EMPLOYEE OWNERSHIP

Working towards financial freedom

Employee ownership can bring benefits to businesses, staff and customers. Banks have a role to play in this exciting restructuring process, which one CEO describes as making him and his staff ‘the true masters’ of their own destiny.

EMPLOYEE ownership is not new to the UK – in fact, retailer the John Lewis Partnership and global engineering firm Arup have clocked up around 160 years of employee ownership between them. However, there is now substantial growth in this ownership structure among many smaller, regional businesses, following the introduction of the Employee Ownership Trust (EOT).

What is employee ownership?

The Ownership Dividend, launched recently by the Employee Ownership Association (EOA), shows that transitions to an employee holding structure are especially popular with those seeking an alternative to a trade sale or a management buyout (MBO).

For many owners, a trade sale is often not the most desirable exit route. It doesn't secure the future of the business in its current location for both employees and customers. But employee ownership enables a firm to exit on its own terms and timescale while achieving full financial value.

The evidence in the report The Ownership Dividend published in June 2018 shows that in addition to providing owners with the exit they want, employee-owned businesses are proven to engage their workforce in a more meaningful way, via their ownership stake. This stake, delivered via direct shares, a trust, or a hybrid, along with the accompanying influence exercised through a structure of representation, drives more individual discretional effort. This then directly results in higher levels of financial performance, with new employee-owned businesses reporting an immediate increase in profits in the year after transition. The evidence also shows that these businesses have more formal corporate governance structures, take a long-term view of investment and are subsequently more resilient.

Financing the transition

The EOT was introduced in the Finance Bill 2014 and allows for complete exemption from capital gains tax on the proceeds of a sale to owners who sell a minimum of 51% of the equity of the business to the EOT. There is also an additional benefit to employees, where bonus payments made via the EOT can be paid tax free up to the sum of £3,600 per employee per annum.

Employee-owned companies offer banks similar financing opportunities to other private companies but, with an EOT, there is an additional opportunity for banks to lend to the EOT for the acquisition of shares on behalf of employees.

Banks typically share the EOT lending role with selling shareholders (vendors) whose loans are fully subordinated to those of the bank. However, because vendors (usually the founder) often continue to be involved in the business, providing continuity, this is often an attractive credit proposition for banks.

Some banks are establishing specialist EOT financing units to attract this type of business. Finally, it is important for banks to be satisfied that an EOT is not paying more than fair market value for its shares as well as the loan from the bank being prioritised over the vendor loans to the EOT.

Red flags

When considering any risk that would prevent banks from lending for this purpose, the biggest risk is a technical one: if the EOT's shareholding falls below 50%, it will become liable to pay capital gains tax. This is not an issue if this happens for good reasons, such as an onward sale of the company, but it could create an unwelcome tax liability in situations where the EOT is not in funds to meet the tax bill. The lending bank would seek an indemnity from the company to cover this risk.

Any existing business debt would form part of the credit appraisal process and may constrain the amount of debt available to finance for an EOT transaction. CB

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Case Study - Cambridge Weight Plan

Corby-based Cambridge Weight Plan Ltd (CWP) employs around 220 staff and has a turnover of £40m per annum derived from the manufacture of the diet products. In the UK CWP sells and markets the brand through 3,000 independent CWP consultants and exports to independent distributors globally.

The first commercial version launched in the UK as The Cambridge Diet in 1984. A management buy-out took place in 2005, however, despite driving excellent results, the subject of succession soon came around again. This time the owners were looking for a longer-term, more sustainable solution that could convert share certificates into cash while preserving the successful business model that had been created. In 2009 the options considered were: to pass on the business within the family, a next-generation MBO, a trade sale, to float or to move to employee ownership.

The employee-ownership option was chosen with the business moving to an EOT, delivered via a two-stage transaction. In autumn 2010, there was a 49% sale via a £14m bank loan, followed by a further 51% sale in autumn 2014 using a £20m bank loan, both financed by Lloyds. CWP engaged its bank at the start of the planning process and the firm also took legal advice and support to effectively manage the process and the potential divergence of interest between the company, the EOT, the retiring owners and the continuing management.
There was an independent valuation of the business and consideration of management incentives, which was key for the bank in order to lock in the team responsible for repayment of the loan.

Chris McDermott, CEO, comments: “One of the big impacts employee ownership has had on the business is to do with our long-term thinking and strategic planning. We are able to take a much longer view now because we do not have external shareholders expecting annual dividends or considering a sale within the next few years. We have instigated a complete brand review process that looks at a five-to-10-year time horizon (rather than three to five years) – the results of which we are about to launch to the UK market.

“We are a profitable business; our employee stakeholders experience regular profit-share bonuses of between 12-15% of salary each year. We have created ‘Voice Groups’ across the company enabling stakeholders to have input into the running of the business, including how the company should share with them any residue profits it might make in the future. We did this because in July 2018 we paid off (in full) the outstanding loans used to purchase the company purchase the company – two years early – enabling us to declare ‘Financial Freedom Day’ on national Employee Ownership Day 2018. And to celebrate, the company gave £1,500 to each stakeholder. It was at that moment that it felt we all became the true masters of our own destiny.”

Article by the Employee Ownership Association, the membership body for the sector, with support from RM2, an independent corporate finance advisory company specialising in structuring and financing EOT transactions and in converting private companies to employee ownership.