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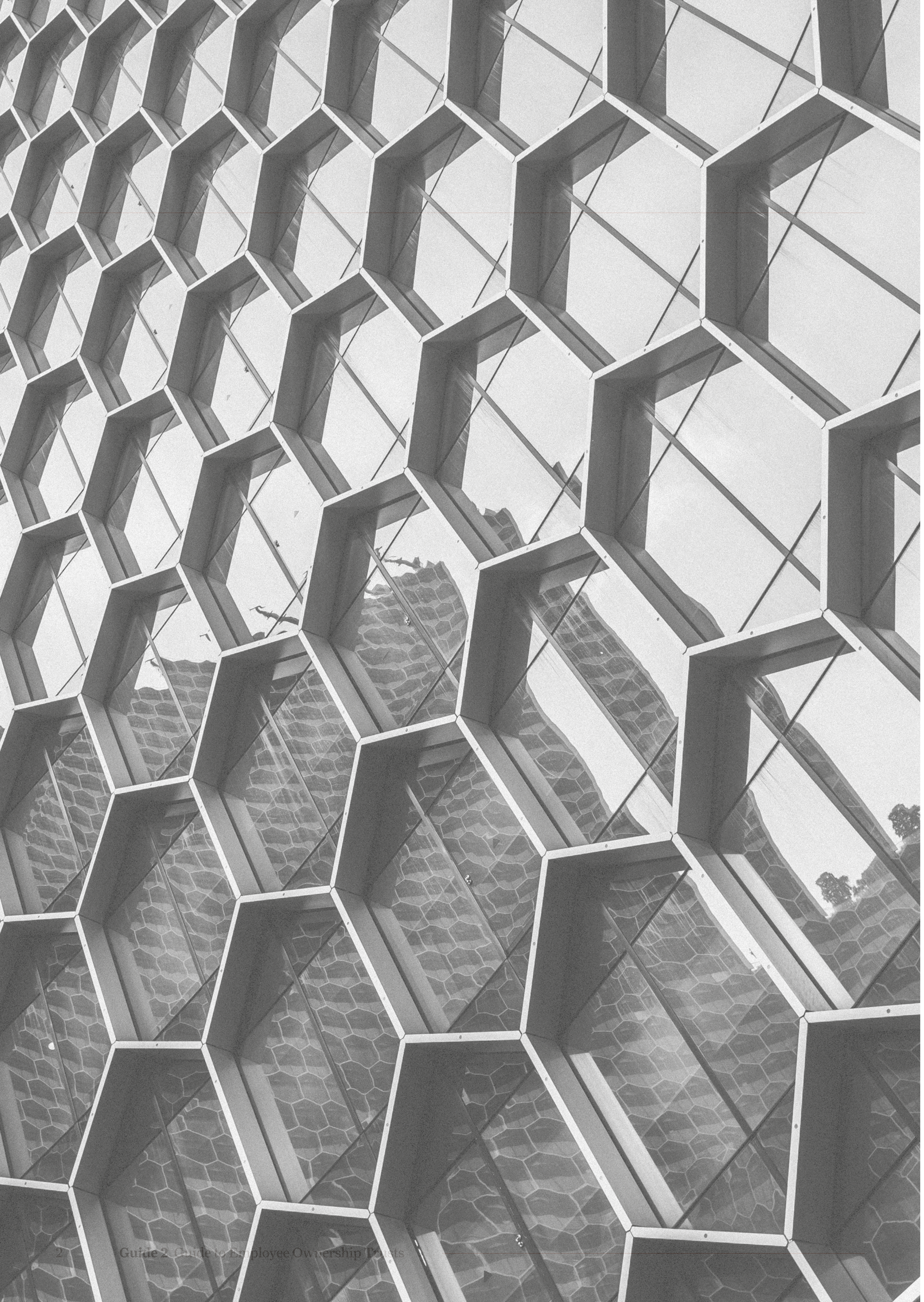
Guide 2
Employee Ownership Trusts



AVONDALE

Guide 2
Employee Ownership Trusts (EOT)

Avondale is a leading Mergers & Acquisitions' strategy consultancy. We have been working with the best entrepreneurs and companies, operating both locally and globally, for almost 30 years. Our firm provides a fully integrated service from business sales and acquisitions to business growth, strategy and employee ownership.

