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SUCCESS FROM SUCCESSION: Structuring and funding an employee buy-out

What is an EOT?

Anyone who has ever rummaged through the bathroom towels or cushion covers at John Lewis has come into contact with an employee-owned business. However, employee-owned businesses saw a major boost to their popularity once their advantages were enshrined in legislation through the Employee Ownership Trust in 2014. The EOT is a form of employee benefit trust, but with distinctive features and tax advantages. 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 box).

By 2017 there were more than 300 employee-owned business employing more than 200,000 people in the UK, according to the sector's representative body, the Employee Ownership Association. That, however, has hardly scratched the surface. "In the UK 120,000 family owned businesses as well as thousands more SMEs will need a succession solution in the next 10 years which represents a huge opportunity for the further growth of the EOT" says Deb Oxley, chief executive of the EOA. Almost 70% of the sector is made up of professional services businesses and manufacturing – 50% professional services and 19% manufacturing. But it's starting to reach a much wider market.

There are significant advantages to employee buy-outs. The existing owner both recognises the contribution of their workforce and retains the culture and traditions of the business, built up over the years. Selling to your employees via an EOT can be a more straightforward transaction than a trade sale, PE acquisition or management buy-out, given that the parties all know each other and the business.

"The structure can make sense for any size or sector of business and is especially attractive, given the tax advantages," says Ms Oxley: "However, our experience is that it's particularly suitable for those owners who care passionately both about the legacy of their business and the people who have built it. A third-party sale can often see the brand and the jobs that they have built over years disappear from the local area. Employee ownership roots jobs and is a sustainable way of protecting the owner's legacy."

What's more, employee-owned businesses generally perform better than those bought by third parties. A recent study by the UK's Cass Business School found that employee-owned businesses "are better at maintaining both top-line financial performance and employment levels, than their non-EOB counterparts".[1]

Incentives for employee ownership, such as Employee Stock Ownership Plans (ESOP), have a longer track record in the US, and there is consequently a greater wealth of research supporting the strength of employee-owned business, with one study finding such firms "increase sales, employment, and sales/employee by about 2.3% to 2.4% per year over what would have been expected,"[2] and Forbes magazine concluding that "employee-owned companies really do perform better and create more jobs over the long run than their counterparts".[3]

According to the EOA, in 2017 the largest 50 employee-owned businesses saw a median increase in operating profits of 10.1% and an increase in productivity year-on-year of 6.2%.

It's no surprise then the most comprehensive study of employee ownership in the UK, which launched its findings in the report The Ownership Dividend in June 2018, evidenced a profound impact on business performance in the first few years of becoming employee owned.

