Ownership at Work

OWNERSHIP INSIGHTS

CAPITAL PARTNERS?

Why it's time for finance and employee ownership to talk

Ewan Hall
David Gorman

Sponsored by

baxi partnership

unity trust bank
BANK WITH US. BANK ON US.

Capital for Colleagues
Advice Investment Growth

Foreword

Banks play a crucial role in helping ambitious companies to create new capital and to grow, prosper and invest. However, it seems that financial institutions have some work to do when it comes to companies that are owned by their employees.

This is despite several high-profile company founders securing widespread media coverage after passing on ownership of their business to their employees, including high street retailers **Richer Sounds** and **Lush**; Wallace and Gromit animators **Aardman**; travel guide **Sawday's**; and farm-to-home deliverers, **Riverford Organics**.

In a growing sector worth nearly £40 billion, employee owned companies make a significant and increasing contribution to the UK's economy. Evidence shows they routinely outperform more conventionally owned competitors; have highly engaged workforces; are resilient in economic downturns and are strong innovators. What's more, according to recent research summarised in this paper, over half of these firms have an unmet need for finance.

We hope this paper will help the financial sector to better understand the finance related issues for businesses looking to transition to employee ownership and how they can ultimately provide more accessible funding and lending solutions. As part of our commitment to this, we are accelerating share ownership for our employees within our business, aligning the interests of our people with those of our shareholders.

As a commercial bank with a social conscience, Unity Trust Bank recognises and values the positive impact that employee owned organisations have on our economy, community and society, and we are very proud to be associated with this paper, which we hope will shape the conversations taking place about investment in employee owned businesses in the years to come.

Margaret Willis
Chief Executive
Unity Trust Bank

Contents

"The main reason for EO's finance gap is financial institutions' lack of awareness or understanding about the sectors."

EXECUTIVE SUMMARY

Despite its growing size, tax advantages and attraction as a succession option the employee ownership (EO) sector can struggle to raise finance. The result is missed opportunities – for finance and employee ownership – on a potentially large scale.

The main reason for EO's finance gap is financial institutions' lack of awareness or understanding about the sector and its characteristics.

EO firms are uniquely investable because evidence shows they demonstrate a combination of high productivity, high levels of employee engagement, receptiveness to innovation, while being resilient and sustainably profitable in economic downturns.

Among problems experienced by EO businesses (EOBs) are poor response rates from banks, lack of any knowledge or expertise about the business model, a tendency to pigeonhole EO wrongly on a par with MBOs, and unjustified assumptions about the vendor financing model.

New research cited by the paper found over one in three EOBs did not feel well informed about potential sources of investment and over half had an unmet need for finance.

Many EOBs are wary of external finance but this could lead to EOBs missing out on opportunities to grow or diversify their businesses.

EOBs present unique features that financial institutions and the procedures they apply to lending and investment need to address.

As well as diversifying their asset base, involvement with EOBs would allow financial institutions to add to their social impact credentials given the sector's high standards of governance, wealth sharing with employees, high levels of employee engagement and deliberate tendency to support local employment and suppliers.

Mainstream lenders should consider establishing a go-to EO specialism within the business, while adapting assessment frameworks and templates that fit the realities of employee ownership.

Equity investors should understand that there is unlikely to be an exit event, such as a trade sale, so the investment approach – such as funding the company's growth - should be structured accordingly.

The EO sector itself should be more open minded about the potential benefits of external finance; and the Employee Ownership Association should do more to forge partnership between the sector it represents and the UK's financial institutions.

Government should use its multiple influencing levers to make financial institutions and advisers more aware of the opportunities employee ownership offers, and should reinstate the role of Minister with designated responsibility for the EO sector.