We help exceptional people and companies achieve their ambitions.

This guide to employee ownership is written to help business owners and management teams better understand how an EOT may help shareholders create succession and secure shareholder value, whilst creating the legacy of a sustainable business working for the benefit of all staff members.

Please contact av@avondale.co.uk if you have any questions

EMPLOYEE OWNERSHIP AN EFFECTIVE EXIT STRATEGY

Different people start companies for different reasons, which invariably influences their exit strategy. Trade sales catch the headlines, but family succession, private equity sales and management buy-outs are all commonly used exit strategies. There is however, a developing approach which is creating significant interest. In the last six months (Summer19) Arbuckles Restaurants, Aardman Productions (the creator of Wallace and Gromit) and Richer Sounds, the electronics retailer, have all sold to their staff to create succession and an exit.

Establishing an Employee Ownership Trust (EOT) can be a great way for some owners to realise the value of their business whilst leaving a positive legacy through the remaining business. An EOT is an indirect form of employee ownership in which a trust holds a controlling stake in a company on behalf of its employees, the most well-known example being the John Lewis Partnership. There is significant evidence that employee owned businesses are more sustainable, take better investment decisions and are more productive, due to employee engagement and their increased focus on success. For this reason, the main political parties all believe that employee ownership is better for the economy than more traditional direct ownership models. As a result, the Finance Act 2014 introduced a favourable tax regime for both vendors and employees involved in EOTs.

There are over 350 employee owned businesses in the UK today, contributing over £30 billion to the economy. With sustainability critical to the culture of many businesses, the approach creates purposeful organisations which are aligned to their stakeholder community.

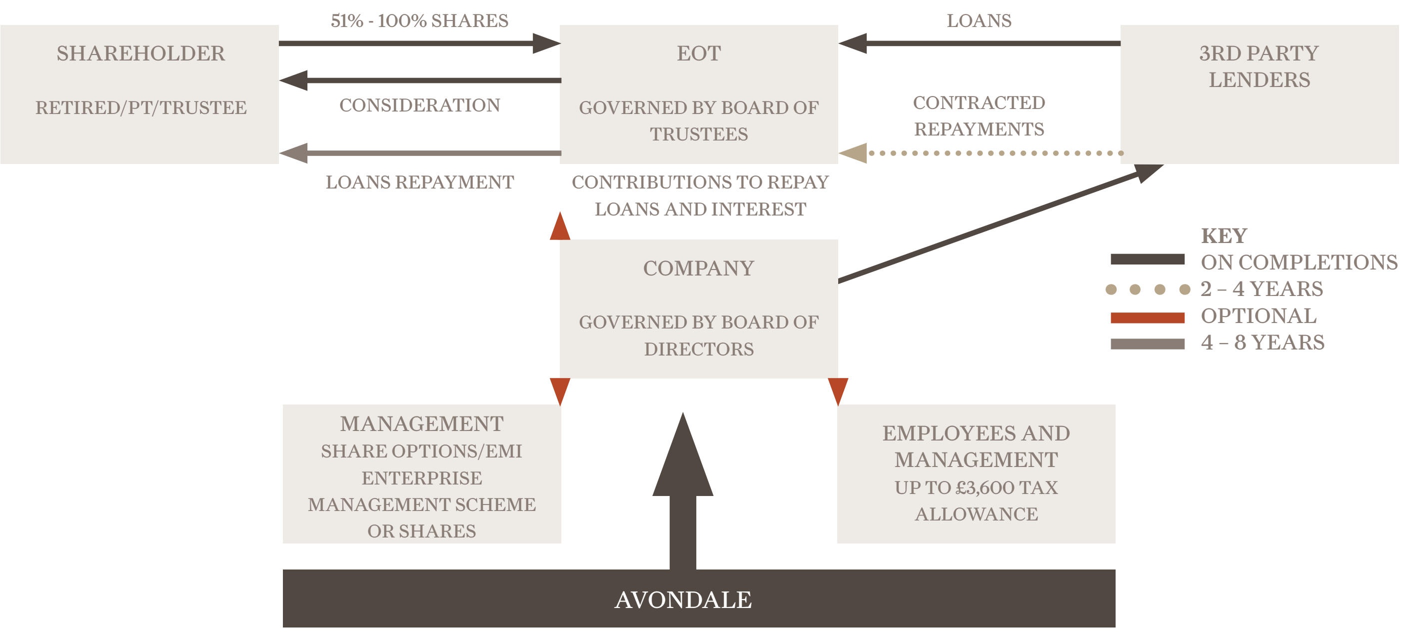
GROWTH	EMPLOYEE GROWTH	PRODUCTIVITY	SATISFACTION
Sales of the top 50 employee owned businesses grew by 10.2% in 2017 compared to GDP of 7.7%	In 4 years, the top 50 have increased average employee numbers from 143 to 357	Productivity increased 4.5% year on year in employee owned businesses against the flat UK economy	80% of employees within EOTs experience a sense of achievement from their jobs

