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Default Rates on Leveraged ESOPs, 2009-2013
Summary

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Based on an analysis of 1,232 leveraged ESOP transactions at three large banks, 1.3% of ESOP companies in the sample defaulted on their loans in a way that imposed losses on their creditors for loans in effect between 2009 and 2013 (or an annual rate of 0.2%). The defaults accounted for 1.5% of the total value of the ESOP loan portfolio for these companies during this period. The bank data were only available for defaults imposing losses; the data presented here do not include defaults that resulted in loan restructuring where the loans were ultimately repaid or were being paid on the new schedule.

In a parallel analysis, the NCEO also asked ESOP appraisal firms to provide us data on defaults that imposed losses on their creditors among the ESOP companies whose stock they appraised between 2009 and 2013. Eighteen firms responded out of the 40 ESOP appraisal firms we asked to provide data. The firms were selected because they were members of the NCEO's directory of service providers. Previous NCEO data indicated that directory members account for about half of all the ESOP appraisals. The eighteen responding firms were able to report data on 845 companies over the study period. Of these, 9 (1.1%, or an annual rate of 0.2%) defaulted in a way that imposed losses on their creditors, while 26 (3.1%, or an annual rate of 0.6%) had to restructure their loans but had repaid or were repaying their loans currently.

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Comparison Data

These default rates seem strikingly low given the economic turmoil of 2008-2011, a period that overlaps and immediately precedes the data represented here. It is difficult to make valid comparisons to data for defaults on leveraged buyouts of non-ESOP companies. The best available comparison data comes from S&P's IQ Credit Pro report on default rates for mid-market companies borrowing less than $200 million. ESOPs would all be in this range, although the median ESOP loan would no doubt still be much smaller than the median for the S&P sample (data for smaller loans is not available). These loans defaulted at 3.75% per year from 2010 to 2013 and 1.99% for the period 2003 to 2013. Defaults here are defined as those imposing losses on creditors. However, the definition of default for these data is "the failure to promptly pay interest or principal when due. Default occurs when a debtor is unable to meet the legal obligation of debt repayment. Borrowers may default when they are unable to make the required payment or are unwilling to honor the debt." This is a somewhat broader definition than ours, which simply asks if the default imposes losses on creditors.

Reliability

The convergence of the default data from the banks and from the appraisers provides more confidence in the result than would be the case if the two sources were significantly different. Of course, there is overlap in the samples in that some of the companies in the bank sample would be clients of the appraisers.

The convergence is further supported by earlier work. In 2010 the NCEO asked major ESOP providers (lawyers, plan administrators, and two major banks) to estimate the percentage of their clients that had defaulted on their ESOP loans in the 2009-2010 period and in all prior years. The twenty-seven providers that responded represented a few thousand ESOP companies. For the 2009-2010 period, they reported that the defaults typically ranged between 1% and 2% for the responding providers, but some providers reported no defaults and one reported that 15% had defaulted. For the prior period, they reported lower ESOP default rates. In aggregate, their results suggest annual default rates under 0.3%, and one large plan administration firm that did a careful analysis reported a default rate of 0.13% annually. This work has substantial limitations: each responded provided estimates rather than actual numbers, and the number of total number of ESOP transactions represented was not available.

Estimating the default rates on ESOP loans is essential to evaluating two of the most common criticisms of ESOPs, namely

- That they are excessively risky
- That appraisals tend to be too aggressive, causing ESOPs to overpay for the shares

Both criticisms suggest that the default rates on ESOP loans should be high, which does not seem to be the case with the loans included in this sample.