

EMPLOYEE OWNERSHIP IN PRIVATE CREDIT

A two-part publication



RESEARCH BRIEF

Asset Allocation for Employee Ownership Funds

The Case for Private Credit for EO Mezzanine Debt Funds

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AUTHORS:

Ishita Shah and Julie Menter, Transform Finance

Alison Lingane, Ownership Capital Lab

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Authors note

At [Transform Finance](#) and [Ownership Capital Lab](#), we are working to help employee ownership financing reach greater scale. As the market grows, one obstacle has surfaced repeatedly in our conversations with asset allocators: Where does this fit in my portfolio? We heard the same challenge from EO fund managers and other field leaders, who see investors get stuck on this question before they can get to evaluating the fund itself.

Asset class classification may seem like a technical question, but it has practical consequences: it determines which investment team evaluates an opportunity, what benchmarks and diligence frameworks are applied, and ultimately whether an EO fund gets a serious look. These publications grew out of a shared conviction that the field needs a clearer answer.

Our research focuses specifically on market-rate EO funds providing subordinated mezzanine debt to ESOP (Employee Stock Ownership Plan) transactions. Our conclusion is straightforward: based on transaction structure and supported by the strategies' return, risk, and liquidity characteristics, these funds are best understood and evaluated as private credit.

We hope these publications help move the conversation forward, and we welcome your questions, reactions, and perspectives as the field continues to evolve.

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The views expressed in this document are those of the authors and do not necessarily reflect the individual views of those listed above or their organizations.

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About this research brief

This publication is one of two companion pieces on employee ownership and private credit. This research brief analyzes how to allocate ESOP mezzanine debt funds in a portfolio. The companion communication guide — [Employee Ownership in Private Credit: A Communication Guide for Asset Allocators and EO Fund Managers](#) — translates those findings for asset allocators and EO fund managers. The two pieces are designed to be used together, though each can stand alone.



This research brief makes the case that employee ownership funds providing subordinated mezzanine debt to ESOP transactions and seeking market-rate returns belong in private credit allocations. Drawing on structured interviews with eleven asset allocators and advisors, and a thorough review by three experts, it examines these EO funds across the four dimensions allocators use to classify private-market strategies: transaction structure, return profile, risk, and liquidity. It finds that mezzanine EO funds are credit strategies at the transaction level, with an emerging track record showing returns consistent with the upper end of private credit; underlying investments in established, cash-flowing businesses with characteristics that can mitigate credit risk, alongside a capital-stack structure that warrants careful underwriting; and closed-ended fund structures consistent with the mainstream of the private credit asset class.

Why Employee Ownership Matters for Investors

Employee ownership (EO) is having a moment. Across the United States, and beyond, investors, policy makers, and the general public, are realizing that giving employees a stake in their place of work is a powerful solution for business, for workers, and for local economies. Research shows, companies with broad-based employee ownership are more productive, perform better financially, retain workers longer, and weather downturns more resiliently than conventionally owned peers.¹ They generate higher wages and build meaningful wealth for workers.

EO also represents a compelling investment. In the United States, 1.2 million companies employing 58 million people — about a third of the civilian labor force — are potential candidates to transition to employee ownership as their current owners retire. Financing those transitions represents an investment opportunity on the order of \$1 trillion. Unfortunately, the capital positioned to address this opportunity — from bank lending to specialized EO funds — represents only a fraction of that total. Specialized EO funds manage \$865 million, and banks provide billions of dollars in senior debt. All told, the capital available today is a tiny fraction of the potential that could be productively deployed.

At Transform Finance and Ownership Capital Lab, we are proud to contribute to the growth of capital available for EO transactions, and recognize there is much more to do.



¹ For specific data on performance of employee owned firms, and their impact on workers, consult [NCEO summary research findings](#), Project Equity "[The Case For Employee Ownership](#)", and Rutgers University [Employee Ownership Applied Research Lab Resource Library](#).

A Practical Barrier: Asset Class Classification

While employee ownership financing has grown significantly over the past few years, fundraising for EO funds continues to face some significant obstacles. **One under-appreciated reason for the growing number of EO mezzanine debt funds is mundane but consequential: asset owners and their advisors often struggle to determine which asset class these funds belong in.** Asset class drives everything that comes next, such as what peers a fund is compared to, what return and risk thresholds it must clear, liquidity expectations, and who in the investment team owns the diligence. Venture capital funds, for example, are highly standardized; an allocator can place a VC fund in an asset class instantly. EO mezzanine debt funds are not yet standardized in that way, so they face added friction before their team, track record, and strategy is even considered.