WHAT IS AN EMPLOYEE OWNERSHIP TRUST?

Employee ownership differs from traditional ownership in that the share capital is part or entirely owned by its employees. The concept is prevalent in the USA and is the fastest growing form of business ownership in the UK. The model is straightforward yet flexible, and simple to adopt. The key difference from a Management Buy-Out is that the ownership sits with the entire workforce, not just a select few. A qualifying period of up to 12 months may be introduced for staff to be eligible, and interests must be allocated based on a non-discriminatory formula (such as length of service, remuneration, seniority etc.).

The EOT itself is a legal trust established to take ownership of the company shares and hold them for the benefit of the employees. The trust is a passive investor so the way a business is run does not need to change and management and operational decisions can continue to be made in accordance with the existing governance and operational framework of the business. The EOT is governed by a panel of trustees, appointed at the time that the transition to employee ownership is made; typically the trust panel will comprise representatives of management and staff, as well as an independent expert, usually acting as chair. The existing shareholders may also be a members, although there are no absolutes here.

"Employee Ownership carried out correctly creates highly productive, ethos-driven and sustainable companies whilst enabling current shareholders to exit over time. There is no Capital Gains Tax on a sale to employee ownership."



WHY LOOK AT EMPLOYEE OWNERSHIP?

An EOT should be explored alongside more traditional succession planning alternatives, such as a company sale to trade buyers or Private Equity, or a Management Buy-Out (MBO). A trade/private equity sale may be the best way to maximise the shareholder value of a business on exit, however, it can also be highly disruptive with an overnight change in culture and management.

Additionally, dependent upon the deal structure of a trade/private equity sale, earn outs or deferred payments may be highly dependent upon the capability of the buyer, and hence relatively uncertain with less control on timing. An MBO will provide certainty of culture and succession, however, market values are unreachable for some management teams, with many unable or unwilling to provide security over deferred payments. Employee Ownership is a great team reward especially when aligned with support to create better strategy, leadership and a cultural change from commercial to a more co-operative model.

The role of employee ownership in boosting growth in the UK economy is recognised, agreed and supported across the political spectrum and there is steady growth in this form of business structure in every sector of the UK, from start-up to significant long-established enterprises. Employee ownership is a highly flexible and successful business structure.

SO, WHAT ADVANTAGES CAN AN EOT OFFER VENDORS?

- Employee Ownership Trusts can achieve full market value for shareholders.
- Value is set by the business's ability to raise third party debt, combined with cash reserves and vendor loans.
- Warrants can deliver an uplift in value to reflect improved future performance, with the EOT model shown to boost profitability.
- Vendors' loans secure interest at commercial rates, creating an attractive ongoing yield to enhance the sale value to sellers.
- There is flexibility over the proportion of shares to sell/keep.
- Provides an opportunity to recognise, reward and engage all staff, not solely the management team.
- Ongoing sustainability reducing future succession issues.
- Can be more suitable where a trade deal is less likely and/or where employees are family, but traditional family succession is not intended.
- A non-combative transaction with the same representatives/advisers on both sides of the deal creating a more certain outcome.
- Vendors are able to drive the transition and succession planning.
- As long as certain conditions are met, a zero rate of Capital Gains Tax (CGT) will apply on the disposal of shares to the EOT.
- Provides a solution to withdrawing retained profits at zero Capital Gains Tax.

WHAT ARE THE BENEFITS FOR THE EMPLOYEES?

