones had net revenues of \$6.5 billion and pre-tax income of \$746 million. The firm is owned today by over 20,000 partners—419 General Partners, 19,310 Limited Partners and 416 Subordinated Limited Partners. The total equity capital of the firm is \$2.6 billion and the amount allocated to each class of partnership is as follows: General Partner—\$1.1 billion, Limited Partners—\$902 million, and Subordinated Limited Partners \$421 million. The pre-tax investment return to each partnership class in 2016 was 43%, 11% and 21%, respectively.

Needless to say, General Partnership ownership at Edward Jones is a highly sought out career

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milepost. Only full-time employees in leadership positions are eligible to become General Partners. They typically are grown internally and the successful operation of a branch office is an important consideration for advancement. The level of General Partner ownership varies widely.

The firm has a mandatory retirement age of 65 years old and a corresponding redemption plan for General Partner Interests—from 56 to 65 years old, an equal percentage of their interest is retired each year so that at 65 years old you exit the firm. At the discretion of the Managing Partner (more below), a portion of a partner's General Partner's interest can be reinvested in an equal amount of Subordinated Limited Partner interests.

By design, the Subordinated Limited Partner interest can be held until death and has a return of approximately one-half of the return on the General Partner interest. More importantly, the Subordinated Limited Partners share pro-rata with the General Partners in the proceeds of the sale of the firm. The Limited Partners also share in the proceeds of a sale of the firm in the same proportion that they share in the firm's pre-tax net income as noted above. The firm is fiercely committed to private ownership and has consistently rejected all overtures to sell out or go public over the years.

Jones is managed on what is referred to as a "strong managing partner" basis. Under the terms of the partnership agreement, the Jones managing partner has primary responsibility for administering the partnership business, including the power to admit and dismiss General Partners and the power to adjust the proportion of their interests in the partnership. There is a functioning executive committee, the members of which, numbering 5 to 9, serve at the pleasure of the managing partner. Their role is to provide advice and counsel to the managing partner. There is also a management committee of up to 21 individuals which is made up of a broader group of General Partners. The managing partner serves for an indefinite term and may be removed by a majority vote of the executive committee or a vote of the General Partners holding a majority percentage ownership of the partnership.

Jones is a reporting company under the Securities Exchange Act of 1934 and regularly files quarterly and annual reports with the SEC. By reason of the strong managing partner structure outlined above, the governance of the partnership is through the managing partner with the counsel and advice of the executive committee.

CIC Group Inc.

CIC Group is a 115 year-old employee owned company headquartered in St. Louis that provides project management, construction solutions, engineering and heat transfer design, welding and metallurgy and heavy rigging and lifting services to the global power, refining, chemical, printing and specialty materials markets. It operates through 20 operating subsidiaries and has over 1,500 employees world-wide. CIC's revenues are non-disclosed, but are estimated to be in excess of \$1.5 billion.

CIC Group was born out of a family business founded in St. Louis in 1896 that built smokestacks,

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industrial tanks and boilers. The founding family was the Nooters and they had only daughters as offspring. One of the lead engineers at the company was married to one of the daughters. As the Nooter family owners died off, the employees purchased their shares on a book value basis (sound familiar?).

Today, CIC Group has under 500 stockholders (to avoid SEC reporting obligations) and share transfers and terms of ownership are governed by a shareholder agreement. The shares pay a 1% dividend. Shares can only be purchased by active employees and, upon leaving the company for any reason, are repurchased over a four year period. The book value of the shares has risen each year and so ownership of the shares is a highly coveted retirement benefit at the company.

The company has the option to repurchase shares from retiring or departing employees by paying cash or exchanging preferred stock in a like amount. The preferred stock pays an attractive dividend. Holders of the preferred have no participation rights in the proceeds of a sale of the company.

The company is governed by a Board of Directors consisting solely of existing employees of the company. The Board determines who can purchase shares in the company and how much an employee can own.

I recently interviewed the CEO of the company about the benefits and burdens of employee ownership. On the benefit side, he emphasized the “team” spirit of the company and how the alignment of interests of their very diverse employee base (skill sets and geography) is aided by the ownership. On the negative side, he mentioned that they tend to be more risk averse than he would like and this has impeded their ability to execute on some acquisition opportunities.

Concluding Observations

Each of the companies profiled above is very impressive, not just for its longevity but for its commitment to purpose. When speaking with employees at each company, there is a clarity about what the business is all about, what counts as success and an appreciation of the legacy left by those that have come before. The employees readily acknowledge a personal responsibility of stewardship...a duty to advance the success of the company for the next owners.

Becoming “employee owned” is clearly an evolutionary process. Graybar had its origins as a subsidiary of one of the largest companies in existence at the time it became employee owned. Both Edward Jones and CIC Group evolved from family ownership.

You must also have an employee base which can embrace the responsibilities of ownership and be able to perpetuate the business through good business and governance practices. In each of the above examples, the employees had the opportunity to acquire ownership on very favorable terms (book value or less) and each firm “institutionalized” that structure to enable future employees to do the same. The senior leadership teams at each of the companies has a strong sense of stewardship.

This form of corporate ownership deserves greater recognition and study so more companies can

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consider it as a viable ownership succession alternative.

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