CELEBRATING A DECADE OF DIGITAL INNOVATION

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Are Your Employees Ready to Take Over? A Look at ESOPs

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A DECADE OF DIGITAL INNOVATION · 10 YEARS

By Chris Jensen

Finding Creative Solution to Succession Planning Challenge

After I graduated college in 1985, I launched my journalism career by securing a job as a reporter at the *Mirror-Recorder*, a weekly newspaper in Stamford, N.Y. Stamford is a small village of about 2,300 people, located 20 miles from my hometown of Delhi and in the foothills of the Catskill Mountains. I enjoyed the nine months I spent in Stamford, but I don't have any memories of wandering into the local hardware store.

Many towns the size of Stamford no longer have hardware stores, a victim of market forces and retail evolution. However, Stamford was lucky—it had Ralph Beisler. Ralph's parents had started Railroad Avenue Supply Company in 1963 and Ralph took over the business in 1975 when his father died. He kept the hardware store going in a small town where the economy was never booming.

After 35 years of successful ownership, Ralph was looking forward to retirement. There was just one problem—his kids didn't want to take over the business and he couldn't find a local buyer. Ralph came up with a pretty creative solution to his succession planning challenge. Turn to page 32 and see how he and other hardware retailers have passed on their businesses and retained jobs while still meeting their retirement goals.

My brother Scott is sure glad Ralph has found a way to keep Railroad Avenue Supply open, because he is a frequent shopper there. He and his family live just down the road in Hobart, and Scott's trips to the Ace store often turn into inspiration for the Digby's Hardware cartoon he creates for our magazine.

Digby's cartoon is just one of the components that make our magazine stand out, and we are getting noticed. *The Hardware Connection* was just named a FOLIO: Digital Awards finalist for Best Digital Magazine. We were up against all the other trade and consumer magazines in the country, so we are pretty proud of that distinction. One of the other finalists for this prestigious award is *AARP The Magazine*, which has a circulation of 23 million.

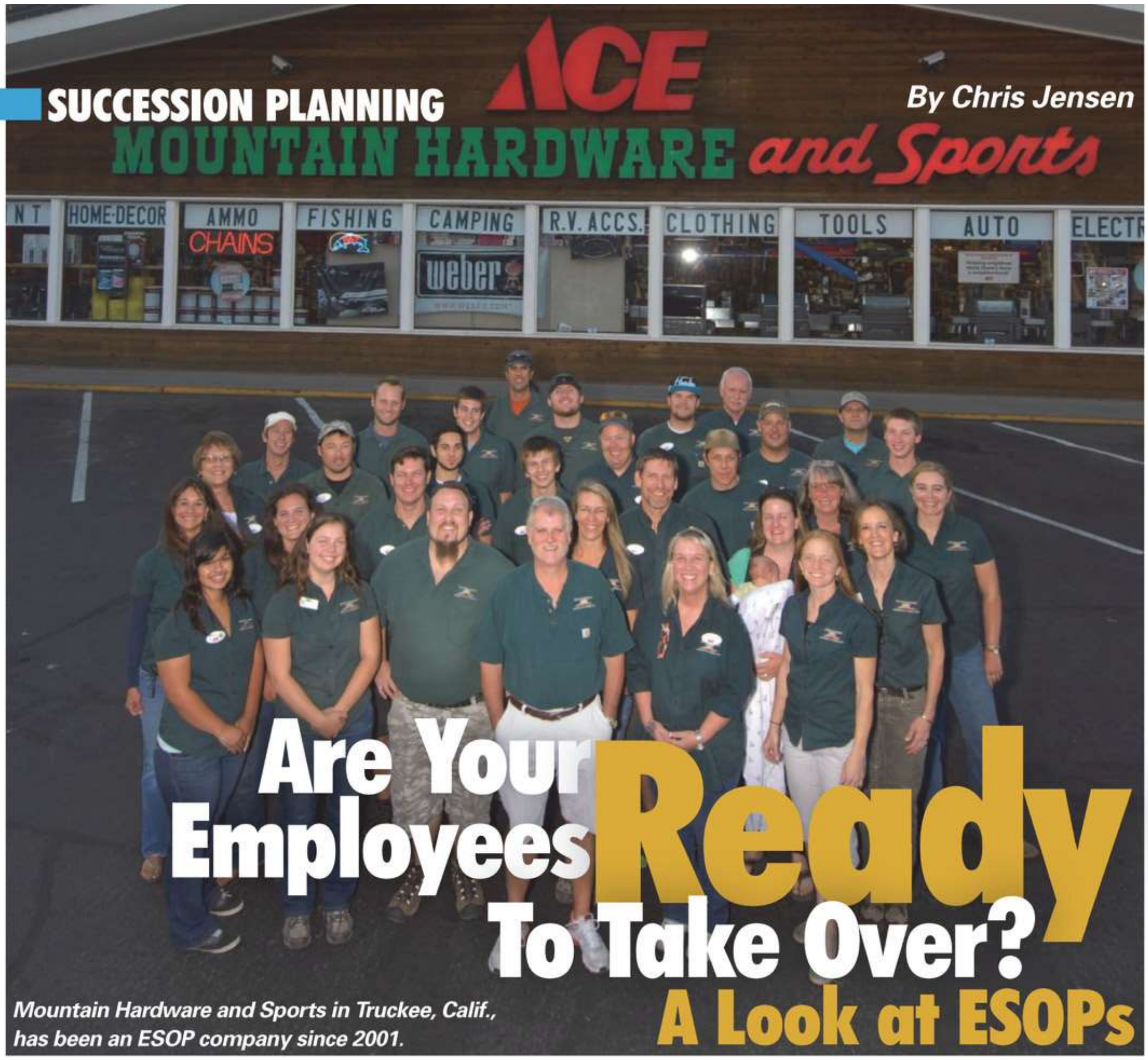
This latest honor represents the sixth award *The Hardware Connection* has won for editorial excellence in the past five years. *The Hardware Connection* is celebrating its 10th anniversary this year, so turn to page 41 to learn more about our decade of digital innovation. ■

