THINCATS

EMPLOYEE OWNERSHIP TRUST

YOUR GUIDE TO EMPLOYEE OWNERSHIP

Is an employee ownership trust (EOT) the right exit strategy for your business?

The growing popularity of EOTs

For the founder of a company, handing over the reins can be one of the most difficult things to do. They have spent years building up a business and a trusted brand, they may know every individual employee, and they know what they want for the future of the company. Once they have decided to sell, business owners have a range of succession planning options available to them, each with different tax and commercial implications. Management buy-outs (MBOs) are challenging without a proven leadership team while third-party sales may not appeal to a vendor who wants to safeguard the core values and identity of their firm going forward. Most will also want to reward and protect the staff who have been instrumental in creating them. Employee ownership can be the answer to many of these succession stumbling blocks.

Thousands of SMEs and family-run businesses will have founders who are looking to exit their business or change its ownership in the next five years, according to the sector's representative body, the Employee Ownership Association (EOA). "Employee ownership offers a flexible way of transferring ownership either wholly, or in part, to the employees, with clear benefits of more engaged employees empowered through a stake and a say to drive increased performance and deliver better impacts," says James de le Vingne, chief executive of the EOA.

The Employee Ownership Trust (EOT) enables a company to become owned by its employees via a trust. EOTs hold a controlling stake in the underlying firm and, as a legal requirement, must benefit all employees on an equal basis (see Qualifying Conditions section below).

THE OVERALL EO SECTOR HAS DOUBLED SINCE 2020.

Since the UK government introduced the EOT scheme in 2014, growth in employee ownership (EO) has accelerated in the UK, particularly over the past few years. Although it is still relatively small, at an estimated 1030 businesses, the overall EO sector has doubled since 2020. In 2021, a further 210 owners transitioned their businesses using the EOT model, according to figures released by EOT specialist adviser RM2. This brings the total number of EOT-owned businesses to 700 – versus only 220 in 2018 – with many more in the pipeline.

As most will be aware, the John Lewis Partnership was one of the pioneers of the structure. Professional services businesses and manufacturing made up the majority of the sector in the first few years following the legislation, but it is now attracting a much broader spectrum of companies. High-profile examples include outdoor adventure company Go Ape, which sold 90% of its shares into an EOT in October 2021 (the remaining 10% of the business being retained by the co-founders). Perhaps one of the clearest example of how the EOT model can safeguard the business ethos, creative values and independence of a company while also rewarding those who helped create its success can be seen in Aardman, the UK's biggest animation production company and creators of Wallace and Gromit. It became an employee-owned business in 2018. On selling 75% of the business to employees, the founders described it as a 'continuity deal' and an effort to avoid its future sale to a major studio.

Today, EOTs count for one in every 20 private company sales in the UK. But this figure could be much higher, says Chris Budd, owner of The Eternal Business consultancy, which helps companies making the transition to EOT. This is because it is not always in the best interest of the people who advise business owners on their sales to suggest the EOT as a path to exit. "There is no purchaser to negotiate with, so business brokers and corporate finance advisers don't always have much of a role to play. I have even heard from some owners who have been inaccurately advised that the EOT is not right for their firm, or that they won't achieve a fair value by going down this route."

RESEARCH SUGGESTS THAT EMPLOYEE OWNERSHIP BOOSTS PRODUCTIVITY, IMPROVES EMPLOYEE RETENTION, AND STRENGTHENS THE PERFORMANCE OF A COMPANY OVER THE LONG TERM.

There are significant advantages to EOTs. Research suggests that employee ownership boosts productivity, improves employee retention, and strengthens the performance of a company over the long term.

By spending time on the cultural transition to employee ownership, the existing owner can both recognise the contribution of their workforce, and retain the culture and traditions of the business, built up over the years. Selling to an EOT for the benefit of your employees can be a more straightforward transaction than a trade sale, PE acquisition, or MBO, given that the parties all know each other and the business.

The structure is attractive for all regions and sectors, says de le Vingne, although recent growth has centred around professional services, with a high concentration in construction. Information and communications, wholesale and retail, and manufacturing are also prominent. "Businesses are increasingly choosing the EOT route because it offers a sustainable succession opportunity that rewards the hard work of those who helped build the business while also offering a legacy for future generations."

