Delivering Employee Ownership Network

Employee Ownership as a Solution to Business Succession

Policy Paper

April 2005

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This paper has been prepared by the Delivering Employee Ownership group – an informal national network of organisations who specialise and advise on employee ownership.

Baxi Partnership Limited (BPL) (Contact: David Erdal)

BPL is a trust-owned investment company which invests only in 100% employee owned buyouts of strong companies and then helps them develop partnership cultures.10b New Technology Centre, North Haugh, St Andrews, KY16 9SR, Tel 01334 479 101, email: mail@baxipartnership.co.uk, www.baxipartnership.co.uk

Co-operatives^{UK} (Contact: Helen Seymour or Helen Barber)

Co-operatives UK represents the spectrum of co-operative enterprise throughout the UK, the Channel Islands and the Isle of Man. Its purpose is to develop and extend the co-operative sector, including employee owned businesses. Holyoake House, Hanover St, Manchester M60 0AS, tel 0161 246 2921, helen.seymour@cooperatives-uk.coop or 0161 246 2954, helen.barber@cooperatives-uk.coop

Co-operative Assistance Network Ltd (Contact Brian Titley)

A workers co-operative of specialist trainers and consultants, CAN has extensive experience in the social economy sector. Tel 023 8071 0622, Email: norman@can.coop, services@can.coop, www.can.coop

Co-operative Business Consultants (contact Bob Cannell or Kate Whittle)

Management and training consultancy specialising in participative and democratic management techniques. CBC enables employees to manage their employee owned businesses. www.cbc.coop Tel 0787 030 4027 email bob@cbc.coop or kate@cbc.coop

Co-operative and Mutual Solutions Limited (Contact Dave Hollings or Gareth Nash)

Employee owned business with expertise in community and employee led transfers of business ownership. Work mainly, though not exclusively in north west England. Tel 07967 815321/2, email: dave@cms.coop, gareth@cms.coop

Economic Partnerships (Contact Geof Cox)

A social enterprise development company specialising in organisational change and restructuring, including the externalisation of trading operations from public and voluntary sector bodies and public sector staff buy-outs. Email: geof.cox@economicpartnerships.com, www.economicpartnerships.com

Employee Ownership Scotland Ltd (Contact: Hugh Donnelly)

EOS specialises in supporting employees to take control of their own destiny. This can be a buyout in succession, divestment or rescue or a new start using either co-operative or ESOP structures. Tel 0141 304 5465. email: eos@sol.co.uk, www.eos.coop

Equity Incentives Limited (Contact: Graeme Nuttall)

We advise on design and implementation of employee share plans. We are dedicated to wider employee share ownership. Clients range from John Lewis partnership through to small and newly established companies. Tel 020 7861 4717, graeme.nuttall@equityincentives.co.uk, www.equityincentives.co.uk

Industrial Common Ownership Finance Ltd (ICOF) (Contact: Andrew Hibbert)

Loan Finance provider for employee ownership and co-operative businesses. From £5,000 up to £125,000. Security not a condition of a loan. Minimum employee shareholding of 51%.

227C City Road, London EC1V 1JT, Tel. 02072 516181, email: icof@icof.co.uk www.icof.co.uk

Ithaca (Contact: Anthony Jensen)

Ithaca is a consultancy, research and training practice committed to advancing economic, social and political progress by specialising in projects that focus on employee democracy and participative work practices. Tel 020 737 1899. anthonyj@ibstrategies.co.uk

Job Ownership Limited [JOL] (Contact: Patrick Burns)

JOL is the association of employee owned and trust owned businesses. It has been researching, advising and lobbying on employee ownership since 1979. Abford House, 15 Wilton Road, London, SW1V 1LT. Tel. 0207-821-9298, info@jol.org.uk, www.jol.org.uk

Succession London

Succession London promotes the concept of succession to business owners selling their enterprise or retiring. The agency then supports the employees to buyout the business. We encourage all staff to participate in the buyout.
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Unity Corporate Advisors

As part of Unity Trust Bank (the Trade Union & Co-operative owned Bank), we have been specialists in the area of Employee Share ownership since 1987 and helped to put in place the first UK ESOP at RoadChef. In 1994, Unity Corporate Advisors was set up as a separate division of the Bank. Tel 0121 616 4173,

Scott Bader Company Limited

In common ownership since 1951 (all shares held in trust in a registered charity). Multi-national chemical manufacturer and distributor with long experience of employee involvement and participation and corporate social responsibility. Wollaston Hall, Wollaston, Northants N29 7RL Tel 01933 666755, denise_sayer@scottbader.com; www.scottbader.com

Wales Co-operative Centre (Contact: Norman Watson)

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Wrigleys Solicitors (Contact: Chris Billington)

Led through the Charities and Social Economy Department of this niche practice headed by Malcolm Lynch, Wrigleys advises a number of employee owned businesses having taken many of them through the succession route. Tel 0113 244 6100, email: chris.billington@wrigleys.co.uk; www.wrigleys.co.uk

Delivering Employee Ownership Network

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Policy Paper

This paper has been prepared by the Delivering Employee Ownership group – an informal national network of organisations who specialise and advise on employee ownership.

