Selling the Benefits of Ownership  
*ESOPS give a stake in the business to employees*

ANDY ROSEN  
Daily Record Business Writer  
June 21, 2007 5:47 PM

WASHINGTON—The recent annual shareholders’ meeting at Macfadden, a Silver Spring-based contractor that works primarily with the federal government, had the feel of a company retreat.

The conference room was packed and guests talked and laughed while they networked before a presentation by President/CEO Russ Hall. In a group exercise, participants pretended to be geese in a flock, a process designed to highlight the virtues of teamwork and leadership.

Hall highlighted company financial information and described Macfadden’s 2006 performance, but the meeting was longer and more detailed than many other companies’ stockholder events. After all, these weren’t just shareholders; they were also employees.

Macfadden — which provides data support and information technology services to federal agencies with a focus on humanitarian efforts — completed its transition to an employee-owned firm this year.

The company is now held by an Employee Stock Ownership Plan, or ESOP, which it used to buy out retiring founder Jim Macfadden. Now, Hall said the company’s challenge is to get employees working more closely to expand the business.

“We’ve got to all be able to sing the same song, and that’s our challenge,” he said, adding that “business development is everybody’s business.”

ESOPs, which bestow substantial tax advantages on the companies that use them, have been in the news lately. In a prominent example, Sam Zell used an ESOP to purchase Tribune Co, the national media conglomerate that owns The Baltimore Sun. In that multibillion dollar transaction, Tribune will become privately held, with the ESOP owning about 60 percent of the company and Zell controlling the balance.

But the vast majority of ESOPs are small, private companies like Macfadden, which has about 75 employees and took in $11 million in revenue last year. According to the Oakland, Calif.-based National Center for Employee Ownership (NCEO), more than 90 percent of the country’s approximately 9,250 ESOPs involve closely held
companies. In many instances, ESOPs are used to buy out one or more owners of a small company.

Under such an arrangement, the company puts money in trust to buy its stock, which is placed in individual accounts for employees to be cashed in for retirement funds when they leave the company. Employees are not personally at risk if the company loses money, but some experts point out that there is a risk that an ESOP will not perform as well as other retirement investments.

Some of the highest-profile ESOP transactions involve large, publicly traded companies, partially because ESOPs have the ability to borrow money, which other types of retirement plans do not. By borrowing through an ESOP, companies can make both their principal and interest tax-deductible. Small companies enjoy those same advantages.

The ESOP approach worked well for Macfadden’s founder Jim Macfadden, who sold his interest in the company as he prepared to retire. In addition to the tax benefits, experts say companies with successful ESOPs also tend to improve morale and employee productivity by engaging staff members in the growth of the company.

In an e-mail, Jim Macfadden said the tax advantage of selling to an ESOP was attractive. An owner who participates in such a sale does not pay taxes on the proceeds as long as he reinvests them. Still, Macfadden said he was ultimately more interested in giving his employees control over the company.

“|The tax advantage was a factor, but leaving the company to the employees was clearly the biggest factor,” he wrote. “If I had taken the company on the open market, I would have been somewhat better off financially, even after taxes, but it would have been at the price of the employees.” |

Corey Rosen, executive director of the NCEO, said it is important for ESOP companies to develop a strong “ownership culture.”

Macfadden employees did not actually buy the company. Instead the firm borrowed about $3 million to purchase the company’s shares from Jim Macfadden. Employees did not make direct contributions toward the deal but can earn equity in the company as it grows. The company maintains its 401(k) retirement plan for employees as well.

“The better your performance, the easier it is to absolve the debt,” Rosen said, highlighting an advantage of increased productivity that often comes with employee ownership. He said banks do not lend money for ESOP transactions based on the assumption that performance will pick up, but improved profitability can help.

He said ESOPs should develop ways to empower employees, giving them a say in how the company is managed, and keeping them informed about how the company is performing financially. It takes time to get new management and communication
structures in place, said Rosen, but companies should show employees that they are making progress.

“The longer you wait, the more cynicism you [have to] overcome,” Rosen said. “On the other hand, it’s difficult for a company to make the transition … in a very short period of time.”