"It works for anybody that wants to see their business continue, look after their employees, and get a fair market value for the business," agrees Budd.

Moreover, renewing employee engagement and commitment is high on the agenda for many businesses in the current climate, especially for those that have struggled during the pandemic or that have seen staff motivation drop due to prolonged furlough or work-from-home schemes.

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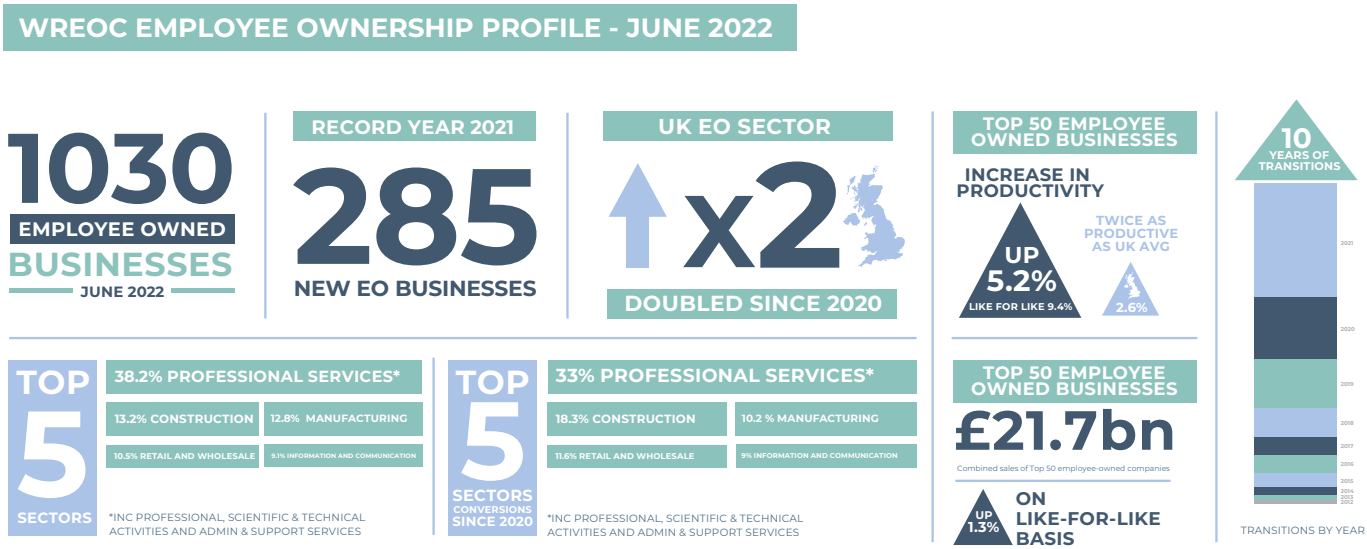
Employee Ownership in the UK - key facts and figures



Credit: RM2

Who can benefit?

The EOT structure is suitable for any business size or sector. It is popular among professional services firms, such as architects and financial advice companies because they tend to be purposeful businesses where the owners want to see the business continue beyond them. But it is equally applicable to engineering companies, childcare facilities and so on.

There are four key areas in which EOTs can provide a positive solution. These are:

- **Succession planning**

  The most typical route to employee ownership is from private owners – an individual entrepreneur or family business. Yet, as mentioned above, studies have shown that many family-owned businesses and SMEs do not have a succession plan. This lack of planning sometimes results in a distressed succession caused by illness or financial pressure. Transitioning to employee ownership via an EOT, however, provides the opportunity to plan for the succession and should be considered alongside other succession options such as MBOs and trade sales.

- **Growth planning**

  As explained above, employee ownership and the employee engagement inherent in it drive performance benefits. Employee ownership structures engage employees in a more meaningful way - they are more likely to willingly give discretionary effort as an integral part of their daily activity at work and this often results in increased efficiency and lower costs, in turn driving growth. Planning for the long term can also be easier because the structures are independent of external stakeholders, who may be looking for short-term rewards.