SUCCESSION PLANNING

By Chris Jensen

Are Your Employees Ready To Take Over?

A Look at ESOPs



Mountain Hardware and Sports in Truckee, Calif., has been an ESOP company since 2001.

Many hardware retailers struggle with succession planning, waiting too long to get started and then finding their options are limited if their children don't want to take over. Some retailers are discovering the benefits of a creative approach to succession planning: selling shares to an employee stock ownership plan (ESOP) or worker-owned cooperative.

Read on to see how these two different approaches have paid off for independent retailers in the hardware industry.

PUTTING FAITH IN EMPLOYEES

Mountain Hardware and Sports operates Ace stores in Truckee and Blairsden, Calif., plus a standalone equipment rental store in Truckee.

Doug Wright serves as president and ESOP trustee for the company, which dates back to 1977. He was hired as general manager in 1999, two years before Mountain Hardware and Sports switched to an ESOP, and he has been the ESOP trustee since its inception.

Wright says the idea originated with the financial adviser of one of the founders, which led to a period of evaluation in which no one could come up with a good reason not to go for it. It took seven months to put everything together.

As an entity the ESOP purchased 49 percent of the business in 2001. In 2005, another 2 percent was bought so the ESOP became majority owner. In 2007 the ESOP paid off its initial stock purchase loans—the notes carried by the founders—and in 2013 the remaining 49 percent was purchased by the ESOP with open market loan funds. Three founders—a fourth left in the early 1980s—are retired from working in the business but are still active on the board of directors.

The company currently has 94 employees and close to 60 are fully vested, according to Wright. "Our staff has a lot of autonomy to make decisions, which gives them more flexibility. We encourage everyone to be involved and engaged," he says.

Click to watch video on the employee owners of Mountain Hardware and Sports.

Employee-owners are also provided with health insurance, gym memberships, ski passes and more benefits. "We are benefit rich, but you still have to be relevant on the balance sheet," says Wright. "People have a stock, literally, in the future of the company. Turnover happens everywhere, but less here."

ESOPs provide fairly significant tax benefits, according to Wright. Company contributions to repay any loans taken out by the ESOP to purchase company shares are tax-deductible. If it's an S corporation, then the ownership shares held by the ESOP are not subject to federal income tax. Employees pay a reduced tax rate when they retire or leave the company, but pay no tax on the amount contributed by the company to the ESOP on their behalf.

"A portion of profits go to administering the plan and we have an ESOP attorney on retainer," says Wright, who adds that regulations and record-keeping have expanded over the years as a result of abuses that occurred at other ESOPs.