Government should replicate the success of the Scottish Government's capacity building investment in the growth of its own employee ownership sector – offering grant support for businesses transitioning to EO, and a guarantee facility instrument to help EO firms secure suitable loans more easil

Ownership at Work

Ownership at Work

Ownership at Work's mission is to generate new thinking and ideas on employee ownership's contribution to the UK economy. An independent think tank, Ownership at Work publishes policy papers, guidance and research on the fastest growing business model in the UK economy. Holding charitable status, Ownership at Work is a politically impartial research partner of the Employee Ownership Association, the national body which speaks for the UK's £30 billion-plus employee ownership sector.

Ownership at Work wishes to acknowledge the support of Unity Trust Bank, Baxi Partnership and Capital for Colleagues in the authorship and publication of this paper.

Baxi Partnership

Baxi Partnership is a unique organisation with a unique history. Founded in 1866, the third generation of the family owners, led by Phillip Baxendale, transferred the shares into a trust for the benefit of the employees in 1983. Baxi Partnership has been providing finance to employee owned organisations since the early 2000s and continues to do so today. Advice is provided to the employee ownership sector by its subsidiary Baxendale.

Capital for Colleagues

Capital for Colleagues (C4C) is an investment management business focusing exclusively on employee owned businesses (EOBs). Its unique service is to:

- **Advise** clients who want to become employee owned, as well as existing EOBs looking to grow their business.
- **Invest** patient capital in the form of equity and debt to enable the initial transition to an EOB or to help the business grow.
- **Support** a company's board to grow the business and help develop their employee ownership culture and practice.

Unity Trust Bank

Unity Trust Bank is a commercial bank with a difference. We only lend to organisations who help to create a better society and we focus on delivering social impact, not simply maximising profit. The ambitions of the bank are to expand its employee ownership so all staff will have a meaningful stake in the business.

Ewan Hall

Ewan is a director of Baxi Partnership and advises clients on commercial and corporate projects, specialising in transition, governance, ownership and financial structures for employee owned organisations. He has been advising on employee ownership since 2003 and has worked with over 100 employee owned organisations. He holds a number of trustee/trustee director posts with employee owned organisations and is regularly asked to speak at employee ownership events across the UK.

David Gorman

David is partner and investment manager with advice and investment managers Castlefield, who are employee owned and were instrumental in founding Capital for Colleagues plc in 2014. He holds an MBA from Alliance Manchester Business School and is a chartered member of the Chartered Institute for Securities and Investment. David is a member of the Financial Reporting Council's Investor Advisory Group and the FRC's Advisory Group on the Future of Corporate Reporting.

1. EO AND FINANCE

This paper aims to address why the UK employee ownership sector – despite collectively accounting for a substantial 4% of the UK economy[1] and growing at a faster rate than its non-EO counterparts – struggles to raise finance to fulfil its considerable commercial potential. The paper will explore why this gap exists, and what needs to happen to fix it for the good of financial institutions, the employee ownership sector and the wider UK economy.

The EO sector has attracted growing interest from both Government and the media in recent years because of its record of delivering impressive and sustainable business outcomes, offering an alternative solution to the UK's productivity challenge as well as being exceptionally resilient in economic downturns.

A growing evidence base shows the EO sector – worth nearly £40 billion and rising – displays stability, innovation and embedded value to local economies. These are all qualities lenders and investors should be motivated and assured by; it is in the interest of both EO businesses and financial institutions that the sector's finance gap is bridged.

Recently the EO sector received a surge of positive attention leading to improved awareness of the potential role it could play in strengthening the UK economy. In 2017/18 the biggest inquiry[2] into employee ownership was undertaken by the Employee Ownership Association (in collaboration with the eaga Trust and the John Lewis Partnership and supported by Cass and Manchester Business Schools). This shone a spotlight on compelling evidence to support what the sector has known since its inception: that EO businesses do well and that their form, replicated more widely, could offer both a productivity boost and better model for strong, resilient businesses and workforces.

The future of work

Just as crucially, a more fundamental trend is under way. Faced with a swell of baby boomer business owners reaching retirement age, employee ownership provides a constructive answer to the problem of succession, often with fewer risks to the business, communities and employees than traditional trade sales.

