Price Bailey
CHARTERED ACCOUNTANTS

Financing employee ownership

A guide for Trustees of an EOT

July 2021

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This guide is designed for those considering or who have recently set up an Employee Ownership Trust (EOT) for their organisation. It is primarily aimed at Trustees of the EOT to provide them with an overview of their responsibilities as Trustees, the key financing considerations to the successful implementation and ongoing management of the EOT, and to provide some guidance on how best to communicate this to employees across the business. However, it is useful to anyone involved in an employee-owned organisation to understand some of the financial intricacies of employee ownership.

Within this guide we discuss:

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We also provide a case study of a recent EOT transaction we completed with Damia Group, plus an interview with Robert Salvoni from Bluefruit Software a year on after we supported them in the set up their EOT.

Roles and responsibilities of Trustees

The core role of Trustees is to ensure that the company operates in the best interests of the employees. Importantly, they are not expected to be involved in the day-to-day management of the business, this is and continues to be the responsibility of management and the company's directors (remember the Board of Trustees for the EOT is separate from the Board of Directors of the company).

Instead, their involvement and approval concerns strategic decisions, for instance:

- Decisions off course from the approved business plan
- Proposed M&A activity
- The appointment of key senior personnel or changes to senior employees terms of employment
- Approval of annual accounts
- Approval of annual budgets and business plans
- Approval of any expenditure above a certain amount e.g., purchase of assets or performance bonuses.

However, it is important to make the distinction that whilst the Trustees have the right to approve or reject plans regarding strategy and growth, they do not play a part in designing or executing it. They are there to ensure that the business continues to operate sustainably, in a way that will benefit its employees.

Trustees' financial responsibilities concern:

- The acquisition of further shares, for example if the vendor wants to exit completely at some point in the future and the EOT seeks to buy their shares (as the EOT is the most likely acquirer),
- Ensuring the timely repayment of vendor loans for share purchases,
- Defining the structure of employee bonuses,
- Refinancing options and decisions on vendor loans.

Financial benefits & facilitating growth

Understanding the financial benefits

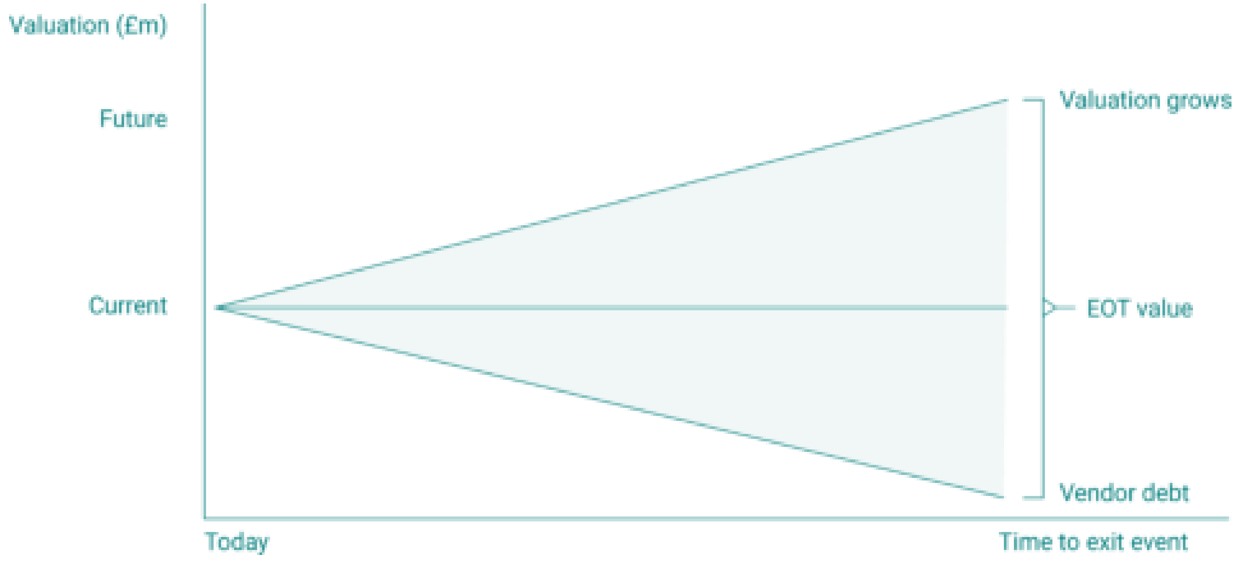
There are both financial and non-financial benefits realised by EOTs. One of the important roles of the Trustees is being able to communicate these in such a way that employees understand the value to them.