The group submitted written and oral evidence to the Small Business Services's (SBS) review of business transfer and has been invited to participate in the SBS's evaluation of ways to implement the review's action proposals.

The paper's overall proposition is that:

- Employee buy-outs are an increasingly attractive and popular business transfer outcome.
- Take-up of employee buy-outs by vendors is being constrained by a number of specific barriers that amount to market failure – notably lack of awareness, advice and guidance and appropriate finance.
- SBS can play a constructive role in helping to remove or reduce those barriers, which in turn will help to diminish the UK's high business transfer failure rate.

We strongly welcome the SBS's 'Passing the Baton' review and commend its analysis and recommendations for improving the UK's business transfer performance. In particular we welcome the acknowledgement of the valuable role that employee buy-outs can play in business succession, and the commitment to spread awareness of this option.

We urge the DTI and SBS to ensure that the recommended action is pursued with urgency, and that additional options for improving business transfer are considered and progressed in consultation with expert bodies in this field.

1. What are employee owned businesses?

There is no one model of employee owned business and no single way that such businesses may structure and describe themselves. The legal models adopted by businesses transferring to employee ownership include company limited by shares, industrial and provident society (IPS), company limited by guarantee and trust based ownership models including by an employee benefit trust.

Some such businesses will call themselves a co-operative, others not. Some may refer to themselves as a trust (i.e employee benefit trust), and some may not advertise their ownership structure at all. This sometimes makes it difficult to map and understand the sector and its breadth and diversity.

All will have management structures to suit the size and organisation of the business. All will have degrees of democratic control, with management accountable to the employee owners, usually through representation systems. All will put good communication, empowerment and participation at the heart of their business.

There is no official data on the scale of the employee owned business sector. However, cautious estimates suggest its turnover is in the £15-20 billion turnover range when all co-owned companies are included. The evidence available to Co-operatives[UK] , JOL and other specialist bodies in this field is that the sector is growing and that there is a significant rise in owner interest in employee buy-outs.

In many other countries employee ownership is widespread and its benefits are generally recognised. Nearly 25% of employees in the USA are members of an ESOP (Employee Share Ownership Plan). In the Mondragon area of Spain's Basque region, employee owned businesses employ nearly 40,000 people and turn over some £7bn a year. Half the GDP of Italy's Emilia Romagna region is generated by employee owned businesses with 60,000 workers.

2. The challenge of business succession

The recent cross-departmental review undertaken by the Small Business Service (Passing the Baton) revealed that a significant number of businesses are vulnerable to transfer failure. It is estimated that only between 5 and 15% of family businesses reach third generation. In 2003 the Small Business Service reports that 500,000 new businesses were created and a similar number exited. Increasingly family businesses are being transferred outside the family.

A UK survey from 2001 indicated that approx 30% of closures could be regarded as succession failures – otherwise viable businesses which close for lack of a suitable successor. Durham University estimates that the number may be up to 100,000 business closures per year.

The survey concluded that support systems for business transfer are only partially developed and that ideally support systems would have nationwide coverage and would deliver services to a recognised standard. The survey also recognised the significant challenge of increasing the number of trained professionals and the training available for those within the current system and responsible for interacting with clients.

If an owner is looking to retire, change career or move away (and there is no obvious heir) a sympathetic disposal to the employees is a route used successfully on numerous occasions. This might involve the employees purchasing the business over time, performance related payments and/or the ability for an owner to gradually reduce their involvement with the successor business.

Succession is a key issue facing business owners who often see no easy way of realising the value built up over the years while safeguarding the jobs of longstanding and loyal employees.

Many business owners have found a successful solution by selling the business to the employees. It offers a way to secure the business and jobs in the community, retaining its independence and rewarding employees.

3. The benefits of businesses being purchased by employees

The purchase of a business by, or on behalf of, the employees offers benefits to the out-going owner, the employees, the wider community and the economy.