Our goals with this brief are practical: to help asset owners make consistent, well-grounded allocation and benchmarking decisions, and to help fund managers anticipate how their strategies will be evaluated. **This brief makes the case that, for "market-rate" EO mezzanine debt funds, the best home in most asset allocation frameworks is private credit (also called private debt).²**

A few caveats are worth stating up front. This brief focuses on specialized EO mezzanine debt funds seeking market rate returns in the United States, which today are largely debt providers for Employee Stock Ownership Plan (ESOP) transactions. This analysis does not mean to imply that EO investing overall is an asset class; it's a strategy that can be applied across a wide range of asset classes. In addition, the analysis here will not apply to every fund, given the diversity of investment approaches that currently exist in this marketplace. Finally, this brief is not meant as investment advice, instead it's a research summary to help inform asset allocator's own diligence.

² We use "market rate" in quotation marks purposefully. The standard "market rate" of return is an average of performance across investments structured around an economic model that externalizes social and environmental costs. In addition, given the lower default rates and operational stability of employee-owned companies, we argue that EO investments warrant a market rate calibrated to their actual (not perceived) risk profile.



Methodology

This brief draws on 11 structured interviews with asset allocators and advisors, many more informal conversations, detailed feedback from three specialist reviewers, the authors' own experiences working with EO fund managers and asset owners, and prior research from Transform Finance and Ownership Capital Lab. A list of interviewees appears in the acknowledgments.³

A note on private credit as an asset class

Private credit (also called private debt) refers to debt financing provided by non-bank lenders typically to private companies in the middle and lower middle market. The asset class has grown rapidly over the past two decades, to reach \$2.6 trillion in global assets under management at the end of 2024, and includes senior secured loans, junior debt, distressed debt, and specialty finance strategies.⁴ Returns typically come from interest payments as well as upside from warrants and equity participation.

³ The interviewees listed in the front of the publication were investment leaders at foundations, family offices, and investing advisory firms representative of the types of investors active in EO at the time of publication.

⁴ Estimates vary by scope and methodology, ranging from ~\$1.6T ([Cambridge Associates](#), narrower corporate scope) to ~\$3.5T ([AIMA's Alternative Credit Council](#), broadest definition). We chose Pitchbook's [Global Private Debt Report](#) datapoint of \$2.6T global AUM.

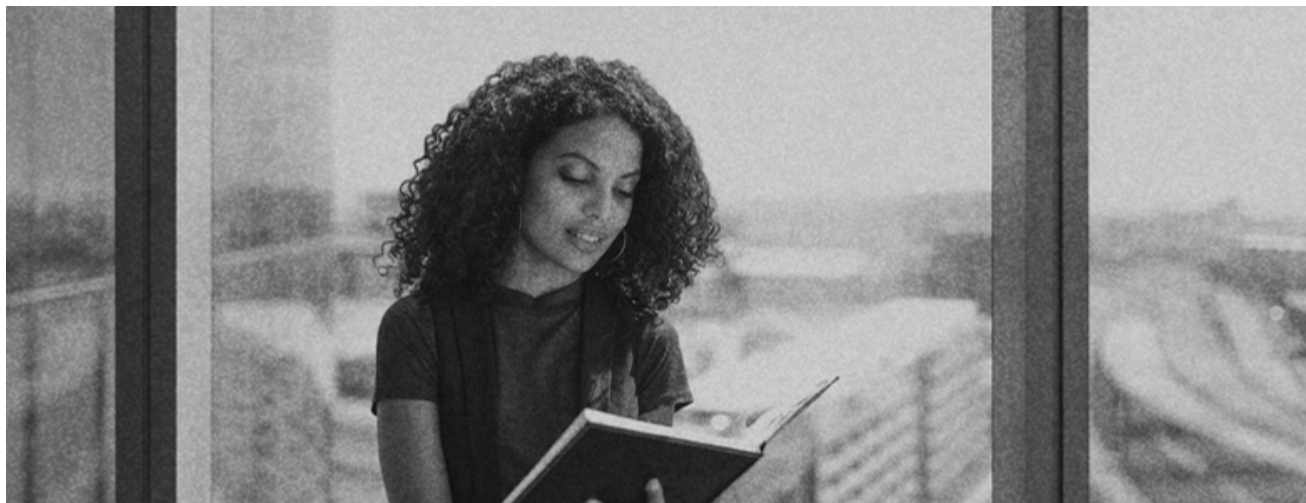
The Mechanics of an EO Fund

EO funds today pursue a range of strategies — ESOP conversions, worker cooperatives, Employee Ownership Trusts, partial broad-based employee equity allocation, or EO combined with other impact themes such as real estate or regional lending. This diversity — some are EO-exclusive; others are multi-strategy funds where EO is one of several investment approaches — creates its own classification challenges. **The analysis below focuses on the most common market-rate strategy in the U.S.: funds providing subordinated debt to ESOP transactions, a strategy being pursued by a growing number of funds.**