- **Start-ups**

  Historically, there has been a perception that this isn't a relevant area for employee ownership, especially for those companies with only a small number of employees. However, this model can be very attractive to entrepreneurs who want to share the risk and reward. "A question that often arises is what is the minimum size for an EOT to be effective? As a rule of thumb, we advise 10 employees," says Budd.

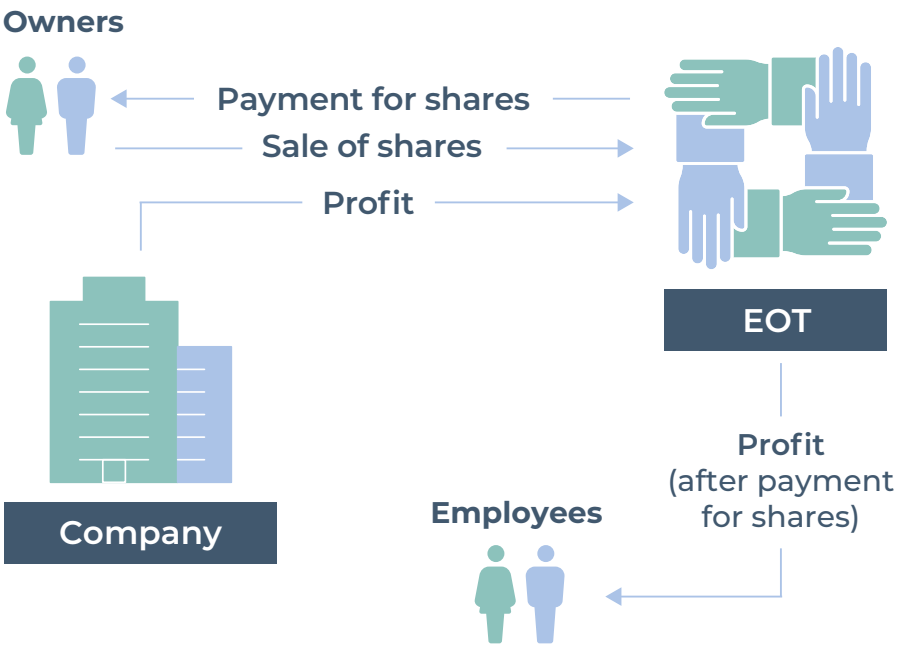
- **Public sector spin-outs**

  This is prevalent within local government and the NHS, where limited companies, community interest companies or social enterprises are spun off to provide a particular service: for instance, adult social care. Although most of these structures will be not-for-profit, the employee-ownership element is often relevant here as the business seeks to change cultures and engage employees in a new commercial environment.

EMPLOYEE OWNERSHIP STRUCTURES ENGAGE EMPLOYEES IN A MORE MEANINGFUL WAY

HOW DOES IT WORK

How does it work?



Qualifying conditions

EOTs offer a different approach to using shares as an incentive. The indirect model means that a trustee holds shares collectively on behalf of the employees. This avoids the administrative and tax complications of direct share ownership. Some employee-owned companies have a mix of direct and indirect employee ownership. These hybrid models are also compatible with EOT structures.

To qualify as an EOT, a sale must meet the following conditions:

- The business must be a trading company or the main company of a trading group.
- The EOT must retain a controlling interest in the business.
- The number of continuing shareholders (and any other 5% participators) who are directors or employees (and any persons connected with such employees or directors) must not exceed 40% of the total number of employees of the company or group.
- The EOT's trustees must ensure that the profit is distributed among all eligible employees on the same terms.

Tax efficiency

The government sought to encourage the 'John Lewis economy', which was reflected in its commissioned Nuttall Review of Employee Ownership, published in July 2012. This, in turn, resulted in Schedule 37 of the Finance Act of 2014, which introduced generous tax reliefs for employee-owned firms with indirect employee majority share ownership through EOTs.

There are tax benefits for both owner-vendor and employee-buyer. The most significant elements of this are:

For the vendor

There is a total capital gains tax (CGT) exemption on all gains made when a majority interest is sold to an EOT.

If, on the other hand, shares are sold outside of this structure – for instance, in a trade sale or MBO – the vendor would pay would pay 10% CGT after Business asset disposal relief (BADR, formerly entrepreneur's relief) to the first £1m of lifetime qualifying gains by individuals, up to £100,000. There is no risk of CGT clawback after the year of completion and the following financial year.