- The business owner has an exit from the business which rewards him/her and ensures the business stays alive and goes on to thrive. It avoids asset stripping by competitors and retains the business and jobs in the locality.
- Selling to the employees ensures that the people on whom the business has depended are placed in control of the company, have control over their own futures and are adequately rewarded in the future.
- Selling to employees gives control to those who have helped to build the business up over a number of years – those who know it best.
- Research indicates a combination of employee ownership and employee participation allows companies to outperform comparable businesses in terms of profitability, productivity and growth.
- Employee ownership combined with good management leads to better performance, the spread of wealth and a better working experience
- Businesses owned by their employees have achieved exemplary degrees of corporate social responsibility, including involvement with the communities they operate in, and strong commitment to sustainability.
- Managers and the employees are on the same side and together they take the crucial decisions of ownership: distribution of profits, major strategic moves, and board representation.
- The employee owned sector represents a valuable widening in the diversity of corporate ownership models operating successfully in the economy, widening choice for employees, consumers, job seekers, suppliers and purchasers.
- Employee owned business governance is characterised by high levels of integrity, transparency and accountability.
- Businesses owned by their employees offer a valuable additional model of enterprise by distributing responsibility, and encouraging a collective sense of business ownership, commitment to innovation, and workforce-wide awareness of financial imperatives
- Employee buy-outs can be viable and desirable recovery options in insolvency scenarios, especially in economically deprived areas – by retaining jobs and skills in the local community, ensuring continuity for suppliers and customers.

4. The development trajectory of employee buyouts

When it is time for an owner to sell all or part of a business, either because of retirement or moving on, there are several choices. These include family succession, a trade sale, liquidation of the assets, listing on AIM, selling to management or selling to the employees (which will include the management as employees).

There may not be a willing family member to take on the business. A trade sale can be time consuming, costly and will open up the business to intense scrutiny. Selling to a third party may result in the facility being closed. Even if the business is kept open, key staff may be replaced when ownership is transferred. Liquidation of the assets will almost certainly not take into account goodwill (reputation or customer loyalty) and is likely to yield the lowest return.

The last option – to sell to the staff - is not one which most owners think about but it can be a tax efficient route for transfer, maximising the value of the business, preserving goods and services within the locality and safeguarding jobs.

Selling to the employees means selling to a group of people who have a vested interest in keeping the business going.

<u>Key issues to be addressed in an employee buyout</u>

1. An independent valuation of the business as a whole is carried out which will take into account past performance and future prospects. Often the vendor will have a good idea what price s/he wants and negotiation with the employee buyers will need to take place;
2. The vendor will have to decide whether s/he wants to realise the full value of the business on completion or is willing to accept deferred payment(s). Does s/he want to sell the assets or the shares? What is the most tax efficient payment method? Does s/he want to undertake work for the new employee owned organisation on a consultancy basis?
3. The employees will need to resolve some key issues. Are they willing to invest some of their own money and how much? What kind of legal structure will match their requirements? Who will be employed in the new business and in what position? How will the new organisation be managed?
4. If the business is to succeed on transfer, sufficient capital will be required to buy out the owner, to service any debt and to provide working capital. The employees will need to ensure suppliers are willing to deal with the new enterprise on similar terms.
5. An owner does not have to sell the business all at once, subject to agreement, payment can be taken over time.

5. The obstacles to employee buyouts

A host of barriers and obstacles mean that employee buyouts are not carried out as frequently as they might.

<u>Data</u>

- Lack of official data on extent and features of the employee owned sector makes it difficult to gear policy responses appropriately. Owners, business advisers and policy makers are all entitled to know the scale and characteristics of the sector they are being asked to consider adding to.

<u>Knowledge and information</u>:

- Lack of awareness and understanding of the employee buy-out option by businesses owners and their trade bodies.
- Lack of awareness in the business support community both of the option per se and of the processes to be undergone in a successful buyout.

- Lack of familiarity with and understanding of advantages of employee ownership and the buy-out option and knowledge of successful employee buy-outs [1]

Support/advice/guidance:

- A dearth of intermediaries (including business advisors, solicitors and accountants) able to advise on the option. This will include advice on possible legal, structures to adopt, the transfer process, financing mechanisms and support in building new management structures.
- Inadequate referral mechanisms to ensure that relevant opportunities are passed on to those with the expertise who can help and advise.