- An EOT is run for the benefit of the staff, providing enhanced job security for employees.
- Employee Ownerships have evidenced improved employee wellbeing, staff engagement and a sense of achievement.
- All qualifying employees can receive bonuses in line with their interest in the EOT. Any amount payable up to £3,600 per annum, per employee, is Income Tax free, equivalent to receipt of a £6,000 bonus for a higher rate taxpayer.
- EOTs can be combined with Enterprise Management Share Incentive plans (EMI) options to facilitate direct share ownership, although pension and bonus payments can be a simpler model.
- EOTs serve as a differentiator in terms of recruiting and retaining staff, which engenders a far more effective team.
- Employees share in the sale proceeds if the company is subsequently sold.

WHAT ARE THE CONSIDERATIONS?

As with any transaction, there are significant considerations to technical qualifying factors and also the suitability of your organisation to the employee ownership model.

An EOT must meet the following requirements in order to be eligible for CGT relief and income tax relief:

- The company transferring shares must be a trading company or group.
- The EOT must not hold more than 5% in the company prior to the transition and must have a controlling interest by benefits to staff under the EOT cannot be discriminatory.
- The company should not have more than a ratio of 2 on 5 for directors (plus any employees related to them) to employees and directors in total. The same ratio applies to shareholders with in excess of 5%.

THE FOLLOWING PRACTICAL AND CULTURAL ELEMENTS NEED CONSIDERATION:

- A fair value can be achieved often exceeding that of a trade sale.
- An EOT needs a driven and effective management team, either in situ or established over time, with the vendor's support. In either scenario, the transition from owner to management team needs careful implementation.
- An EOT will only prove successful if the culture of the workforce is considered. How do you instil a feeling of ownership and importance in individuals?
- The employees' voice is extremely important and greater transparency and employee involvement is encouraged. However, this needs to be balanced with the need for an effective decision-making process and structure.
- An EOT can be re-sold although to date there is little evidence so far to support an appetite for this in the UK.

Employee Ownership is a better way of doing business

HOW DO EMPLOYEES/ MANAGEMENT TAKE TO EOT'S?

This is an important intellectual point. Some may see the tax breaks as cynical encouragement rather than understanding the altruistic nature of the sellers in creating an entity that can benefit all for the long-term. Certainly, with the right marketing, businesses like the John Lewis Partnership use their ownership structure to commercial advantage, whether through their recruitment or driving sales; it simply feels better than the capitalist ethos of the shareholder model, even whilst still needing to be utterly commercial within a margin driven environment.

Key managers may lament the lost financial opportunities of majority share ownership before understanding that bonuses, PAYE or pensions can be a far better method of wealth creation than the uncertainty and risks of equity. The tax-free benefits to staff worth up to £6,000 a year to higher earners is a great encouragement but ultimately transition, succession, ongoing management incentive and strategy will all affect the legacy of employee ownership.

With interest in the trust calculated for all employees based on a non-discretionary formula overseen by the trust, employees can easily visualise the personal benefit of promotion, longevity of tenure or seniority, depending on the methodology of calculation.

Carried out correctly, an employee owned business can succeed long beyond the current shareholders with far more engaged employees.