In a leveraged ESOP transaction, the company borrows money to purchase the departing owner's shares, and repays that debt out of operating cash flows over time. Employees receive shares in the company (via the ESOP trust) at no out-of-pocket cost, then cash out when they retire or leave the company.

The longstanding and well-established ESOP financing model historically combines senior debt from a bank (typically lending only up to 3x EBITDA) with seller financing from the departing owner (frequently 50-70% or more of the sale price), with the seller note payback starting only after the senior bank loan is paid. Many sellers are unwilling or unable to significantly postpone their ability to cash out from their business, which may be their only retirement nest egg. The emerging model that EO funds have pioneered replaces a significant portion of the seller note with subordinated mezzanine debt, which sits between the bank senior debt and the smaller seller note in the capital stack, and is repaid from the company's cash flows. Warrants are typically added to these transactions to provide meaningful upside returns if the company performs well.

Two structural features distinguish ESOP transactions from conventional leveraged buyouts. First, there is typically no equity sponsor below the debt: the equity is held by the ESOP trust on behalf of employees. Second, the target companies are established, cash-flowing businesses able to support a debt-funded transition, with valuation multiples typically in the 4–6x EBITDA range in the lower middle market.



How Allocators Classify Private-Market Funds

For most institutional investors, intermediaries, and advisors, asset allocation is a central organizing principle. Portfolios are typically divided between public and private markets, with private markets further segmented into venture capital, private equity, real assets, and private credit. When allocators decide where a fund fits, they consider four dimensions:

1. Transaction Structure — what the fund actually does with capital.
2. Return — gross and net IRR, and the pattern of distributions.
3. Risk — capital stack position and asset-level risk.
4. Liquidity — fund tenor, lockup, and any redemption features.

Different allocators weigh these dimensions differently: some prioritize transaction structure, others lead with returns or liquidity. That said, across our interviews, transaction structure tended to anchor the initial classification decision; the other dimensions added nuance but rarely reversed the decision.

An important caveat: some allocators do not apply asset allocation rigidly. Investors with strong impact mandates, philanthropic vehicles, and family offices often prioritize thematic alignment over strict classification. The rest of this brief speaks to the majority case where asset class allocation is necessary.

Examining EO Funds Across the Four Dimensions

Each of the four dimensions describes where EO mezzanine debt funds align with private credit and where they are more similar to private equity.



1. Transaction Structure

On the transaction dimension, EO funds are unambiguously credit strategies. Fund managers provide loans to finance an ownership transition; their position in the capital stack is debt, not equity. This structure is consistent with mainstream definitions of mezzanine private credit.⁵ Across our interviews, this is the dimension allocators returned to most consistently when initially placing these EO funds, and the most fundamental anchor for classification: what is the capital actually doing?

One nuance is that EO fund managers are typically more involved post-transaction than a typical mezzanine debt provider — for example, many work actively with portfolio companies on building ownership culture practices that drive productivity gains that support repayment, and to increase the company value that determines warrant payouts. In a conventional sponsor-backed private credit deal, that work would be handled by the private equity sponsor; in an ESOP transaction, the EO fund manager may fill elements of that role directly.

⁵ "Mezzanine debt is a type of subordinated debt with embedded equity instruments attached. Those instruments are called warrants, which are equity participation rights. Embedded equity with the debt can also include call options and rights." Pitchbook, [What is mezzanine debt?](#)



2. Return

ESOP fund net internal rates of return (IRR) typically target the 10–15% range, overlapping with both upper-end private credit and the lower end of private equity, and allocators sometimes describe them as "credit-plus" or "equity-like returns with contractual structures."