Fiscal

The decision to revoke the tax relief on company subventions into an employee benefit trust makes the process of an employee buyout more difficult and viability harder to achieve. As a general rule, companies can get tax deductions when shares are awarded direct to employees. But the Finance Act 2003 overrides case law and prevents a company from getting a deduction for contributions to an employee benefit trust (EBT) which are used to buy shares held indefinitely in trust. Accounting rule changes may also prevent a company from recognizing an expense for contributions to an employee trust[2].

Other barriers include -

- The tax penalty on loans from close companies to employee trusts
- Capital gains tax (CGT) on sales to an employee trust
- The complexity of UK to UK transfer pricing rules in relation to transactions with employee trust
- National insurance contributions (NICs) arising under the Inland Revenue approved share incentive plan (SIP) if shares are removed within first three years and the long period (5 years) for which SIP shares must be retained in the SIP
- The difficulty of getting advice on tax related valuation matters from Shares Valuation in advance of a transaction.

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[1] In addition, a survey conducted of employee buy-out practitioners (1998) overwhelmingly (90%) stated that the key barrier to the buy-out emerging was that the employee buy-out route was not chosen by managers as they feared it might diminish their rewards. On the other hand, employees were seen by a majority of practitioners as having a desire to participate in the running of the business when the full implications had been explained. The research showed that employees receive greater job satisfaction from a democratized work place and once they understand the issues embrace the opportunity to have greater power and influence in the running of the business.

[2] The negative effect of this change is to downgrade – wrongly – the importance of a collective shareholding in maintaining any long term employee ownership structure; and to increase the financial challenge on EBOs to find the necessary funding, because less money is needed from external funders if a company's own contribution to its EBT is tax deductible.

- Lack of depth of awareness of tax advantaged schemes as route into employee participation in private companies.
- The lack of a tax advantage for employee buy-outs in insolvency situations

Finance

There are no affordable sources of "patient capital" for employee buyouts if by this we mean equity or mezzanine finance. The only specific sources of finance for succession are Industrial Common Ownership Finance (ICOF) Ltd; the Baxi Partnership; and Finance Wales.

ICOF makes unsecured loans of up to £125,000 at commercial rates to co-operatives, employee ownerships and social enterprises. It has (including the Co-operative Action Fund) a total capitalisation of just under £5 million for the whole of the UK and lends only to businesses with a minimum 51% employee ownership. Typically ICOF makes between 5 and 10 investments into employee buyouts each year as part of its overall programme. It reports an extremely high success rate, both in terms of financial success and in terms of employee participation and is keen to do more.

Baxi Partnership Limited (BPL) is an investment company owned by The Baxi Partnership Trust whose purpose is to support employee buyouts, with three key elements: commercial success, employee ownership, partnership culture. Each company will develop a partnership culture, with intensive communication, consultation and involvement, and with cash profit sharing as well as individual share ownership. BPL has approx. £20m, of which some £5.5m has been invested in helping three companies complete the transition to employee ownership and in strengthening one company already owned by its employees.

The Finance Wales succession fund was set up in 2000. However, partly because of State Aid rules, this has been extremely expensive: a minimum of 5% above base even for secured lending, plus a high annual "premium". The scheme is currently under review.

There are specific difficulties with offering equity or patient capital for succession. One is the issue of control of the business, which Baxi have addressed in a number of ways. However clearly a business is not employee owned if it is controlled by outside investors. The other significant issue is that of return. A standard venture capital investment expects high failure rates and thus has to compensate by high returns from the successes – not usually suitable for an employee ownership succession as these do not tend to be in businesses in a high growth phase. Patient equity investment would need the investor to be offered revenue support, since returns would be long term and speculative at best.

Trade Unions

- Trade unions rarely consider, let alone propose the employee ownership option in any of these scenarios. Many appear uncertain of the role for unions within employee owned companies. Their lack of interest, verging in some cases on antipathy, acts as a further barrier to this business transfer option. However, they are an important constituency in certain succession situations. They will have a particular interest where members' jobs are affected by potential insolvency or plant or premises transfer. They will have a particular interest where members' terms and conditions could be threatened by change of ownership.

Procurement

- Inadequate provision in public procurement guidelines for inclusion of employee owned businesses and/or consideration of value of employee owned service provision.

6. Policy Proposals

The Delivering Employee Ownership Network recommends that a work programme is drawn up in partnership with the Small Business Service and others to take forward the following proposals:

Small Business Service Review

- Establish a steering group of representative bodies in the business succession field and task it to oversee implementation of the recommendations in 'Passing the Baton' as a matter of urgency.
- Review membership of the Small Business Council with a view to firstly ensuring adequate business transfer expertise and secondly ensuring representation of the SME employee owned business sector.