For the employee

Under Schedule 37 of the Finance Act, the company is allowed to pay annual income tax-free cash bonuses of up to £3600 per employee. Because it is a bonus, not a dividend, the company does not have to be in profit.

More than the tax breaks: the bigger picture

EOTs are often marketed for their tax sweeteners, but this misses the bigger picture. Indeed, says Budd: "an owner who focuses solely on the tax breaks will fail to undertake the crucial cultural changes so important to making a sale to an EOT work." There are much broader benefits to taking the EOT route and selecting this model should be based on philosophical considerations as much as financial drivers. Advantages include:

- **Continuity and independence**

  Selling to a third party can often mean that the brand is subsumed into a bigger entity and jobs are cut or relocated from the local area or premises closed. Employee buyouts can ensure continuity for employees, customers and suppliers alike and retain the brand's independence.

- **Greater control**

  The terms of a sale to an EOT are much more within the owner's control than for most other forms of exit strategy. An owner can plan when and how the sale will occur, which is a significant advantage.

- **Faster transactions**

  Selling to an EOT for the benefit of your employees can be a more straightforward transaction than a trade sale, PE acquisition or MBO given that the parties already know each other and the business itself. Execution tends to be more efficient and - given that the transaction variables remain under the control of the sellers – time to complete is also significantly less than with third-party sales. Instead of getting caught up in lengthy sales negotiations with an external buyer, the management can continue to focus on the day-to-day running of the business.

- **Lower costs**

  Professional fees should be considerably lower than a trade sale because it does not involve negotiation between two parties. Instead, an accountant gives a market valuation and an EOT is established. There are still legal fees involved, however, and it is important to employ an EOT specialist lawyer.

- **Sensitive data is protected**

  Confidential or commercially-sensitive information does not need to be disclosed to potential trade buyers, which may also be competitors.

EMPLOYEES HAVE A GREATER SAY IN STRATEGIC DECISION-MAKING, EITHER BY HAVING ONE OR MORE EMPLOYEE REPRESENTATIVES AS TRUSTEES ON THE MAIN BOARD OR THROUGH AN EMPLOYEE COUNCIL.

- **Greater employee engagement and commitment**

  Introducing an employee-owned structure can retain, motivate, and engage staff. Employees have a greater say in strategic decision-making, either by having one or more employee representatives as trustees on the main board or through an employee council. There are also incentives for employee ownership such as Employee Stock Ownership Plan (ESOP).

  This leads to enhanced employee wellbeing and reduced absenteeism, enabling the workforce to take the business to the next level.

- **Improved business performance**

  Because some or all the owners of a company are engaged with the company on a day-to-day basis, while simultaneously having a long-term interest in its success, this tends to generate positive outcomes. Employee-owned businesses typically outperform those bought by third parties.

- **Broader benefits to the local economy**

  Employee ownership retains jobs for existing employees and is a sustainable way of protecting the owner's legacy. They tend to create more jobs over the long term than their non-EOT counterparts. With this in mind, the EOA launched the Ownership Hub, a joint project with Co-operatives UK, which supports economic regions, offering them expertise and resources to grow employee and worker ownership as part of their economic strategy. The first Hub partner is the South Yorkshire Region and there are a further two regions to be announced shortly. "While the growth of employee and worker ownership is accelerating, we needed a new approach to support a greater scale and pace of growth and deliver impact in economies and communities," explains de le Vingne. "We believe that the Ownership Hub is aligned with the Government's drive to boost opportunity and productivity in the regions."

IF I WAS GOING TO GET INVOLVED IN A BUSINESS, IT SHOULD REALLY BE IN SOMETHING I KNOW A LITTLE ABOUT.

Case studies

Ovation
SOUND FINANCIAL PLANNING

Why I sold to an EOT

Chris Budd founded financial planning practice Ovation Finance Ltd in 2000 and sold it to an EOT 18 years later.

"I found myself repeatedly being asked the same question by business advisers, accountants, and other business owners: 'What are you doing to add value to your business?' For some reason I found this an extremely difficult question to answer. Then, one day, I finally realised why. I wasn't focused on the value of my business because I wasn't focused on selling my business.

