# Unlikely Pioneers

### A machine shop takes a new approach to employee ownership

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David Baird knows machines. With almost 30 years' experience running lathes, drills, and grinders, he can tell if a piece of equipment needs a tune-up by listening to its hum. Despite being a skilled craftsman, Baird figured he'd always be a blue-collar wage slave. "Guys like me can make some good money," says the 47-year-old machinist, "but we rarely get the chance to manage something, own something, to be part of something bigger."

Last September, Baird got his chance. He became one of eight employee-owners of Select Machine, the Brimfield (Ohio) company where he has worked for seven years.

Many small businesses become employee-owned through Employee Stock Ownership Plans, or ESOPs, which let owners gradually sell their stakes to employees and roll over capital gains. But Select Machine was too small to handle the costs of an ESOP. Instead, it formed what may be the first employee co-op to get tax advantages similar to those of an ESOP: the selling owners get deferred capital gains, and the co-op buys out the owners with pretax money.

Perhaps the only people more pleased about the new structure than the employees -- now owners -- are Doug Beavers, 53, and Bill Sagaser, 56. They founded Select Machine 13 years ago to provide custom parts for demolition and construction equipment. But when they began to consider retirement, they weren't thrilled with their options. The company itself was healthy enough: profitable and debt-free, with $1.5 million in revenues. But Beavers' and Sagaser's adult children weren't interested in the business. Prospective buyers planned to dismantle the company and lay off its workers, preserving only the client list. "These are our guys, our family, and we wanted them to keep on working," Sagaser says.

So the duo transformed their company into a worker-owned co-op, selling their shares in a multistage process. They retain control of the company for as long as they continue working. The newly formed co-op will buy Sagaser's and Beavers' shares using a bank loan to be paid off with company profits. The interest on that loan is tax-deductible to the company. Remaining company profits will be divvied among the worker-owners using a formula of earnings, hours worked, and other variables.

Setting up a co-op is much less expensive than establishing an ESOP. Most small businesses can get going for $10,000, and annual administrative costs are virtually nil, says John Logue, director of the Ohio Employee Ownership Center (OEOC) at Kent State University, the nonprofit that advised Select Machine. That compares to an ESOP's typical setup costs of $50,000, plus at least $10,000 to $15,000 in annual administrative costs. "As a form of succession planning, an employee-owned co-op is a neglected tool," says Logue. "Now these guys can shelter a capital gain, see the business they built survive, and pass on their management skills to their former workers. This is a model that cries out for replication."

A co-op doesn't make sense for every small business. ESOPs may work better for profitable, capital-intensive companies with more than 25 employees. But owners of smaller outfits looking for a smart retirement strategy that keeps their companies alive may want to follow Select Machine's lead. "It doesn't get much better than this," says Beavers. "When we began this process I really didn't know what a co-op was. Now we're the poster boys for how to do one right."

It was early in 2005 when Beavers' and Sagaser's banker suggested they contact the OEOC for guidance. Logue knew an ESOP was too expensive for Select. But management was willing to stick around through the transition, and workers were eager to become their own managers. That got Logue thinking: Why not create a worker-owned co-op?

## TAX-FREE ROLLOVER

The government doesn't track co-ops, so exact numbers are hard to pin down. Logue estimates that only about 300 of the thousands of co-ops in the U.S. -- mostly purchasing groups, credit unions, and agricultural concerns -- are employee-owned. But he wasn't aware of any that were eligible for a 1042 rollover, the 1984 addition to the tax code that makes ESOPs a smart way to defer capital gains.

That provision had been largely ignored because co-ops are 100% employee-owned, making them tough to finance, says Mark Stewart, the co-op attorney at Shumaker, Loop & Kendrick in Toledo who put together Select's plan. "Everybody was ignoring co-ops because you have to have a lot of things in place to make it work," says Stewart. For example, it's practically impossible to form one if the owners are looking to bail, says Richard Dines, program manager for cooperative development at the National Cooperative Bank in Washington. "If the owners are history and the management skills go out the door, that's a recipe for disaster," says Dines. "No one wants to finance a situation like that."

Select Machine's own metamorphosis was complicated. Stewart and Logue led a team that hashed out a multistage plan that included everything from a feasibility study to articles of incorporation and bylaws. Six months later, Beavers and Sagaser sold 40% of their shares to the workforce. To finance the deal, the co-op took out $324,000 in loans, personally guaranteed by Beavers and Sagaser. The remaining shares will be sold when the loan is repaid, in about three years. The monthly loan payment of $6,000 comes out of the company's cash flow.

Beavers and Sagaser, now co-op members, qualify for a tax-free rollover of the proceeds. Typically, owners have to take a cut on the price of their shares if they sell a minority stake to employees, but Beavers and Sagaser got full market value because co-ops are automatically member-controlled. Another plus: no outside investors to squelch the deal.

The Select Machine group set up a co-op membership board that includes Beavers and Sagaser and six of the eight machinists on staff. One employee opted out because he is leaving the company. Another hadn't been working at Select long enough to qualify, because the co-op's bylaws require members to have a year's tenure. A one-time membership fee was set at $1,000 a person.

Once a month the members meet in a tiny conference room in the 18,000-square-foot steel building. Beavers and Sagaser teach the group how to read financial statements, handle purchasing, and pursue strategies to expand the business. "The whole idea of a cooperative appeals to us on a very basic level," says machinist Randy Morrow, 26. Morrow admits he was wary of learning what he calls "Business 101." But that has changed. "I thought you had to be a farmer or an artist to join a co-op," he says. "But we all want to keep our jobs and grow this business. Now I can actually read a financial statement."

The new owners are taking things one step at a time. With a hefty loan to pay off, "it's not like we're going to give ourselves a raise," says Baird, who was named co-op vice-chairman. "We're owners now, not robber barons." There's talk about starting a second shift and offering a retirement plan, but so far the new owners have kept things running much the way Beavers and Sagaser did. That means no supervisors looking over their shoulders and closing at 2 p.m. on Fridays after sharing a huge homemade lunch. That way, employees can go home and spend time with their other families.

By Joan Raymond

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