On an individual employee basis, employees can benefit from any annual bonus (of up to £3,600) plus the proceeds in an exit event (e.g. future sale), provided they are still employed by the business at the time of exit.

Non-financial benefits include:

- Positive impact on culture
- Improved employee voice (employees will have a representative on the board of Trustees)
- Commitment
- Reduced absenteeism

Understanding the financial benefits



It is hoped that the combination of financial and non-financial benefits, particularly the cultural shift that comes with employee ownership, will accelerate value growth and facilitate the repayment of any deferred consideration via vendor loans.

By repaying the vendor loan sooner, the value of the shares held for the employees increases because the EOT is no longer burdened by the debt repayment to the vendors, and coupled with the anticipated increase in employee engagement and the positive impact this should bring to productivity, this will accelerate the growth in value of the shares held for the employees.

Communicating growth

- It is powerful to engage with employees with updates on performance and the achievement of strategic goals. Ensuring that this is communicated effectively is very important to the success of employee owned businesses.
- Sometimes Trustees can forget that for many it may be the first time employees are seeing financial information. Therefore, it is often useful to be able to explain in real terms what the information and financials means for them & what they can influence.
- The specific detail of what information to share will vary company to company. It is useful to both report and communicate in terms of the most appropriate Key Performance Indicators (KPIs) as it is something all employees will be familiar with and how their role plays into them. Equally, the addition of visuals and graphs are useful to be able to show the direction of movement.
- It is not unreasonable that many employees are used to thinking of value in terms of income (e.g., personal salary and company turnover). There is work to do in shifting this outlook to a long-term, capital mind set that helps demonstrate how value growth benefits them, e.g., moving from thinking about what I am being paid, to how profit margins interact with valuation.
- It is also powerful to remind employees that the employee body will control the destiny of the business, as the Trustees have a majority stake. Hence, the employees can block an aggressive offer for the business from a Buyer they wouldn't want to work for.

Communicating growth

- Often it can be useful to put some planning and training in place to help all employee owners become more financially literate – again, the extent to which this is needed varies from company to company.
- The most important message to communicate is how **revenue, profit and cash flow** impact on the running of the business, and then highlighting how employee owners can, through their productivity, contribute towards these objectives, as well as receive financial rewards from the results.
- Additionally, if quality, privileged data is available, it can be useful to use benchmarking of competitors and comparable businesses so that employees can understand the business' success relative to the others in the industry – adding further context, and hopefully boosting motivation to drive value growth.