If I sold Ovation, I would end up with a lump of cash in the bank. I would then find myself sat on the sofa the next day without two things: a sense of purpose and an income.

To get an income, I could invest, perhaps in the stock market or in a property. What returns might I get? Four per cent, after tax? If I invested in a small business, however, I should be able to achieve a much better return. More importantly, I could also get involved. In that way I could get an income and get my sense of purpose back. And if I was going to get involved in a business, it should really be in something I know a little about. Like, maybe, a small financial planning practice..."

KEY CONSIDERATIONS

Success in succession: key considerations

- **Preparation is everything**

  Too busy with day-to-day running of their business, owners often delay making the decision to exit. The danger then is that they find themselves at the point of needing to sell the business without having put in the preparation. This can limit the options and lower the potential valuation achieved.

  "Most problems happen because owners have been impatient or haven't recognised that there are potholes ahead that they can't see. There is a tendency to think 'I know what I'm doing, I've been running this business for years' without recognising that EOT structures have a different way of operating," says Budd. "Essentially, you need to work on the transition before the transaction."

  For most EOT sales, the owners are primarily paid based on the future profits of the business – it is therefore very much in the owner's interest to make those cultural changes before the sale occurs. Ideally, this transition process could take around two years but very few take that amount of time, says Budd. That is not to say that you can't continue to work on the cultural change after the formal transaction has taken place, he adds. "If the cultural change takes around two years but your sale happens after about two months don't stop working on that change – it's absolutely crucial."

"WORK ON THE TRANSITION BEFORE THE TRANSACTION," CHRIS BUDD, OWNER OF THE ETERNAL BUSINESS CONSULTANCY.

- **Create an engagement plan**

  Within that transition, there are several key areas to assess. The first stage is to consider how this news will be shared with the leadership team. "Prepare an engagement plan, which will consider the wants and desires of the key people in the business. How are they going to hear this message? Deliver it in the most positive way possible – for each of them. You might not always get the joyous response you think you will get," says Budd.

- **Map out the company fundamentals**

  In the majority of cases where there is a succession problem, it is the owner that is at least part of that problem. "The transition process is really all about the transition of control," explains Chris Budd. "It's very difficult to let go of your baby."

  Decide what is important about the business when you step away from it. Imagine yourself no longer involved - what cannot be changed (for example a strong purpose, its core values)? Without these in place the owner will not let go of control.

- **Recognise the different style of leadership required**

  Talk to the leadership team before the wider workforce. The leadership can then begin to work with the owner on making initial changes to the business (for example if you don't yet have a functioning board) preparing the way to involve all employees. It's important to avoid a power grab – often when an owner/manager leaves the business there will be one or more of the leadership team expecting to take over as boss but in an EOT this does not happen – there is no new boss. Instead, the ownership of the business moves from a minority to being owned by a trust fund for the benefit of everyone. Leadership and ownership will be separated by the sale of the business to the EOT. A new style of leadership is required; one that engenders employee empowerment and engagement.

- **Involve your employees at the right time**

  The next stage is where all staff are involved, making changes to the business which will ultimately allow the owner to step away and sell to the EOT. But focus on your delivery – this needs to be about the employees, not the owner. "Lots of announcements of the plan to sell to an EOT are introduced by the owner as 'I've found my perfect exit!' It's easy to do," says Budd.

- **Choose the right trustees**

  Closer to the transaction date, key decisions need to be made, including the selection of the trustees. The trustees of the EOT act like the shareholders of the business, holding the board to account and representing the interests of the employees. Choosing the right trustees is therefore crucial.

  The Eternal Business Consultancy recommends three types:

  1. Employees - so the interests of employees are heard
  2. Director (not the owner) – it can be very tempting for the owner to appoint themselves or a close contact as trustee but this is not a good idea if you want to maximise employee engagement, explains Budd. "It's about handing over control. If you're putting yourself or your close contacts in key positions then you are not doing that and engagement will not follow." While this is perfectly understandable given that owners will invariably be paid out of the future profit of the business, their interests can be amply protected by legal means through the sale and purchase agreement, he adds.
  3. Independent - external to the organisation.

