EXPLAINING EMPLOYEE OWNERSHIP: A COMBINED STAKEHOLDER – RESOURCE-BASED VIEW

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Our last paper hypothesized that ESOPs have the potential to foster and nurture strategy-appropriate culture. ESOPs by themselves are not sufficient to enhance firm performance.
Role of Strategy

Direct Causation

Performance
Strategy-Appropriate Culture

- Strategy
- Strategic Choice
- Direct Causation
- Performance

Moderates effect of strategy on performance

ESOP
Success

• Success is a function of how an ESOP helps management solve the problems of resource dependence and stakeholder management.
Companies compete in three (3) markets:

- Labor
- Capital
- Product
Employees and Investors provide resources that are used to serve Customers. Company must compete effectively in all three markets.
Different constituencies within an organization are responsible for managing resources.

If a resource is difficult to obtain, its constituency can dominate the organization.

Management endeavors to keep the three constituencies in balance.
External forces determine which internal constituency has power.

Power is determined by what the organization most needs to survive—hence, “resource dependence.”
Dependence-Capital

- Reliance on external funds for growth
- Investors' demands impose constraints
- Management loses control
Resource Dependence - Labor

Reliance on mobile workers
Resource Dependence-Product

• Reliance on a single industry or product

• Requires a growth rate as least as great as the industry to survive
Management must keep these three constituencies in balance or it does not achieve its strategic goals.
Management’s Goals

• Growth rate (high vs. low)
• Target Return on Net Assets
• Independence
  • Financial
  • Managerial

Management’s Challenges

• Sustainable growth
• Reduce dependence
• Balance competing constituents’ demands for funds
\[ g(S) = g(NA) = r \ [ RONA + d \ (RONA - i) ] \]

What are the constraints on growth?

- \( g(S) \): Growth rate in sales
- \( g(NA) \): Growth rate in net assets
- \( RONA \): Return on net assets (ROE)
- \( r \): Earnings retention ratio
- \( d \): Debt / Equity ratio
- \( RONA - i \): After tax cost of debt

How can management keep these in balance?
\[ g(S) = g(NA) = r \ [\text{RONA} + d \ (\text{RONA} - i)] \]

Alter balance by adjusting:

**Return on Net Assets**
- High-risk, high-return investments can boost return

**“r” Rate of Earnings Retention**
- Decreases dividends to investors, i.e., increasing retained earnings and funds for growth or funds for employees’ QWL

**“d” Debt / Equity Ratio**
- Increases RONA; but such leverage increases financial risk
\[ g(S) = g(NA) = r \left[ RONA + d \left( RONA - i \right) \right] \]

Bottom Line:

Funds are limited

3 Internal constituencies compete for funds

Companies do better when demand and supply of funds are in balance
"Organization" Constituency

Demands quality of work

Career opportunity

Interesting work
External Stakeholders (Constituencies)

Production Constituency

Demands funds for growth
Finance Constituency

• Demands lower retained earnings and higher dividends when company relies on external funds for growth
Ideal Balance

- Internal source of funds for growth
- Loyal, immobile workforce
- Diversified product
Warning: Controversial Propositions.

Proposition P1: All else being equal, an ESOP firm with a diversified product line is more likely to perform better than an ESOP firm with a single product line (4 > 3).

Proposition P2: All else being equal, an ESOP firm with a diversified product line is more likely to perform better than non-ESOP firms whether diversified or non-diversified.

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<th>ESOP</th>
<th>Non-ESOP</th>
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<tr>
<td>Diversified</td>
<td>4</td>
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<tr>
<td>Non-Diversified</td>
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**Proposition L1:** All else being equal, an ESOP firm competing in a market characterized by low labor mobility is more likely to perform better than an ESOP company competing in a high-mobility labor market (4>3).

**Proposition L2:** All else being equal, an ESOP firm competing in a market characterized by low labor mobility is likely to perform better than a non-ESOP firm regardless of the mobility in its labor market (4>2; 4>1).

<table>
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<tr>
<th>Mobility Level</th>
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<th>Non-ESOP</th>
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<tr>
<td>Low Mobility</td>
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<td>High Mobility</td>
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Proposition C1: All else being equal, an ESOP firm that is non-dependent on the capital market is more likely to perform better than an ESOP that is partly dependent upon the capital market (4>3). 

Proposition C2: All else being equal, an ESOP firm that is non-dependent upon the external capital market is more likely to perform better than non-ESOP firms whether dependent or independent (4>2; 4>1).
**Proposition C3:** All else being equal, an ESOP that is partly dependent upon external capital markets is more likely to perform better than a non-ESOP company regardless of the financial dependence or independence. (3>2; 3>1).

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1. The extent to which an ESOP company’s supply of funds (RONA) is sufficient to satisfy demand for funds (target growth rate) is positively correlated with its probability of survival.
The extent to which an ESOP company is able to generate funds internally is positively correlated with its probability of survival, *ceteris paribus*. 

**Warning:** Controversial Propositions!
ESOP companies with a diversified product line are more likely to survive than undiversified ESOP companies, *ceteris paribus*. 