A modern, increasingly millennial workforce is more attuned to the benefits EO brings, including greater employee voice, improved wellbeing for workers, shared reward and a more equitable business model – all factors in the sector's impressive growth rate (approximately 60% growth since 2010[3]).

The EO incentive

A mounting body of evidence shows that employee owned businesses are typically more innovative and productive because workers have a meaningful stake in the business, leading to higher employee engagement that in turn can trigger superior performance to traditional business models.

With all of the main political parties supporting the model, financial institutions need to become more familiar with employee ownership and prevent unfamiliarity or misconceptions hindering opportunity for both the EO and finance sectors. With the prominence of EO rising, and the need for more equitable and sustainable ways of doing business becoming the gold standard to future-proof the economy, it has never been more important for business leaders, financial institutions and Government to build the sector into their policies and plans.

[1] Employee Ownership Association (EOA) figures

[2] The Ownership Effect, comprising The Ownership Dividend, a Global Literature Review and Evidence Report

[3] Research from White Rose Centre for Employee Ownership cited in The Ownership Dividend, Page 19

[4] EOA definition: https://employeeownership.co.uk/what-is-employee-ownership/

[5] Page 4. Prof Joseph Lampel (Alliance Manchester Business School), Dr Aneesh Banerjee (Cass) and Prof Ajay Bhalla (University of London), June 2017

[6] The Nuttall Review of Employee Ownership, July 2012

What is Employee Ownership?

Employee owned businesses (EOBs) are totally or significantly owned by employees[4]. They operate across all areas of industry, including manufacturing, professional services, retail and health & social care, totalling more than quarter of a million owners in the UK alone. Notable examples of EOBs include the John Lewis Partnership, global design and consulting specialists Arup, celebrated animators Aardman and award-winning hi-fi specialists Richer Sounds. High street retailers Lush launched an employee benefit trust in 2017, becoming 10% employee owned with the possibility of increasing employees' ownership stake in the future, further underlining the growing interest in the model. The number of well-known brands becoming employee owned increases every year.

Organisations can become employee owned through exiting owners selling to employees as a solution to succession, but also via new businesses choosing to share equity with their teams, or public services spinning out of the public sector to form public service mutuals (PSMs).

There are three principal ownership structures:

i) **Direct ownership**, where employees become majority shareholders and hold those shares directly; ii) **Indirect ownership** – where shares are held for the employees in an employee trust, or iii) a **blend** of both, which is the most common choice.

What EOBs have in common is that employees have a meaningful stake in the business, with mechanisms to enable them to influence how the business is run. Employee ownership enables shared purpose and reward, providing businesses with additional levers through which to drive performance and generate success. EOBs tend to have transparent cultures with good corporate governance and high workforce engagement at their core and will often share profits with employees in the form of more equitable bonuses than is seen in traditional business models.

The impact of the above is to create sustainable organisations that are better protected from exploitation or risk and which have a long-view by nature, allowing deep ties to be forged with local suppliers, communities and stakeholders. According to EOA's Ownership Effect Inquiry: *What does the evidence tell us?*[5], *'in 2016, the top 50 employee-owned firms had a combined turnover of £22.6 billion, and posted a growth of 10.2%, compared to the UK GDP growth of 7.7%. These top 50 employee owned firms had a combined workforce of 175,000, which has grown by 15% over three years, compared to growth in the workforce in the UK economy of 5.8% over the same period.'*

So, what's the problem?

Despite interest in the model growing, the sector is held back by a lack of awareness and understanding from lenders, investors and other intermediaries who can play a key role in accelerating its growth.

Following publication of the Nuttall Review (2012), the Coalition Government went some way to spur the creation of more employee trusts by offering tax incentives through The Finance Act 2014. Exiting owners who sell to a special form of employee trust – an Employee Ownership Trust (EOT) – are exempt from capital gains tax and employees of businesses majority-owned by an EOT can enjoy an income tax-free bonus of up to £3,600.