A unique business model: governance and employee engagement

Greater employee engagement does not change the operational management and corporate structure. Management will still be responsible for the day-today operations of the company, with board oversight. But a 'meaningful' stake for the employees goes beyond financial participation. It must also underpin organisational structures that promote employee engagement in the company. In this way, employee ownership can be seen as a business model in its own right.

The EOT changes the governance and the level of employee engagement through such measures as the latter having the ability to contribute to decisions, thus offering meaningful engagement in strategic decision-making. This is often achieved either by having one or more employee representatives as a trustee on the board, or through an employee council.

"An employee-owned business does not function in the same way as a privately-owned business and the main reason for that is the existence of a new body in the governance structure - the trustees," says Budd. "You're going from a business that is both owned and managed by the same people to one that is owned and managed by different people. That separation from ownership and decision-making creates a totally different culture."

There are three core building blocks to developing a great ownership culture, says de le Vingne, marrying the employee stake with influence, joint purpose and values through strong:

1. Leadership
2. Governance
3. Engagement and Communications

> LIKE EVERYTHING WORTH HAVING IT TAKES WORK, BUT THE BENEFITS FOR INDIVIDUALS, THE BUSINESS AND THE ECONOMY ARE WELL EVIDENCED," HE ADDS.

FUNDING YOUR EOT

A common obstacle to converting an existing business to employee ownership is the limited availability of capital funding. The EOT framework offers capital gains tax relief to business owners who can self-fund a business conversion. Although employees can finance a buy-out with their own cash, in practice this is usually a minor source of capital. The shares will be bought on their behalf through the EOT with finance typically coming from two sources:

Senior debt

This is generally raised from a bank or alternative finance provider, such as ThinCats. While some banks have supported EOTs, they are not major players in the space. More stringent lending criteria put in place following the global financial crisis (primarily Basel II regulations) have made them reluctant to lend to SMEs. This is especially true for cashflow loans, which have a higher risk score for banks than lending against fixed assets.

WHILE A SMALL NUMBER OF BANKS HAVE FUNDED SOME SUCCESSFUL EMPLOYEE BUYOUT TRANSACTIONS, THERE IS A LACK OF CONSISTENCY IN POLICY. THIS IS WHY A VENDOR LOAN IS STILL THE MOST POPULAR ROUTE TO EMPLOYEE OWNERSHIP TRANSITION.

Most transactions using company resources fall into the category of cashflow loans, Greg Beamish Head of Credit, ThinCats explains: "It's not just service industry firms that would fund on a cashflow basis, where their assets walk out of the door every evening; even in manufacturing industries, there will be debt against machinery, so part of the loan needs to be used for refinancing." While a small number of banks have funded some successful employee buyout transactions, there is a lack of consistency in policy. This is why a vendor loan is still the most popular route to employee ownership transition."

As a result, it is alternative finance providers like ThinCats - with their knowledge of SMEs and credit processes that are tailored to the specific market - that are filling the gap left by the changing role of banks over recent years. In this respect, the UK market is following the lead of the US, where alternative funders have been successfully supporting SME capital requirements for decades.

Subordinate debt

This is often provided by the vendor, whereby they effectively convert a portion of their equity interest into a loan to the EOT.

While the seller can fix the level of interest for this below the normal market level – effectively lending at 'mates' rates' to his employees – "there is no necessary reason why that should be the case," says Greg: "vendors are taking the same risk as a financial institution would be fulfilling the same role and can be remunerated accordingly."

ONE ADVANTAGE OF VENDOR FINANCING OF THE SUBORDINATE DEBT IS THAT IT PROVIDES THEM WITH ABOVE-MARKET RETURNS FROM AN ASSET FOR WHICH THEY UNDERSTAND THE RISK BETTER THAN ANYONE ELSE.

One advantage of vendor financing of the subordinate debt is that it provides them with above-market returns from an asset for which they understand the risk better than anyone else. Given the idiosyncrasies of the transaction, it's important that buyer and seller have corporate advisers and loan capital providers on board that are familiar with this sort of deal. Otherwise, the risk of delay - and even failure to complete - increases.