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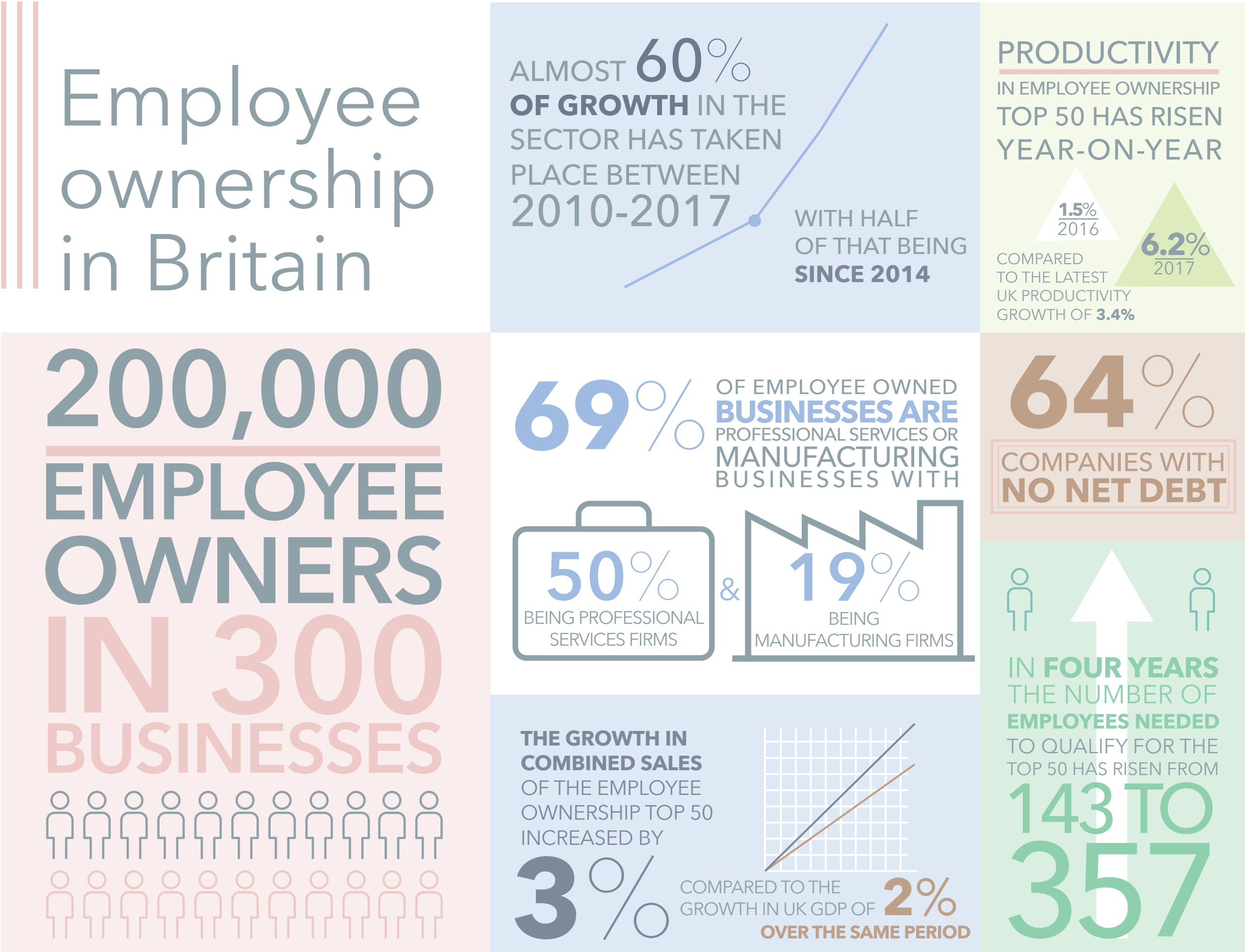
1 https://www.cass.city.ac.uk/__data/assets/pdf_file/0011/208010/Cass-EOB-research-Press-Release-2014.pdf
2 https://www.nceo.org/articles/research-employee-ownership-corporate-performance
3 https://www.forbes.com/sites/darrendahl/2016/05/02/whats-so-special-about-employee-owned-companies-like-new-belgium-brewing/#142501a772d1



Source: http://employeeownership.co.uk/resources/facts-and-figures/

Birth of the EOT

Over the past few years, the government has looked for ways to encourage the 'John Lewis economy'. This was reflected in the government-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. While it hardly made the headlines at the time, the implications are profound.

While EOTs aren't right for everyone, there are four main areas they can provide a positive solution for, according to the EOA. These are:

- **Succession planning.** A number of studies have shown that many family-owned businesses or SMEs do not have a succession plan. The outcome of this lack of planning is sometimes 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.** Because employee ownership structures engage employees in a more meaningful way, the discretional effort or responsibility often results in increased efficiency and lowering cost, and so driving growth. Planning for the long term can be easier because the structures are independent of external stakeholders, who may be looking for short term rewards.
- **Start-ups.** There's a perception that this isn't a relevant area for employee ownership. However, this model can be very attractive to millennials, where entrepreneurs want to share the risk and reward.
- **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.

Qualifying conditions

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 shares are available to all eligible employees on the same terms
- While shares must generally be available to all eligible employees on the same terms, trustees may distinguish between employees on the basis of remuneration, length of service and hours worked

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Tax efficiency

The tax benefits that the Finance Act brought in are beneficial for owner-vendor and employee-buyer alike. 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 10% CGT after entrepreneurs' relief. A vendor can therefore make more from an EOT sale than they could from a trade sale, even if the latter commands a higher multiple, as is illustrated in the table below.

So, while the trade sale price may be higher, it is how much the vendor retains that matters – in the below case, £462 more than the trade sale. In the above example, assuming a 0.5x multiple differential, the vendor is still better off with the EOT sale, after CGT is paid. There is no risk of CGT clawback after year of completion and the following financial year.

For the employee

Under Schedule 37, the company is allowed to pay annual 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.