FORMS OF EMPLOYEE OWNERSHIP

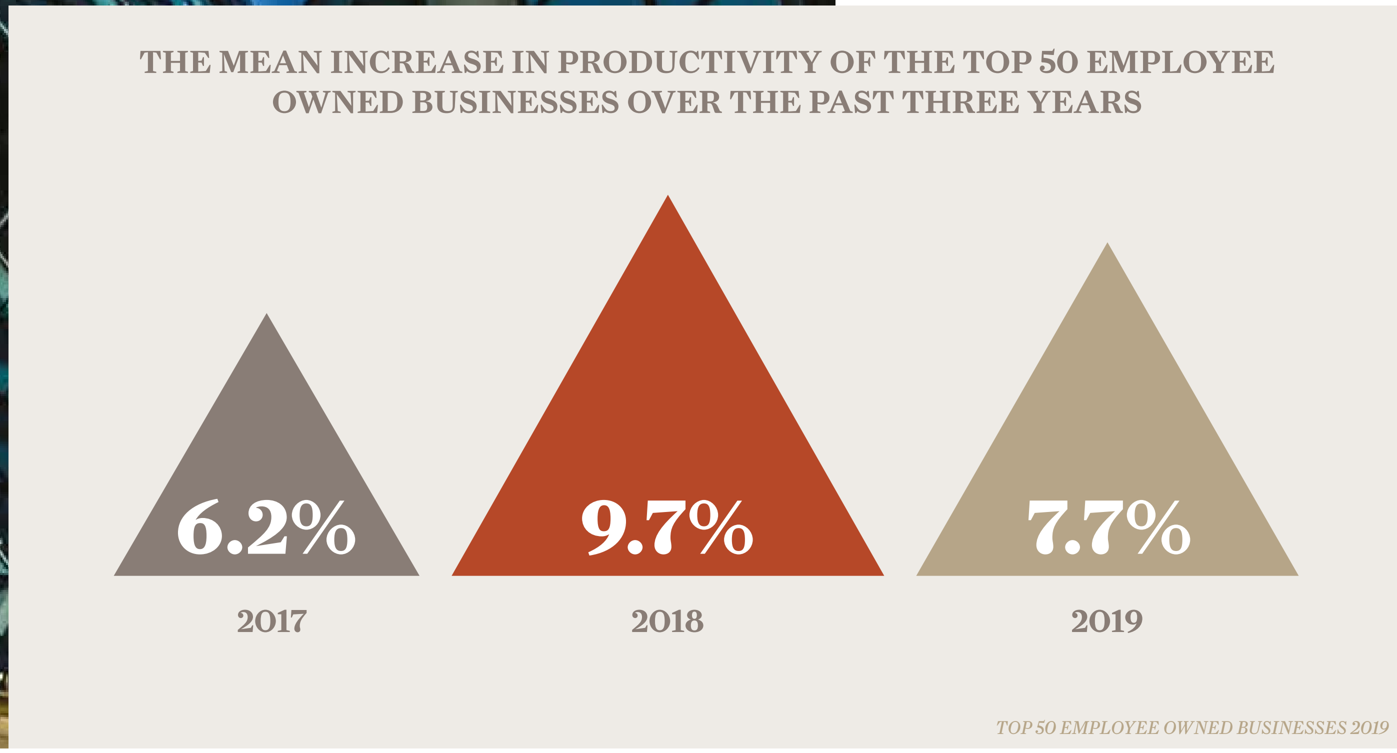
There are three models of employee ownership:

Direct – employee ownership of shares, personally holding shares directly. Shares are traditionally acquired by employees either through buying shares, obtaining free shares through a Share Incentive Plan (SIP) or being granted share options. The latter two are most frequently aligned to the profitability of the business as well as individual contribution. Shares may also continue to be held by original shareholders or past employees, which may be positive or negative depending on the individual business.

Indirect – shares are held in trust on behalf of all employees under an EOT. The trust manages the shares on behalf of the employees under the terms of a Trust Deed and trust law agreed at the time of implementation. The trustees have oversight of the trust itself, but no responsibility for the day-to-day management and operations of the business. Both management and employees are represented on the trust panel, which is chaired by an independent trustee. Individuals only have the benefit of the shares held under trust whilst remaining employees of the business. On departure they have no further benefit from the shares.

Hybrid – a combination of majority 'indirect' trust ownership with additional 'direct' individual share ownership. This option allows for certain individuals to have direct ownership either in addition to, or outside of, those allocated through the EOT. Under this model 'direct' ownership must remain below 50% of the total shares issued.

Indirect trust based EOTs are the simplest model to implement and maintain after implementation, though may not meet the requirements of all businesses. A key consideration is the underlying reason for implementing the EOT and the intentions after implementation. It may be that including an element of direct share ownership through a hybrid model may resolve short-term issues but would dilute the original purpose and long-term goal of full employee ownership.



FUNDING THE EOT

Once a shareholder has decided to sell to an Employee Ownership Trust (EOT), the next important question is how to finance the transaction.

This is usually structured and assessed by a specialist such as Avondale. Analysis will include understanding the headroom for debt, against seasonality and forecasts. This will sit alongside a review of the overall valuation target, along with assessing the cost or interest in either vendor loans or any debt secured for the transaction.