Mountain Hardware and Sports maintains a traditional board of directors and the board selects the ESOP trustee. Wright is grooming his successor by having the CFO serve as co-trustee.

"An ESOP is not for every company and it's not a magic switch that you flip. You have to be a certain size," says Wright, who adds that the company contribution to the ESOP is 25 percent of gross payroll as a maximum. To be eligible to participate, employees have to be over 21 and work 1,000 hours a year. Shares are held for them in a trust.

The distribution payout is supposed to be once an employee leaves they don't get anything for five years, and then from years six through 11 they get 20 percent each year at the share value. "This keeps you from having a run on the bank," explains Wright. "We started paying out the first year they leave, because we don't want anyone to leave disenchanted and want them to get their rewards."

The company works hard to communicate regularly with employees and promotes its status as employee-owned on social media and other marketing. Mountain Hardware and Sports was honored for its communication excellence with a national ESOP award in 2017.

"We have a great communications committee led by Heather Svahn. We put out a newsletter and try to make everyone feel like part of a family. Most employees get access to financial information except salaries, so they are informed about the business," Wright says.

The last recession was a good test of the ESOP's ability to withstand a business downturn. "We had some sales decline, but when attrition happened everyone else picked up the slack. We knew we didn't have a lot of distributions in front of us, so the cash could be used in the business," say Wright, who proudly notes the company has never laid off any employees in 42 years.

"I am a firm believer in the ESOP model. It takes a lot of work, but it is really worthwhile," concludes Wright.

PRESERVING THE STORE AND JOBS

Ralph Beisler had hoped to be retired by now. At 75 years of age, he has finally enacted a succession plan that can work for his business, Railroad Avenue Supply Company in Stamford, N.Y. More importantly, it was the only plan Beisler could come up with that kept the Ace store open and enabled his five employees to keep their jobs.

On January 1, 2019, Beisler and his five employees formed a worker

Railroad Avenue Supply in Stamford, N.Y., is now a worker cooperative. The six employee owners include (left to right): Stefano Bagnardi, Kelly Chien, John Bonhotal, Ralph Beisler (former owner), Bob Shafer and Sarah Weishar. (Photo credit: Liz Page, Mountain Eagle.)

cooperative. The six now collectively own the business. A worker cooperative is a business entity that is owned and controlled by the people who work in it, so it is different from an ESOP.

The biggest difference is that a worker cooperative follows the principle of "one worker, one vote." In an ESOP, employees earn shares over time and are vested at different amounts.

"My main goal was preserving jobs for my employees," says Beisler, who had the store on the market for nearly 10 years. Another objective was to keep it with Ace. Other Ace members in the area were not interested in the business due to its sales volume, which is roughly $700,000. That's pretty good volume in a town of 2,300 people, but was not enough to attract an outside buyer.

Beisler's two sons both work for ECi and were not interested in taking over the store. He didn't want to liquidate the business and leave the town without a hardware store. The next eye-opening moment came in 2017, when Beisler and his wife took a cross-country trip to California in an RV. "We were gone two months and when we came back the store was still there," he says.

He read an article in a trade publication about a business in Ohio that converted to employee ownership. Then a retired locksmith came into the store one day and suggested they form a worker co-op. Beisler looked into it and started working with an attorney.

He reached out to the non-profit Cooperative Development Institute (CDI) out of Northampton, Mass., and they sent information. "CDI helped us to develop and revise our articles of incorporation, review bylaws and prepare a purchase agreement," Beisler says.

Beisler, who owns the store building, is financing the security agreement and loan agreement. He hopes five years down the road the employee-owners will be able to buy the building from him.

At one point, Beisler had majority ownership while his two sons and two employees had minority shares. In August, he purchased all the minority shares so they could start with a clean slate.

Each employee-owner purchases one share and gets one vote. The buy-in was $2,000 each, with the new employee-owned corporation buying stock from Beisler. Some employees did a lump sum payment and some are paying over time with a portion coming out of each paycheck.

Profits will be distributed in cash and membership allotments will be held for three years like Ace corporate bond issues. "They will have a date when they mature and there's a process for paying them out," Beisler explains. In a worker cooperative, profits can be distributed based on hours worked, seniority or any other criteria devised by the employee-owners.