TABLE 1: It's not what you get, it's what you keep: the advantage of EOTs for vendors

	Trade Sale	PE Sale	EOT Sale
EBITDA Multiple	6.00	5.50	5.50
Valuation/Gross Consideration	18,000	16,500	16,500
Change from Trade Sale Valuation		(1,500)	(1,500)
Percentage Reduction		-8.33%	-8.33%
CGT Payable	(1,962)	(1,799)	0
Net Proceeds	16,038	14,702	16,500
Change in Proceeds from Trade Sale		(1,337)	462

Source: RM2

Non-tax advantages

While these tax sweeteners have promoted the structure recently, they are not the only benefits. For instance, execution tends to be more efficient, with both parties being familiar with one another. Transaction variables are under the control of the sellers and time to complete is significantly less than third party sale alternatives, according to EOT specialist adviser RM2 Corporate Finance, which reports a three-to-four months average transaction time for an EOT, as compared to nine to 12 months for a 'conventional' third party sale. What's more, commercially-sensitive information is not disclosed to potential buyers who may also be competitors.

Sale costs also tend to be lower: total transaction expenses should generally not exceed 5% of transaction value.[5]

There are also broader benefits to the local economy, as Ms Oxley explains: "Employee ownership is bound up with questions of how we can create a sustainable business base, with a regional focus that can develop and protect jobs in those regions. There's an increasing government focus on regional development, and EOTs can have a key role to play in supporting and sustaining these regional economies."

Deal structure

Although it's possible for employees to finance their buy-out with their own cash, in practice this is a minor source of capital. The shares will be bought on their behalf through the EOT. Finance for this will typically come from two sources:

Senior debt

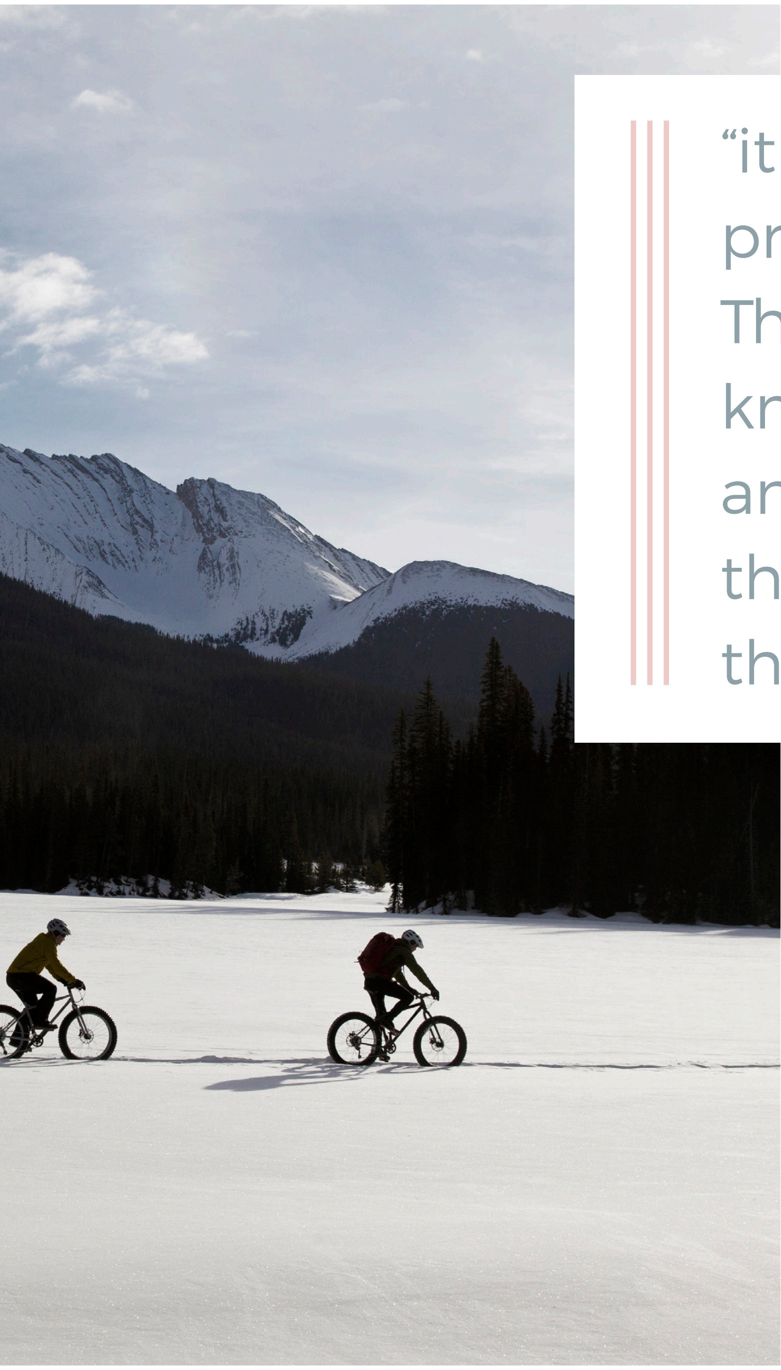
This is generally raised from a bank or alternative finance provider, such as ThinCats. While a few banks have dabbled with EOTs, they are not major players in the space. To a large extent, this is because more stringent lending criteria – primarily Basel II regulations – since the global financial crisis make them reluctant to lend to SMEs. This is especially the case with regard to cashflow loans, as these have a higher risk score for banks than lending against fixed assets. Most transactions using companies' resources fall into the category of cashflow loans, as Garry Karch, managing partner at RM2 Corporate Finance, 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."