Research and data

- The requirement on Inland Revenue to generate and compile data on the extent and principal features of employee owned businesses in the UK.
- SBS sponsorship of research into owner and business adviser attitudes to employee ownership options, the quality and availability of advice on employee buy-outs, perceived and actual barriers to employee ownership, and the sustainability and viability of employee buy-outs compared with other business transfer outcomes.

Information, awareness and dialogue

- Systematic dissemination of focussed information and guidance about employee ownership and employee buy-out option through all relevant official channels, in particular the websites of Small Business Service, Companies House, Business Links, Regional Development Agencies, Inland Revenue.
- Target these and other awareness raising initiatives at key target groups including company owners and entrepreneurs, accountants, solicitors, insolvency practitioners, other business advisers, small business representative organisations, business support intermediaries, trade unions.
- Instigate and facilitate dialogue with key specialist academics, practitioner and professional bodies and small business representative bodies – with the aim of spreading awareness among key target groups.

Building capacity and capability among intermediaries

- Develop a programme of awareness–raising and information among the business support infrastructure with the support of the SBS and aimed at intermediaries at local and regional level. Use a variety of media and include a series of face-to-face presentations.

- Develop a programme of awareness raising and information targeted at accountants and solicitors through their trade bodies and publications.
- Build awareness and expertise among business advisers of the specific management and governance requirements of employee owned businesses such as participative governance, enhanced communications and team working capability

The role of trade unions

Develop a dialogue between employee ownership and business succession specialists and senior trade union decision makers, brokered by the SBS, aimed at involving union officials more often and more effectively in the transfer process.

The tax regime

In particular -

- Promote awareness of the scope and range of tax advantaged schemes that underpin typical SME routes into employee ownership and employee financial participation.
- Remove the tax penalty on loans to employee trusts by close companies.
- Allow a corporation tax deduction for payments to employees' trusts where the trust retains shares for general employee benefit.
- Confirm that government favours a policy of encouraging companies to fund employees' trusts to acquire and retain shares.
- Grant CGT exemption (instead of 10% CGT) on sales to employees' trusts intending to hold shares in the long term.
- Remove the employer's NICs exposure in SIP shares removed from the SIP, during the first 3 years and a reduction in the SIP scheme's current 5 year for share retention to 3 years
- Clarify how transfer pricing rules apply in internal UK transfers between, for example, a trustee company and its founding company
- Grant a tax advantage for employee buy-outs in actual or potential insolvency situations, sufficient to give at least a 10% price advantage to employee buy-outs
- Give advice on valuation and taper relief issues from Shares Valuation.

The finance regime

- A Treasury and DTI initiative to increase awareness of employee ownership option and benefits among financial institutions; active consideration of measures to create new funding facilities for employee buy-outs.
- Increases in the availability of loan capital through funding existing and proven institutions in the field, enabling them to develop new models of equity finance as proposed in "Co-operative Capital" by Jim Brown (Co-operative Action publication, 2004). In particular, revenue support for "patient capital", perhaps along the model of the Adventure Capital Fund for social enterprises, should be considered.

Procurement

Review public sector purchasing, and procurement guidelines, with the objective of significantly increasing the opportunity to bid, and the share of contracts won by the employee owned business sector.

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Appendix

Case studies

Savant Enterprises is an information technology development and consultancy. Savant designed the blood product control software for the English blood service. In 1999 the family owners decided they wished to retire and seriously considered a trade sale. This would have meant moving the business and the staff to another location. The management was unwilling to move and made this fact clear to the owners. The management and staff knew that they had the skills and expertise to run the company themselves and the employee-owned option offered a real solution to both parties. In 2001 it became employee owned with 32 members.

"Savant Enterprises is a software development company based in Carnforth, Lancashire and has been employee-owned since 2001. Software development requires a great deal of team work and is a people based business. Employee ownership fosters the team culture and ensures that employees get recognition for their efforts."

Ian Henderson, Managing Director

Universal Bulk Handling Ltd was a world class company manufacturing liquid and gas tank containers put into receivership in February 1998. UBH International Ltd was established in August 1999 as an employee owned company limited by shares as part of an attempt to salvage jobs. A package of finance was put together including 90 employees agreeing to invest £5000 each (either their own redundancy monies or borrowed). It now (2004) has 120 employees and a turnover of £8m

"Being employee owned has enabled us to overcome the problems of recession and the challenges of a fierce market place. Our ownership structure has encouraged a flexible and creative approach by the workforce and has also enabled the business to escape short-term demands for shareholder returns. We can take a long term approach."

Mike Himbury, Managing Director