This reform has had a significant impact on the number of businesses opting for EO at the point of ownership succession – see Ownership at Work's recent paper *Equity for All – how a simple trust can spread ownership and wealth to millions.*

However, some recommendations made by the Nuttall Review are yet to be fully implemented. The leading recommendations were around the role Government should play in raising awareness and promoting employee ownership. Whilst the efforts of politicians are welcomed by the EO sector – with all main parties voicing support for employee ownership and government funding for public service mutuals – the model is arguably only just beginning to permeate the business mainstream.

Particularly relevant to this paper is Nuttall's ambition to elevate EO to a mainstream business level *(Recommendation Q: convene a taskforce of legal, tax, accountancy and other professional bodies [to make…] employee ownership a more integral part of advice provided by intermediaries[6]),* and to improve communicating financing opportunities to EO businesses (Recommendation R).

The cloak of invisibility still appears to be shrouding the employee ownership sector, judging by its low profile among financial institutions. The aim of this paper is to show investors, lenders and advisers why they are missing a trick by failing to engage with the UK's fastest growing business model.

2. TACKLING THE BARRIERS

EO businesses are found in all areas of the UK economy, and a significant portion of them are SMEs – meaning they face the same challenges as non-EO businesses of the same scale, especially in the wake of the 2008 financial crisis which saw banks limiting funding pipelines. It can be difficult to assess the credit risk posed by SMEs, with financials sometimes being hard to consolidate and interpret; and furthermore, the loans sought may be too small to be attractive to mainstream banks.

However, EO businesses have their own set of unique challenges that create further barriers to securing finance, and it is these that should be addressed since they frequently stem from information gaps and systems that are bad at addressing alternative models.

Typically, EO businesses may seek finance for the following reasons:

- To fund a transition to employee ownership without hampering forecasted growth of a business; or in some cases, to enable a transition to happen at all
- For growth and scaling up (including M&As)
- For innovation and launching new products
- For the purchase of assets

But in the process of seeking finance, employee owned firms and financial institutions they approach can encounter hurdles such as the ones we summarise below.

EO finance research project

In 2018 Baxendale and Social Investment Business undertook research to assess the social impact of EOBs and their demand for external investment. The research included a literature review along with interviews with 21 senior leaders of existing and pre-transition EOBs. This paper draws on the summary report along with wider unpublished findings: https://www.baxendale.co.uk/whatwethink/

Impact through ownership: Summary Report – Social Investment Business and Baxendale

[7] Employee Ownership in Britain: Size and Character – White Rose Employee Ownership Centre (authors Prof Andrew Robinson & Prof Andrew Pendleton)

Awareness gap

Whilst employee ownership is not new, over 60% of EO companies became employee owned since the start of 2014, and in 2017 and 2018 the number of EO firms increased by 17.2% and 18.5% respectively[7]. Trending up in popularity so recently, it's easy to see why the fundamentals of EO are not widely known across the mainstream finance sector, or even understood by the majority of professional advisors. It's now critical that the finance sector does become familiar with the model, since the biggest barrier to funding reported by EOBs is a lack of understanding from those outside their sector.

Researchers from consultancy Baxendale interviewed EOBs in 2018 as part of a joint research project into the sector's demand for funding. Their unpublished report found a widely perceived lack of understanding around the EO model amongst high street banks, with interviewees reporting mixed levels of success unconnected to financial performance – demonstrating a patchy and inconsistent reception.

Whilst some interviewed firms had secured loans from banks (though not always on first try), other profitable businesses going through the process of transitioning to EO experienced poor response rates, with one bank asking to review all the EOT documentation, which can be a common request. Experiences like this are likely to stem from the fact that no high street bank has a dedicated EO team, so willingness to enter into loan discussions with EO businesses may be based on surprisingly arbitrary variables if there are no available bank personnel familiar with the model.