ThinCats has an experienced credit team that can understand the specifics of each business, assess the viability of a buy-out plan, and approve all transactions. This is supported by proprietary quantitative screens that allow us to quickly identify those businesses that we believe are best able to thrive in the EOT structure.

NETWORK ROI IS AN EMPLOYEE-OWNED, FULL SERVICE, IT SUPPORT COMPANY BASED JUST OUTSIDE OF EDINBURGH.

Case studies

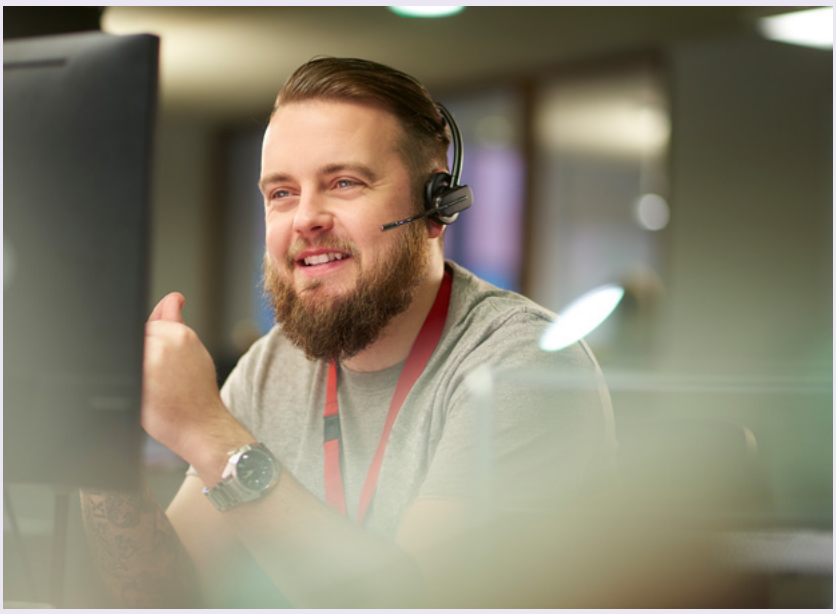
Network ROI
Together, we get IT

ThinCats helped a full service, IT support company, Network ROI, achieve a sale to an EOT by providing £1m funding to finance the transition.

Network ROI is an employee-owned, full service, IT Support company based just outside of Edinburgh. Since 2003, they have grown their client base and UK coverage by providing consistently high-quality service and ensuring that their people's technical capability matches their clients' ambitions.

After ensuring that the company was on a strong growth trajectory, Sean Elliott, founder looked to its next stage: "We started looking at this in 2012," he says: "I was coming up to 50, and we began to look at an exit strategy and a business plan to support that. I considered the usual options such as a trade sale, but came across the concept of employee ownership."

There are 32 employees, all with a stake in the business as a result of the ThinCats financing. "The loan has allowed us to transition to full employee ownership, facilitating my succession," says Sean. Network ROI believe that their clients benefit from their employee ownership model through the way they challenge themselves to find solutions together and how their employees are empowered to drive improvements.



Summary

Since their introduction in 2014, the popularity of EOTs has grown considerably. In the initial Nuttall review of the structure two years earlier, it discussed a programme designed to bring employee ownership into 'the mainstream of the economy' - perhaps that time is now. The structure can offer equivalent and potentially greater returns to vendors than third-party alternatives, with lower risk to the existing business culture and make-up, while fostering improved employee engagement and the positive outcomes that brings.

Given the highly specific nature of the transaction, however, participants need to draw on the expertise of both specialist EOT advisers and the lender to ensure that the deal is optimally structured, funded and executed. A partner that can understand both your business needs and the intricacies of the EOT structure will prove invaluable in moving your business forward to the next stage.

How can we help?

ThinCats has worked with numerous companies over the eight years since the EOT structure was introduced, helping them navigate its complexities and achieve the best outcome for their long-term business success.

If you are considering selling your business to an EOT please contact your regional development director for more information.

thincats.com

Thincats

EMPLOYEE OWNERSHIP ASSOCIATION

BETTER BUSINESS TOGETHER

ThinCats is a trading name of the ThinCats Group, c/o ESF Capital Limited (Registered in England and Wales No. 09707863)
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