EO fund returns combine two streams: regular interest payments on the subordinated debt, and a more back-ended payout from the warrants attached to the deal. This combination is characteristic of mezzanine private credit, where equity kickers such as warrants can supplement contractual interest and contribute to higher total-return potential. The warrants typically pay out later in the deal — triggered by loan maturity, refinancing, recapitalization, or a liquidity event, with timing varying by structure.⁶ Either way, the warrant component is back-ended relative to the interest payments, which makes the underlying transaction's return profile over time less smooth than an income-oriented private credit strategy. Principal repayment velocity is also slower, since subordinated principal is often paid down after senior bank debt on relatively back-loaded schedules; which affects gross IRR, cash recyclability, and reinvestment risk. **As a result, some allocators perceive EO funds as less "income-generating" than traditional private credit, even when overall return targets are comparable.**

⁶ Warrant payouts are back-ended, with timing determined by the specific loan agreement. In bank-financed transactions where warrants are attached to seller notes, redemption typically cannot occur until the seller financing is fully repaid. In private credit mezzanine structures, warrant redemption terms are negotiated directly and may be triggered by loan maturity, refinancing, recapitalization, or a liquidity event — often years into the fund's life. In unitranche structures where the EO fund controls multiple tranches, terms may be structured differently. Across all structures, the warrant component makes the overall return profile less smooth than a pure income strategy.

3. Risk

On the positive side, there are considerable risk mitigation factors in EO transactions.

Funds typically invest in established, cash-flowing companies in stable sectors and geographies providing materially lower underlying-asset risk than venture or growth equity. ESOP companies have historically demonstrated meaningfully low default rates on bank senior debt (under 0.3% annually) relative to non-EO businesses, and broad-based employee ownership has been demonstrated to boost productivity and resilience. Valuation multiples are typically 4-6x EBITDA which reduces the repayment burden, and in ESOP transactions, an ESOP trustee is responsible for ensuring the company is fairly valued, which limits the risk of over-valuation. Finally, and importantly, 100% S-Corp ESOPs pay no federal income tax, and no state income tax in nearly all states — meaningfully increasing the free cash flow available to service debt relative to a conventionally-owned company at the same leverage multiple, and supporting their strong debt payment track record.

The main driver of risk is the absence of an equity cushion below the debt. In a traditional sponsor-backed deal, equity capital absorbs first losses; in an ESOP transaction, mezzanine capital sits closer to the bottom of the capital stack, with a seller note — typically representing 10–20% of the deal — serving as the primary first-loss position, and no equity sponsor below it. Change of control can also be a concern: ESOP transactions typically occur when a founder or owner is looking to retire, meaning they may coincide with leadership transition and the operational risks that brings. That said, the seller note keeps the departing owner financially attached to the transition, creating incentive alignment for a clean management handoff. In addition, EO fund managers typically hold one or more board seats until their loan is repaid, providing active oversight during precisely this transition period — which meaningfully offsets the risk but only if the manager has the right skills, builds effective oversight and monitoring capacity, and establishes productive relationships with the management team.

On balance, our interviewees view this strategy as carrying similar or lower risk than conventional private credit.



4. Liquidity

On liquidity, the fund structure of EO funds is more conventional than it may initially appear. A common misconception is that private credit strategies typically offer periodic redemption windows or shorter-duration vehicles. In practice, 80% of global private credit committed capital is held in closed-ended fund structures with no investor redemption rights.⁷ EO funds' 10-year lockups and absence of redemption features are squarely within the mainstream of the asset class and are a natural container for their repayment profile. Allocators benefit from distinguishing between two separate questions: fund-level liquidity and underlying asset liquidity. At the fund level, EO funds offer low liquidity — closed-ended, no redemptions, approximately 10-year term — which is also a driver of risk. At the underlying asset level, the picture is more nuanced: ESOP debt repayment depends on the capital stack and loan terms (which can vary by fund). The long fund term reflects the potential multi-year maturity of the underlying loans and the back-ended nature of warrant payouts. EO funds are structured to match their assets' repayment profile.

Allocators whose frameworks require shorter-duration or semi-liquid private credit vehicles will find these types of EO funds are not a fit for that specific sleeve. Those allocating to closed-ended, longer-duration private credit — which represents the large majority of the asset class — will find the structure familiar.

⁷ The 20% of private credit assets that do offer some degree of liquidity are mostly held in semi-liquid structures with limited redemption rights, which employ liquidity management tools to ensure the liquidity available to investors is consistent with the underlying asset profile.

EMPLOYEE OWNERSHIP IN PRIVATE CREDIT

The table below summarizes how EO funds compare to typical private credit on each dimension.