Macfadden has stepped up its communication with employees, using events like the annual meeting, seminars, and e-mail and print communication. One major goal, Hall said, is to improve communication with employees about ways to enhance performance and customer service. He referred to this process as “cross-pollination.”

The company also has an ESOP committee, which includes employees and focuses on informing staff about the ownership structure. Employees get an annual statement of how much equity they have earned in the company.

Some employees said they did not think the ESOP ownership plan would have much of an effect on them, while others are looking forward to having a direct stake in the success of their company.

“I think it gives you a great impetus to want to push forward on developing new business, because you’ve got a piece of the pie,” said Gloria Allen, Macfadden's project manager for a contract with the U.S. Agency for International Development.

She has been with the company for 13 years. “It’s a very nice feeling that you’re all in this together,” she said.

Employees’ stake in the company is provided as a benefit, somewhat like a profit-sharing plan. Their stock gives them voting rights in some company decisions, but only for major matters such as mergers and acquisitions.

Hall also serves as the ESOP trustee, who is supposed to represent the interests of employee-owners. Some other ESOPs have looked to people other than company executives to act as trustees, but NCEO’s Rosen said by e-mail that it is not uncommon to have an executive serve as trustee as long as that person is not benefiting from the sale of the company.

According to NCEO, there are about 150 ESOPs in Maryland.

The Baltimore-based Maryland Brush Company Inc. is one such company. It became an employee-owned operation after staff at the brush division of PPG Industries decided to purchase the operation in 1990.

By 1994, Maryland Brush had begun to restructure its operation, moving from a top-down management structure to one based on self-directed work teams.

“I think it’s a natural progression in fulfilling the idea of an ESOP,” said president
and senior engineer Stephen J. Mullan. He said the transition to employee ownership was challenging as employees grew accustomed to the new structure.

“They were an employee and an owner overnight,” Mullan said, describing the change in roles for employees. “They wanted an automatic say in everything that happened.”

In the end, he said, the transition was successful. He said employees have adapted to the ownership culture, and the company has performed well. Maryland Brush has paid off about $4 million it borrowed during the ESOP transaction, he said, and the company’s stock outperformed the benchmark Standard & Poor’s 500 Index over the four years between 2002 and 2005.

Mark Chen, an assistant professor who specializes in corporate finance and corporate governance at the Robert H. Smith School of Business at the University of Maryland, College Park, said he is surprised that more companies do not opt to go to ESOP ownership. He noted that companies can have partial ESOP ownership and still take advantage of the tax and productivity benefits that come with full employee ownership.

Chen also noted several potential pitfalls of ESOP ownership, however. Companies that take on a lot of debt like Macfadden put themselves at risk. Also, ESOP companies must regularly measure their value to determine shareholder equity, and that can be expensive, he said.

It can be especially troubling if many employees retire or leave at the beginning of the ESOP, Chen said, because that can put pressure on future returns for continuing employees.

Jim Macfadden founded Macfadden in 1986 as a startup that provided automated data processing for government agencies. His first contract was to support the consulting firm Booz Allen Hamilton in records management at the General Services Administration.

Over the next two decades, the company grew by adding several major clients, including the U.S. Agency for International Development, the Federal Aviation Administration and the U.S. Department of State.

Jim Macfadden said he began to plan his exit from the company about six years ago, and in 2004 he sold 35 percent of the company to the ESOP. Hall became the company’s CEO that same year.

Last year, the company won three competitive multibillion dollar contracts with federal agencies, and it expects to grow its revenue to $14 million in 2007.

The company remains in transition, Hall said, as it considers growing through acquisitions of smaller companies. He declined to give further details, but said the company would focus on targeted acquisitions over the next three to five years. In
the future, Hall noted that he would be open to exploring a deal in which Macfadden could be acquired by another company.

Jim Macfadden, in his e-mail, said he feels confident that the company’s new management will steer it in the right direction. He said he keeps in touch, but only remotely.

“The employees were and are the major reason why the company has enjoyed the success it has, and the employees deserve to reap the benefits of ownership, both for now and for the future,” he wrote.

# # #