The research also found employee owned firms reporting these impressions of banks:

- Lack of understanding around how obtaining a loan would impact on their autonomy
- Shallow knowledge of the financial opportunities available

Loss of independence fear

On the EO sector side, Baxendale's research detected what can be unfounded fears about bringing in a third-party, even before conversations around the role of the lender have taken place. 'Loss of independence and control' was the leading concern of those seeking finance. Wariness is understandable since these are businesses in the middle of managing an ownership and culture transition.

A connected worry was 'dilution of equity', though newly employee owned firms are more likely to be seeking loans than equity investment.

It is also the case that some EOBs simply don't want external investors – whether through loans or equity. Many EOBs choose the ownership model to safeguard their independence. This can make them reluctant to sign up to financial obligations and put their assets at risk to a third party. But this can limit an EOB's ability to take advantage of opportunities to grow that could be unlocked through external finance.

The Baxendale research study found more than four fifths of respondents felt well informed about their own investment gaps, but just under two thirds felt well informed about potential sources of investment – and this is assuming they are well-placed to judge, since knowledge imparted by advisers can sometimes be incomplete.

Further barriers on the EO sector side included, in a small number of cases, mistrust in banks and a preference for 'ethical lenders', though mainstream banks were usually still their first port of call.

Despite the above concerns, the research did find there was an openness and appetite for forming partnerships with appropriate external sources of finance. With the right values-fit, ethics and understanding of the EO model, there is real scope for fruitful EOB-investor relationships. Further evidence for this in Baxendale's research was the respondents who spoke positively about their dealings with existing investors. Niche investors Capital for Colleagues and Baxi Partnership, as well as social investors, featured in the list of funders, but loans also came from high street banks including HSBC, Lloyds and others.

The vendor finance factor

Another potential obstacle for finance is the common assumption that EO transitions need funding from vendor finance alone (where the remaining debt after completion is paid to the exiting vendor over a number of years through an agreed payment schedule). For businesses hitting uncertain times, this can be problematic, but even thriving businesses may be wary of over reliance on this income stream, particularly if they are planning for a period of scaling up, investment in new products or other avenues of growth.

The ideal option for most may well include a blend of financing options, even if full vendor financing is viable – and of course, this will require both lenders and owners to become more versed in each other's interests and needs.

In its most mutually beneficial form, EO should allow the exiting owner to realise the full market value of the business, providing a legitimate alternative to a trade sale, and exactly how that transaction is arranged will be case-specific. At least some liquidity may be necessary at the point of sale, and many EO businesses might reap the benefits of EO faster if they had better guidance around raising funding for the sale.

Systems that don't fit

Global consulting firm Deloitte has speculated that advances in technology and the ability to quickly store and mine data may give SMEs more success obtaining loans in the future[8] due to improved access to datasets. Since most EO businesses are SMEs, removing barriers to help such firms borrow is helpful. But digital and other qualifying frameworks need to fit EO businesses, which means taking into account their particular requirements. With more analysis and understanding, many assumptions about the risks of lending to EO businesses can be dispelled. Furthermore, at a time when technology is replacing the human element in financial decision-making, it is essential that systems allow for accurate modelling of the credit-worthiness of EO businesses.

A typical problem is that banks – faced with an unknown model but one which at first glance shares characteristics with a management buy-out (MBO) – can apply their 'standard' MBO parameters to EO clients, only to find they don't fit. Examples revealed by the research included banks demanding personal guarantees or wanting new leaders in the business with large individual shareholdings.