They keep the same tax ID and same company name, with a board that elects officers and selects the GM. "The store has to be in good financial shape and without debt," he says. "Banks aren't excited about lending to co-ops, since no individual is co-signing. I still have a $12,000 line of credit I'm co-signing. Most important, you have to have a good mix of employees who work well together."

Not surprisingly, Beisler's employees are enthusiastic about the new arrangement. Stefano Bagnardi, who has worked there almost four years and serves as treasurer, thinks it's a wonderful opportunity. "We work very well together as a team and have a good core of people It's still early in the process, but no worries so far. We're very appreciative of Ralph doing this for us," he says.

Five-year employee Sarah Weishar had been functioning as office manager, and now she serves as general manager of the worker cooperative and has picked up new responsibilities. Everyone agrees she was best suited to handle that position.

Kelly Chien has worked at Railroad Avenue Supply since August 2016. He was hired for a four-month trial and it worked out. He finds it intriguing and exciting to be an employee-owner. "My biggest fear was that Ralph would retire and there was uncertainty over who would take over. I have a personal stake now that I didn't have before," he says.

Chien adds, "Each of us on the team has strengths from previous

Dazey's Supply in Redway, Calif., formed their ESOP in 2016.

positions. I handle media and public interface. We definitely planned how the business would be run collectively. It's encouraging that the business has been growing too."

Railroad Avenue Supply saw sales grow 8.5 percent in 2018, which is spectacular considering the area economy has been relatively depressed for some time. Beisler attributes the growth to a well-executed strategy to pursue B2B sales.

Beisler says it will take a couple of years to get up to speed with the new arrangement as a worker cooperative. People still talk to him like he's the owner, so he has to train himself on his new role. "Everyone has to work together. Everyone's showing goodwill so far, but we're just a few weeks into it," he says.

PLATFORM FOR FUTURE GROWTH

Dazey's Supply is a Do it Best member with three stores in California and one in Oregon, plus a wholesale operation that sells to more than 250 stores. Steve Dazey built a business by catering to rural homesteaders in southern Humboldt County looking for timber, salvage glass and garden and ag supplies.

"Forming an ESOP has been great for the owner, great for the employees and great for me," says Darren Tomasini,

HARDWARE RETAILERS THAT HAVE EMPLOYEE OWNERS

1. **Railroad Avenue Supply Company**—Stamford, N.Y.
2. **Elery Nau True Value**—Montoursville, Pa.
3. **GW Smith Lumber Company**—Lexington, N.C.
4. **Dazey's Supply**—Redway, Calif. (Click here for more)
5. **Jackson's Hardware**—San Rafael, Calif. (Click here for more)
6. **Ganahl Lumber**—Anaheim, Calif.
7. **Mountain Hardware and Sports**—Truckee, Calif.
8. **Franklin Building Supply**—Boise, Idaho
9. **Jerry's Home Improvement Center**—Eugene, Ore. (Click here for more)
10. **Bingaman & Son Lumber**—Kreamer, Pa.

Dazey's president and CEO, who has been with the company 10 years.

Turning to an ESOP came after careful consideration, with a desire to take care of employees of paramount importance. As Tomasini explains, "Steve was in his early 70s and had no kids to take over the business. He was unsure what to do. I'm 55 and had looked into buying the business, but wasn't going to be around long enough to make it worthwhile."

Tomasini attended a seminar at a Do it Best market on succession planning and ESOPs. He shared what he learned with Dazey and they made some calls to research it further. Both saw it as a viable option. After going through a process that lasted one year, Dazey's ESOP closed September 30, 2016. Tomasini became CEO afterwards.

Dazey's Supply currently has about 90 employees, and if their employee count exceeds 100 it requires an annual audit.

ESOPs don't require a lot of paperwork, according to Tomasini, who says they spend about $60,000 a year in ESOP administration fees. Dazey's has an ESOP administrator who has to make sure they are in line with Labor Department and IRS regulations. The company remains an S Corp. like it has always been.

"Our accounting firm does the financials like we've always done, then they go to the trustee, then to the ESOP administrator, who signs off and sends a statement to the employee-owners showing how much the plan is worth, how vested they are and what the profits are to share," Tomasini explains.

"We no longer pay state and federal taxes, so that puts me 35 percent ahead of my competitors," he points out. "We usually make $5-7 million in profits, so before we were giving $2-3 million back to the government."