The sources of the purchase funds are usually from reserves, vendor loans and third-party specialist debt. There may also be some gifting of shares over a period by the current owners.

If a third-party lender is sought, a financing memorandum will be required showing the debt serviceability. Normally the lender will take security for its loan over the company's assets and will require priority for its money over any other provider of funds, such as a vendor loan. The vendor loan will be 'subordinated'.

The greater the formal payment requirements of any vendor loan, the more likely it will be viewed as debt by a lender and the harder it will be for a third-party lender. Subordination requires careful structuring of vendor loans. They may also be structured with warrants that uplift the sums if performance in the business is strong.

Vendor loans must carry interest on commercial terms to ensure that the business is incentivized to repay or even perhaps later refinance the sums to alternative lenders as the business grows.

PRACTICALITIES OF DISTRIBUTABLE RESERVES

A consideration when structuring the financing for an EOT involves the balance sheet and any potential for distributable reserves ("DR"). Distributable reserves are the accumulated earnings of the business over time, less any dividends paid. They may also be referred to as retained earnings or, accumulated profits. In EOT planning they are relevant in two contexts.

FIRSTLY: As debt service by the EOT is funded by gifts or contributions from the company of after-tax funds, the total annual contributions made by the company to the EOT can be no greater than the annual amount of DR. Due to this constraint, it is critical to ensure that the projected debt service on an annual basis is no greater than the projected after-tax profits for the year. The letter of wishes commitment on the part of the company to make contributions to the EOT is always contingent upon it having the available funds.

SECONDLY: The amount of excess cash on the balance sheet impacts value. Excess cash constitutes an increase in equity value above and beyond the goodwill valuation usually determined by a multiple of earnings. Any excess over the amount of DR must be paid over time when accumulated DR exceed the cash balance to be paid out.

IMPLEMENTATION PRACTICALITIES

EOT implementation is driven by shares in the company being distributed through the employees. If the business is currently structured as a partnership, it is recommended that the legal structure is changed to a Limited Company prior to implementing the EOT in order to reduce complexity caused through simultaneous legal conversion and EOT implementation. Through this process, partner allocations can be redistributed to shares either within the EOT or under a hybrid model.

Careful consideration should be given as to how the shares from the EOT will be distributed. Will all staff be allocated free shares commensurate with their longevity and seniority in the business? If shares are to be purchased by staff, will these be under a hybrid structure and outside the EOT allocation or from within the EOT? If the latter, how will the trust finance the re-purchase of any shares being sold, for example on resignation of an employee? If shares are to be sold, will the business facilitate lending options for staff to fund share purchase?

Post implementation, the management of the business to ensure business continuation without disruption and ongoing success is critical. An early review of the leadership and management teams in order to assess competencies in the new framework is advisable. The identification of leadership training, management responsibilities and any role omissions that would need filling by external candidates can be supported by Avondale, thus providing an independent review of the management structure. The aim is to ensure that employees, and particularly leaders, are playing to their strengths and are clear on their personal roles, responsibilities and deliverables.

A wider organisational review may be beneficial when considering the formula for allocation of shares by the trust. If the share allocation formula is based on seniority, responsibility and deliverables in support of the business, consistency across levels and bandings is critical to ensure clarity by all staff as well as avoiding misconceptions on share allocations.

Staff engagement may be additionally gained through the appointment of employee representative trustees to the trust panel. An open and clear appointment process, including encouragement of applications by employees, can be an opportunity to further enhance and promote the employee benefits and underpin employee ownership.

Ongoing administration of EOT share allocation, distributions and record keeping naturally sits within the HR function. Where a scheme is larger or more complex, external experts can provide these services in support of the business.

In addition, valuations of shares post implementation are critical in ensuring visibility of the ongoing benefits. It should be noted that distributing assets from the trust to employees, whether cash or shares, can be documented flexibly within the trust deed so that distributions can be tailored to the capacity of the business at the time of distribution. Thereby, vagaries of the success of the business can be shared with all employees through the EOT via differing distributions.

With the right planning and advice, the implementation of employee ownership is simple and straightforward and depending on the business, can be managed in months but transitioned over years.