Lenders to EOBs need to understand that:

- Personal guarantees are rarely available when lending to EOBs
- There are often key stakeholders – in the form of the exiting owners – who are still personally invested in the business and who are usually paid out over several years. They are still investors, but simply as creditors rather than shareholders. They will often remain heavily involved in the business for a period of time (although no longer in ultimate control) to protect their investment and/or to manage a smooth handover of leadership roles. Controls will usually be in place to protect the vendor's loan, allowing for interventions should revenue forecasts fail to be met. Many informed lenders see this is as a valuable benefit in lending to EOBs as part of a succession plan
- Template loan and security documents may need to be adjusted to reflect the fact that the ultimate owner of the business and potentially the borrower is often a trust rather than a conventional corporate entity. This does not require a lot of adjustment – for example, financial covenants by the trust that assume it is a trading entity are unlikely to be appropriate; a debenture alone from an EOT trustee is unlikely to provide sufficient security for a lender (a share pledge or charge over the trading business's shares is usually more appropriate). Understandably, lenders are sometimes uncomfortable allowing ad hoc changes to template documents for each transaction, so the best equipped lenders will have taken advice in advance and prepared template loan and security documents for EOT-related lending (though very few currently do this)

Assessing risk

The perceived risks of lending to EO businesses may still be too great if the loan cannot be secured (as with any loan to a business). When the vendor's equity value represents a higher value than the business's net assets, banks should evaluate investability on a case-by-case basis, looking at the financing opportunity in the round. One respondent in the Baxendale research project felt the banks they spoke to had a 'black and white approach to approving finance' that did not take into account strengths of the business beyond tick-boxes.

There is a wide variety of timeframes to becoming employee owned, from a single transaction where ownership passes immediately to a gradual process over several years. Similarly, the period of time over which a transition must be funded is hugely variable from a negligible period (usually where a former owner has gifted the shares to the employees) to the typical period of four to eight years and, in some cases (usually where there is a particularly high valuation or a very soft repayment schedule), ten years or more.

External lenders may assume that financing a transition to employee ownership will have an unsuitably lengthy payment plan. But this is not always the case, and though owners staying close to a business for many years helps build stability, the benefits of EO can often be achieved more rapidly if the vendor exit and debt pay-back time (both to banks or vendors) is more compressed.

Where there is both external and vendor debt involved:

- The external creditor almost always ranks ahead of the vendor creditor; and
- After any initial payment is made to the vendor at completion, the initial external debt often needs to be cleared before the balance of the initial vendor debt is paid (although we are seeing an increase in external debt to refinance the final balance of vendor debt after any initial external debt has been repaid).

Lastly, on perceived risk, there is an occasional but damaging assumption that employee ownership is a last resort or an option for failing businesses. This can lead to some financers being suspicious of EO. The EO sector is working hard to quash this myth. EO businesses can still fail, as any business can, but employee ownership offers innate benefits that make EOBs both more commercial than they were before, and more robust.

In addition, the individuals who are often in the best position to judge the risk of lending to the company – the exiting owners who typically know the business better than anyone else – are unlikely to sign up to what is frequently a large amount of deferred vendor debt if they do not think that the business is viable and able to fund the debt. All the parties involved in an EO transition have every incentive to ensure that the business flourishes going forwards.

Debt funded exits

But where any lending (whether external or vendor) is being used to fund a vendor exit rather than growth in the business, the fact is that the business will typically have less working capital for a period of time because surplus profits will be needed to pay down debt.

This is not an EOB-specific issue – it is the case for any debt-financed exit. And where a business requires a lot of capital to grow, the growth potential may be limited while the debt is repaid. The flip side of this is that when the debt has been repaid and the EOB is fully independent without any external shareholders or owners, the business will often have a greater opportunity to retain healthy working capital balances (for example, Arup will usually retain cash equal to six months of typical costs to ensure that they are well-capitalised at all times).

[8] Deloitte, https://www2.deloitte.com/uk/en/pages/financial-services/articles/changing-world-of-sme-lending.html

3. DEMAND FOR FINANCE

The Employee Ownership Association is aiming for the sector it represents to comprise at least three million owners by 2030, forecasting dramatic growth in coming years.