Dazey's still has a traditional management structure in place, so even though employees are co-owners that does not mean they are involved in every decision that is made. "If someone's not working out you tell them to move on," Tomasini says.

The most common method to pay off employee-owners who are vested is six years. "After waiting a year, you pay them 20 percent each of the next five years. That's if someone quit and is at least 60 percent vested," Tomasini says. "If they have less than $5,000 stock value you just write them a check. If it's more than $5,000 and they are fully vested, then you wait five years and then pay out over five years."

Forming an ESOP and turning employees into co-owners has improved morale, according to Tomasini. "Employees definitely care more and make the extra sale. It's been a great thing."

Dazey's also offers a matching 401k as an additional benefit. Tomasini tells the young employees starting out that if they stay until they are 55 they can be a multi-millionaire.

Most ESOPs can grow quickly if they want, since they operate tax free and can plow money back into the business. On January 1, 2018, Dazey's bought two other stores: Hubbard's Hardware in Medford, Ore., and Willow Creek Hardware in Willow Creek, Calif.

"It was an easy negotiation to buy the two stores. The fact we were an ESOP company was very attractive to them," explains Tomasini.

Hubbard's Hardware, a Do it Best member like Dazey's, was founded in 1884. It was owned by five siblings of the Seus family, who had 29 children in the next generation. The succession plan was not just a nightmare, it was nearly an impossible challenge to overcome. The Seus family knew the employees would get taken care of in the deal and the business would live on. It now operates as Dazey's Hubbards.

A CLOSER LOOK AT ESOPS

According to the National Center for Employee Ownership (NCEO) in Oakland, Calif., as of 2015 there were 6,669 employee stock ownership plans (ESOPs) in the U.S., down from 7,138 in 2010. They held assets of nearly $1.3 trillion. A total of 2,857 ESOPs had less than 50 participants. The number of total participants in these ESOPs was 14.4 million, up from 13.4 million in 2010. NCEO estimates that 30-40 percent of ESOP companies are 100 percent owned by employees.

ESOPs were first given statutory authority in 1974. Almost all ESOPs are profit-sharing plans and the majority are C corporations. Six percent of ESOPs are in the retail trade and nine percent are wholesale trade. Nearly half the ESOPs are more than 20 years old, and 32 percent of ESOPs are in the Midwest, followed by 30 percent in the South, 23 percent in West and 16 percent in Northeast.

Click here to learn some of the advantages of ESOPs.

While the main store has seen some business fluctuations, the two new stores are up 40-50 percent under Dazey's ownership, according to Tomasini. "We're a very successful business with strong growth potential."

While forming an ESOP has worked out great for Dazey's Supply, Tomasini notes that it is not the perfect solution for every owner looking to sell. "The owner can't just say what the business is worth. It has to be fair market value and you have to want to do it that way."

He adds, "Steve Dazey is a great guy and employees are important to him.

G.W. Smith Lumber Company in Lexington, N.C., formed an ESOP in 1985.

He's getting paid off with monthly payments over 10 years. He could've gotten more money selling the business to an outside group, but he wanted to do this for the employees. It's not a bad deal for him. He still owns the building and gets paid rent."

Dazey's future is looking up, as they are looking to expand down the road, when Tomasini knows their ESOP status will make them an attractive option to retiring hardware retailers who might be struggling to find the right buyer.

REWARDING LONG-TIME EMPLOYEES

G.W. Smith Lumber Company in Lexington, N.C., was founded in 1905 by Griff and Nora Smith, who delivered lumber loads by horse and wagon. Steve Smith, one of four third-generation brothers to own the business, served as president from 1977 until his son Mark took over in 2010.

This century-old lumber company is now in the fourth generation of family ownership, but employees joined the ownership group in 1985. That year an ESOP was formed to reward long-time employees and help them set aside money for retirement.

Says Steve Smith, "It was a good way to bring employees into the business and buy out two brothers (R.B. and Dan) from their ownership shares. We think of our employees like family here."

He adds, "Every year we pay out a dividend, which represents about a 10 percent increase for employees. It operates like a 401k plan. They can't get the money until retirement. Employees own about 20 percent of the business now. It's been a really good thing for everyone."

Smith explains that the ESOP has its own board of trustees. "The ESOP has money invested in other things, so it's not as much at risk," he points out. "We felt it was important to diversify so that our employee-owners are not held up by the value of the company." ■