Characteristic	Private Credit	EO Mezzanine Debt Funds
Transaction	Senior, subordinated, mezzanine debt, or unitranche to private companies	Unitranche or mezzanine debt to ESOP transactions — a credit strategy
Return target	Varies by strategy; mezzanine strategies typically target 8-13% net IRR ⁸	10–15% net IRR
Return pattern	Interest income; some back-ended upside in mezzanine strategies	Interest income and back-ended warrant payouts; less income-oriented than senior debt strategies
Capital stack	Equity cushion below the debt from a PE sponsor	No equity sponsor (equity held by ESOP trust); seller note typically provides 10–20% first-loss position
Underlying investments	Range; often in private equity-controlled companies	Established, cash-flowing businesses in stable sectors; conservative valuation multiples (~4–6x EBITDA)

⁸Net IRR range for mezzanine debt in Fig 3. of [Private Credit Strategies: An Introduction](#), Cambridge Associates, May 2024.

Characteristic	Private Credit	EO Mezzanine Debt Funds
Lockup	7–10 years (closed-ended); shorter for semi-liquid vehicles	~10 years; closed-ended; no redemptions. Reflects underlying loan repayment profile.
Periodic redemptions	80% of private credit capital is in closed-ended structures with no redemption rights; some semi-liquid vehicles offer limited quarterly redemptions	No redemption features
Distribution profile	Variable; periodic interest income common, with back-ended upside on exit	Variable; periodic interest income with warrant proceeds generally realized later in the investment
Manager involvement post-close	Limited	Active engagement on ownership culture and governance; takes on elements of the role typically played by private equity sponsor
Market maturity	Mature, ~\$2.6T globally ⁹	Emerging; growing fund universe with meaningful early track records

⁹Estimates vary by scope and methodology, ranging from ~\$1.6T ([Cambridge Associates](#), narrower corporate scope) to ~\$3.5T ([AIMA's Alternative Credit Council](#), broadest definition). We chose Pitchbook's [Global Private Debt Report](#) datapoint of \$2.6T global AUM.



EO Mezzanine Funds Are Best Fit For Private Credit Allocation

Across the four dimensions, transaction structure is the strongest component of the analysis — and on transaction structure, EO mezzanine debt funds are most aligned to private credit classification strategies. Returns are consistent with the upper end of private credit. Underlying-asset risk is moderated by investment in established, cash-flowing companies, typically acquired at relatively modest valuation multiples. However, the seller note beneath the mezzanine debt remains a debt obligation and is generally smaller than the equity cushion found in traditional private credit transactions, making disciplined underwriting and the fund manager's experience particularly important. Liquidity at the fund level may look unfamiliar to allocators used to semi-liquid, redemption-oriented private credit, but is consistent with the closed-ended structures that represent the majority of the asset class and follows naturally from the asset's repayment profile. On balance, based on our research, we believe EO mezzanine debt funds seeking market-rate returns are consistent with private credit allocations.

A few qualifications are worth keeping in view. Not every EO fund or investment platform follows the mezzanine-debt-with-warrants structure that anchors the analysis here and may raise different classification questions that warrant separate analysis. And multi-strategy funds, including those combining EO with cooperative finance, real estate, sector-specific lending, or partial broad-based employee equity, face their own classification challenges and often require case-by-case evaluation that does not fit any single bucket.

Considerations for asset owners and advisors

► **Anchor classification in the underlying transaction.** Once the debt structure establishes EO funds as credit strategies, the structural differences from typical private credit —lockup length, warrant returns, post-close manager skillset and involvement — can be evaluated as second-order details rather than classification questions.

► **Benchmark against mezzanine private credit.** Returns of 10–15% net IRR are competitive within the mezzanine private credit peer set.

► **Understand the liquidity structure before evaluating it.** EO funds are closed-ended vehicles. They are longer-dated and less income-oriented than senior private credit strategies, and are not redemption vehicles.

► **Account for the capital stack carefully.** The absence of a traditional equity sponsor below the debt is a real structural difference; a seller note typically provides a first-loss position, but it is thinner than the equity cushions allocators encounter in sponsor-backed deals. The risk is real, but partly offset by underlying business stability, conservative valuation multiples, and the historical low default profile of ESOP companies.



Considerations for EO fund managers

► **Lead with the transaction.** Make the credit nature of the strategy concrete from the first conversation — what the capital is doing, where the fund sits in the capital stack, and how returns are generated — before introducing the employee ownership context.

► **Anticipate the predictable questions and answer them as a unit.** Lockup length, capital stack, post-close involvement, risk monitoring, and distribution profile come up consistently — be ready to paint a full picture rather than answer in pieces.