The Baxendale research study showed powerful demand by EOBs for finance opportunities. Just over half of participants reported a current unmet need for finance, while four out of five reported that they will have an investment need in the next three to five years. Since most of these organisations are already employee owned, the main motivator for this is growth: to do something new.

It should also be noted that the majority of businesses contacted for the research did not seek finance for their transition, though several that did were larger and more profitable EO companies (e.g. with turnover of up to c£325m). However, larger companies also figured in the list of those who did not seek external financing. So, it's not possible to argue that company size is the critical factor: there are too many contributing variables.

The great majority of businesses looking to become EOBs will have a requirement to finance a vendor sale (unless the owner is gifting the shares – which is unusual), but not all will choose to do this with an external loan. Whether they do will be connected to a number of internal and external factors.

Scope for lenders

However, not all EOBs who want funding will be able to obtain it, even from informed lenders who understand EO. A large amount of the growth in the EO sector over the last five years has been in the form of businesses with fewer than 100 employees. Many of these are highly profitable, successful and great lending prospects. But some are small. And because the due diligence and lending process for lending £10m is often very similar to lending £500,000, some lenders do not consider the return worthwhile to look at very small loans or businesses making less than £500,000 to £1m in profits, whether they are EOBs or not. Smaller loans often take the form of temporary facilities such as overdrafts rather than term loans.

EOA's business-led 2017-18 Ownership Effect Inquiry noted that 'the transition to employee ownership is associated with rapid improvement in productivity, often driven by employees taking initiative, and implementing changes in work practices that reduce waste and improve efficiency[8]'. The bottom-line often improves after the transition has completed, which frees up opportunities for further innovation and growth.

With most prospective EO businesses needing to buy out their exiting owners, and planning growth post-transition, there is immense scope for lenders to offer tailored services, including a suite of financing options for EO businesses to help them and their local economies thrive. Also worth noting is that those who become EO as start-ups may have further investment needs, and this cohort of EOBs is set to grow as attitudes towards employee engagement

[8]The Ownership Dividend, 2-18, p19

4. PERFECT PARTNERS

Financial institutions and EOBs could make perfect partners. It's the right time for financial institutions to start accommodating this thriving but still relatively ignored business sector, because the socio-economic environment, business attitudes and modern workforces are combining to make EO increasingly attractive. Growing evidence of the model's resilience and stability should give lenders confidence the sector has the capability to capitalise on investment.

Businesses that transition to employee ownership are frequently long-standing, with a sustained track record of profitability and cash generation; with key leaders (the exiting owners) usually committed as investors for a period of five to eight years (the typical payment period for any vendor debt). These are usually exactly the kind of businesses that lenders wish to fund. And after an EOB has borrowed once (for example, to fund its move to EO), it is more likely to be comfortable borrowing again (for example, for growth). Known, repeat customers are generally significantly more attractive to a lender.

Employee ownership collaborative networks and knowledge-sharing nationwide mean that testimonials and recommendations are often replicated rapidly. There is immense opportunity for banks and other lenders to fill a funding gap which in turn could switch on a pipeline of clients for them. With greater awareness about lending and investment opportunities, EO firms can add to their stability and improve growth prospects. With more understanding about EO's investability, financers could diversify their asset base and returns into one of the economy's healthier and fast-growing sectors.

Some EOBs also need greater awareness of the benefits of external finance and how it can help fund growth, diversification and ultimately a more robust and sustainable business. Not every EOB needs such finance, but some may be missing an opportunity here.