VALUATION	CAPITAL STRUCTURE	TEAM & PLAN
Build data pack for valuation and lenders	Build headroom model and repayments period	What is the business plan?
Open market valuation and affordablilty analysis	Debt /warrants /vendor loan	EMI or direct shares for management?
Determine cashflow	Secure HMRC Clearance	How best to involve the employees? Produce handover roadmap

CASE STUDIES

Richer Sounds, with a turnover of £200 million, is one of the largest firms to welcome the approach. The decision was based on flexibility with only 60% of the shares sold to create a gentle transition for Julian Richer who said: “My father dropped down dead at 60 so I am very keen for this to happen in my lifetime.

I felt the time was right, rather than leaving it until I’m not around, to ensure the transition goes smoothly and I can be part of it. I still really, really care but it is time for the next generation.”

The sale also means the company will avoid an “aggressive” outside investor “changing the strategy”. The trust is in the management team he has built, enabling him to reduce involvement over time.

Richer Sounds have an excellent agile management and service-led ethos and a trade sale would have put this approach in question in favour of driving margins. The EOT enables a longer, softer run at the succession but also realises a large part of the value of the business for Julian quickly against bank debt.

WHAT IS INVOLVED AND HOW CAN AVONDALE HELP?

Employee Ownership requires planning and careful consideration, however, for many sellers it is an exciting exit opportunity. Avondale can lead the whole process and support in transition, funding options, the critical element of leader succession and business support during initial implementation.

We will undertake a feasibility assessment; looking at the financial modelling, headroom, third party funding options and valuation, as well as assessing key management capabilities and the best handover approaches. This helps you best understand how an Employee Ownership Trust may meet your ambitions and compare favourably to other alternatives such as MBOs or the archetypal trade sale.

If appropriate, we will then craft a Financing Memorandum, using our network of specialist EOT lenders to assist with debt funding, securing the right terms and debt serviceability. Our Employee Ownership service also includes all legal drafting, facilitating trustees and documentation and any associated employee management shares if required. In addition to discussions with management and trustees, we assist with transition consultancy.

Implemented correctly, Employee Ownership can be a highly rewarding exit for sellers, creating more sustainable businesses with highly motivated, rewarded and engaged employees.

THE GROWTH IN COMBINED SALES OF THE EMPLOYEE OWNERSHIP TOP 50 INCREASED 2018

3%

COMPARED TO THE GROWTH IN THE UK GDP OF

2%

OVER THE SAME PERIOD

TOP 50 EMPLOYEE OWNED BUSINESSES 2017

IN CONCLUSION

Undertaking a business sale or succession is one of the most important financial decisions a leader or owner will ever make. An Employee Ownership Trust may be as valuable as a trade sale and, with flexibility on the timeline, has many advantages with preparation and the right financial structure, to both realise value and increase time wealth. The approach can be implemented easily and tailored to circumstance. The model works across sector and business lifecycles to create succession and an effective mechanism to engage employees in growth.

It is critical that the strategy of the business and the culture are reviewed at the same time the structure is employed, otherwise the transition will be poor and neither employees nor shareholders will secure the enhanced value and positives the approach offers. Direct, indirect and combination hybrid models of employee ownership can be seen in a range of highly successful exemplar organisations across the UK. EOTs are an exciting option and, with long term Government support and very attractive tax breaks, are also an effective way to increase purposeful sustainable capitalism in businesses without the disruption that lifestyle-led owner driven businesses can have.

LEADER QUESTIONS

- What do you really want to achieve by the implementation of an EOT and have all other alternate exit options been considered in comparison?
- Will a direct, indirect or hybrid structure suit the business best?
- What percentage of shares will be sold or held by the EOT?
- How will the transfer, take-out of existing value and subsequent structure be financed?
- Will employee shares be freely distributed, based on a formula to be agreed, or purchased?
- What will be the taxation treatment for the sellers and employees?
- Is there a catalyst to the implementation that will drive the timeline to implementation?

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Avondale is a leading Mergers & Acquisitions strategy consultancy. We have been working with the best entrepreneurs and companies operating both locally and globally for over 20 years.

Our firm provides a fully integrated service from business sales and acquisitions to business growth and strategy to corporate funding opportunities.

Our expertise, combined with ambition, insight and vision, creates value and delivers excellence.

If you think employee Ownership may be right for you, please call us on **01737 240888** or email: **av@avondale.co.uk**

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