► **Address the private credit headwinds question directly.** Allocators aware of stress in sponsor-backed direct lending will ask whether those concerns apply. Be ready to distinguish EO mezzanine's borrower profile, leverage levels, and fund structure from the parts of private credit experiencing difficulty. This is also an opportunity to highlight your experience over different market cycles and the risk management frameworks you have in place to stay ahead of potential challenges.

► **Know your allocator type before the meeting.** The framing that works for a traditional institutional, more mainstream investor differs from what works for an impact-oriented foundation or an advisor without a private credit bucket. The same underlying argument requires different entry points for different audiences.

For a more in-depth set of recommendations, consult our companion piece: [Employee Ownership In Private Credit, A communication guide for asset allocators and EO fund managers.](#)

It translates the research findings into practical language and frameworks for two audiences:

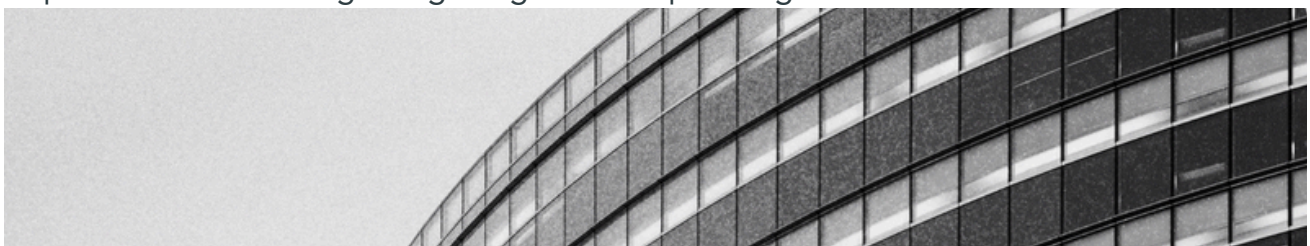
- 1) asset allocators and their advisors working through a classification or diligence process, and
- 2) EO fund managers preparing for those conversations.

Scaling EO financing without losing the point

Placing ESOP mezzanine debt funds into private credit allocations is a prerequisite for the field's growth — but it is one piece of a larger agenda. The EO capital market is still relatively new, and many allocators are encountering EO investments for the first time. The broader work of building the field — mobilizing investment, powering the narrative, deepening infrastructure, and advancing policy — is outlined in the [EO Capital Roadmap](#) stewarded by Ownership Capital Lab.

There is a tension worth naming as the field grows. Fitting EO into private credit frameworks brings comparability, and access to a much larger capital base, but it also creates pressure to conform to conventional private credit on every dimension — shorter lockups, more income orientation, less post-close engagement. Some of those adaptations may be appropriate as the market matures. Others would erode what makes EO distinctive: broad-based rather than concentrated ownership, governance that gives workers real voice, and an economic model designed to build wealth for the people who create it. **The point of growing EO within this asset class is not to replicate private markets under a different label. It is to build a meaningful alternative that benefits workers, businesses, investors, and local economies— and that remains recognizably itself as it scales.**

Asset owners, advisors, and fund managers each have a role in this: classifying EO funds where they belong, benchmarking them against credible peers, and holding the line on the impact features that make the strategy worth scaling. At the time of publication, Transform Finance is facilitating the development of a field-wide impact measurement framework for EO investing to support this work. For investors who are able to, capitalizing impact-first funds is also critical. The workers whose wellbeing depends on this field getting it right are depending on all three.



About Transform Finance

Transform Finance is a research, education, and implementation partner that supports all stakeholders to challenge legacy investment approaches and seed transformative investment models. We develop insights on innovative strategies that shift wealth, power, and risk; inform investors through online resources, public events, communications, and narrative building; and support action through direct investor support, strategic partnerships, and building field infrastructure. We have built a body of research and resources on Employee Ownership investing, including a database of funds and a series of investor briefings, available on our [learning hub](#).

About Ownership Capital Lab

Ownership Capital Lab is a market-shaping platform focused on building the financial infrastructure needed to scale employee ownership investing — across the full spectrum from catalytic and impact-first capital to market-rate private credit strategies. The Lab works across field-building, capital mobilization, product innovation and ecosystem convening — connecting investors, funds and opportunities to enable a step-change in the scale and quality of employee ownership in America. Learn more at ownershipcapitallab.capital.



Photo by Tristan Ruark