Social impact case

Furthermore, there is a social impact case to be made for funding EOBs that could appeal to both mainstream banks and niche lenders/other equity investors. Banks who want to be seen to be enablers of better, future-proofed business have a lot to gain by supporting EO businesses. As a sector, EOBs have good success stories to tell, with real impact on individuals, communities and the local economy including:

- Helping to create a fairer society through sharing wealth with employees
- High standards of governance and an emphasis on equality
- Prioritising prospects for local young people through internships and apprentice schemes
- A happier work environment, confirmed by relatively high retention rates and lower absence
- High levels of employee engagement that encourage innovation with a positive impact on customer outcomes
- Deliberately long-standing relationships with local suppliers which in turn strengthens local economies
- Protecting local jobs by choosing EO over a trade sale that will typically remove jobs from the locality sooner or later

5. RECOMMENDATIONS

For mainstream lenders

1. Ensure there is a go-to EO specialist within your organisation who understands the unique benefits and requirements of an EO model
2. Evaluate whether assessment frameworks and template documents are fit for EO businesses
3. Ensure new technologies fit EO firms, so systems don't decline loans on unfit parameters
4. Don't make decisions based on bundling EOBs in with (i) MBOs and (ii) other SMEs – as they are unique
5. Tap into EO networks through your EO clients and the sector generally – there are a lot of EOBs with a demand for finance out there

For equity investors

1. Be clear that there is unlikely to be an exit event (such as a trade sale) to realise your investment; the business is probably going to have to fund your exit itself. So structure your investment approach accordingly
2. If you are seeking large returns, solely funding exits is unlikely to achieve this; you need to also be funding growth in EOBs that will generate the additional profit to finance these returns
3. Most EOBs are averse to external shareholders, so be open to structuring your finance closer to a debt model (for example, through redeemable preference shares)

For the EO sector

1. The Employee Ownership Association and other influential organisations should do more to connect the EO and finance sectors
2. Companies should be more open-minded about avenues available and the benefits of seeking external finance
3. Intermediaries should create more resources to signpost funding and help trigger a broadening of ambition based on growth aspirations
4. The sector should share experience about successful involvement with finance, to help other EO businesses recognise opportunities
5. The sector should support research which generates hard evidence for financial institutions and employee owned firms of the mutual benefits finance for employee ownership

For Government

1. Ministers and government agencies should use the many influencing levers they hold to make financial institutions and advisers more aware of this growing sector and the opportunities it offers, proactively encouraging the growth of the sector
2. Government should work with EO and the wider mutuals sector bodies to create a new national strategy for diversifying business ownership
3. To coordinate and drive that strategy, Government should reinstate the role of Minister with clear responsibility for EO and other mutually-owned business models, supported by a dedicated Whitehall team
4. Government should establish a framework and budget for businesses facing succession challenges, which incorporates advice and guidance on the option of EO (currently provided in Scotland)
5. Government could go further and invest in the EO sector's capacity to build and attract finance. The Scottish government through Scottish Enterprise (formerly Co-operative Development Scotland) is a live, working example of how this can work – acting as an expert intermediary between companies considering employee ownership and succession, and institutions such as accountants, lawyers and banks they're likely to need
6. The Treasury should consider a guarantee facility instrument – examples of which already exist backed by Government in other sectors – to help EO businesses secure loans more easily
7. Contributions from a company to an EOT to finance a buy-out should be tax deductible for the company. This will allow companies to pay back EOT debt more quickly and increase its attractiveness to business owners. This reform would help EOTs compete with private equity buyers, which use relatively high debt levels to finance acquisitions and which can deduct from taxable profits the interest expense on private equity debt.
8. The "loans to participators" tax charge on company loans to EOTs should be eliminated. This will open up the scope for EOTs in a wider range of companies:

- if loans are made by a company to an EOT, rather than having to make outright contributions to the EOT, this avoids prejudicing minority investors (who are not receiving equivalent payments);
- it allows a company to finance an EOT where the company does not have distributable reserves sufficient to make gifts to the EOT; and
- it could also increase lenders' comfort in financing EOT transactions as lenders generally prefer to lend directly to a trading company, rather than to a non-trading trust with a company guarantee.

Ownership at Work

Sponsored by

baxi partnership

unity trust bank

BANK WITH US. BANK ON US.

Capital for Colleagues

Advice Investment Growth