So, Mr Karch's experience is that while a small number of banks have funded one or two employee buyout transactions, "most steer clear. Every time we approach banks with a deal, for example, they try and shoehorn it into an invoice financing structure."

As a result, it is alternative finance providers such as ThinCats, with their knowledge of SMEs and credit

5 RM2 estimate

> “it is alternative finance providers such as ThinCats, with their knowledge of SMEs and credit processes that are moving into the market.”



processes that a are tailored to the market, that are moving into the market that has been to a considerable degree vacated by the banks over the past decade. 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 Mr Karch: “vendors are taking the same risk as a financial institution would be fulfilling the same role and can be remunerated accordingly.” This is typically in the range of 7-8% above base rate, and all-in returns to the vendor can average in the 10-12% range, according to RM2.

One advantage of vendor financing of the subordinate debt is that it provides them with above-market returns from an asset whose risk they understand better than anyone else.

Given the idiosyncrasies of the transaction, it’s important that buyer and seller have on board corporate advisers and loan capital providers who are familiar with this sort of deal. Otherwise, the risk of delay and even failure to complete increase. RM2, for example, has two decades of experience, and Mr Karch himself did his first transaction in 1988, with the US’s equivalent ESOP structure.

ThinCats has an experienced credit team that is able to understand the specifics of each business, assess the viability of a buy-out plan and which approves all transactions. This is supported by proprietary quantitative screens that identify quickly those businesses that we believe are best able to thrive. As Mr Karch says of ThinCats: “you do what you say you’re going to do, and the decision is made quickly”.

Governance and employee engagement

While greater employee engagement is often a benefit of the EOT, this does not change operational management and corporate structure. Management will still be responsible for the day-today operations of the company, with board oversight. The EOT does, however, change 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 done either by having one or more employee representatives as a trustee on the main board, or through an employee council.

"Post transition, the biggest challenge is bringing the employee-ownership advantage to life. With a focus on employee engagement and governance, and with the renewed commitment of its employees, most employee owned business experience a surge of performance and growth in this aftermath," says the EOA's Ms Oxley.

Case study: Network ROI

ThinCats helped a Midlothian-based IT firm accomplish an employee buyout through an EOT in 2017.

Network ROI was founded in 2003 by Sean Elliot, an IT professional and entrepreneur with more than 30 years of experience. The business delivers a full range of managed IT and connectivity services to organisations throughout the UK.

Having put the company on a strong growth trajectory, Mr Elliot looked to its next stage: "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."

The company needed £1m to finance the transition and went looking for sources of capital. "We had a beauty parade and narrowed down potential funding sources to two – ThinCats and a conventional high street bank," explains Mr Elliot. "While the bank's business development people were keen to construct a loan that was viable for us, when it was referred to the credit committee we were presented with more draconian covenants, such as a shorter repayment term and taking all our business to the bank."

And, while ThinCats made the process "easy and straightforward", says Mr Elliot, "we never got to meet anyone from the bank's credit committee." So ThinCats became the preferred option.

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 Mr Elliot.

Conclusion

EOTs are an exciting growth area. The structure delivers equivalent and potentially greater returns to vendor than third party transactions, and with lower risk. In addition, the business tends to perform well when compared to other structures, post transaction.

However, because of the highly specific nature of the transaction, participants need to draw on the expertise on both the corporate adviser and lender side to ensure that the deal is optimally structured, funded and executed. You need people that understand both your business and the specifics of the EOT structure.

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