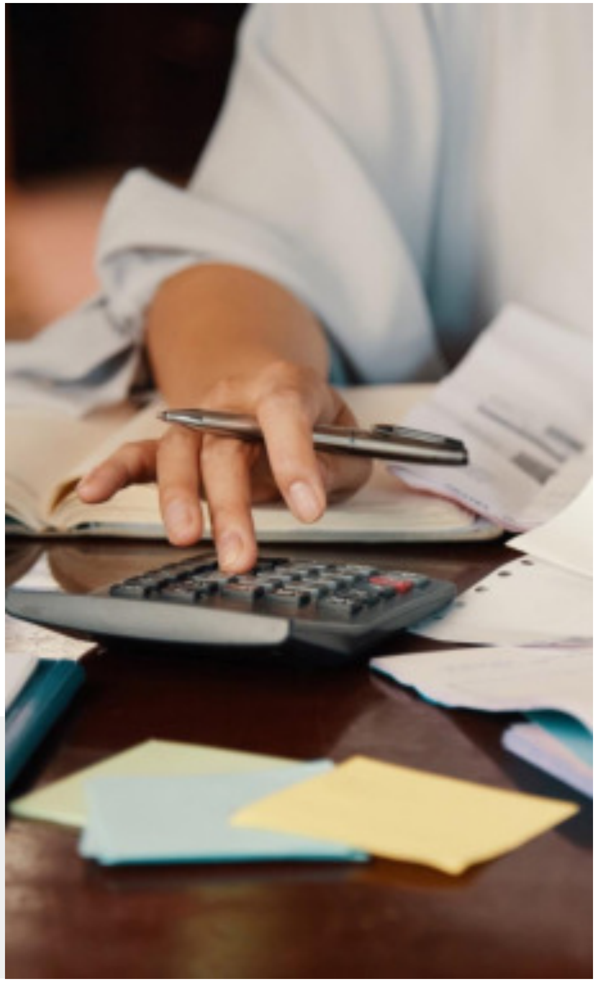
Bonus payments

*The (up to) £3,600 tax free bonus available to pay to each employee is optional.

*It is also important to note that while it is tax free, it is not National Insurance (NI) free and should be paid through the PAYE scheme of the trading business.

Level of bonus and qualifying periods

- The bonus should be applied using an acceptable formula and cannot be distributed discretionally.
- Bonus payments can either be paid at the same rate paid to all qualifying employees, or variations on individual entitlement can be based on any of the three enabled criteria:
  - Remuneration
  - Hours worked
  - Length of service
- Other discretionary bonuses can be paid by employee owned businesses but that these are not part of the tax free distributions.
- Many companies require a probationary period of up to 12 months before a new employee is included in the distributions.
- It can also be useful to have "rules" that are known to all cover bonus payment treatments, including new joiners and leavers.



! Bonuses can be paid out of reserves before consideration to the original owners has been fully paid up. However, the former majority owners can have the ability to block such payments if the agreed payment schedule to them is not being honoured. Trustees and the Board need to also ensure no harm is done to the strength of the balance sheet and the company's ability to meeting working capital requirements by the pay out of tax free bonuses.

Financing an EOT

Financing an EOT

- Most EOT transactions include an element of cash consideration and usually not an insignificant amount of vendor loan.
- The vendor loan is generally a good option and can provide great flexibility in comparison to most commercial loans, albeit it should still be structured on commercial terms.
- A bank may also lend money to the business to enable contributions to the EOT to fund the acquisition; More on this below.
- The increased flexibility that can come with vendor loans may seem like a win-win but can actually be a bit of a red herring. Many owners can be genuinely benevolent regarding repayment both in an attempt to support their employees and their business, but also to 'sell' employee ownership to its employees. What this can do, however, can create a mentality that risks reducing how much responsibility the employee-owners take on to maintain and increase profitability in the company to ensure the loan is paid. Setting up an EOT can create a shift in culture and it is important to set the right commercial tone from the start.

Financing an EOT

- The only source of viability for the EOT is the company's success, therefore any funding provided (whether by the vendors or a third party funder e.g. a bank) will be measured against the company and its expected future performance, as this determines its ability to repay the vendor loan and provide any contributions to the trust (over and above loan repayments).
- It is therefore vital that the Trustee Board of the EOT and the Executive Board of the company are clear and set expectations and governance around how and when the loan will be repaid.

Financing an EOT

However, it alongside good governance, it is important to ensure that the financing for employee ownership is structured in the right way, i.e., striking the right balance between repaying vendors in a timely manner and not unduly pressurising the business by trying to repay too quickly.

Three key elements to this are:

Interest

Depending on the loan agreement, the interest rate can be set as low as 0% or as high as feasible. Several things need to be considered when determining loan size and interest levels such as cash available, required investments for future growth, financing of projects etc.

Timeframe of repayments

The time required to pay debt tends to be more generous than with a commercial loan, and repayment can range to up to 10 years. Setting a timeline should be well considered and will depend on the objectives of the stakeholders. This might mean higher interest after five years, in doing so, encouraging a refinance with corporate debt to accelerate value realisation for the shareholders, or trigger a sunset clause to release the EOT from the liability, if the company is not able to pay the loan in 10 years. An example of interest rate changes that's often seen is:

- 1-2 year initial period = 0% interest
- 2-5 years = up to 3%
- 5+ years = up to 7%, at which point many companies may consider refinancing with cheaper traditional bank debt, rather than fund the higher rates of interest being borne by the EOT on the vendor loan.

Who's is the debt?

It is also important to clarify that the vendor loan debt is the EOT's debt, not the company's and therefore should not affect the company credit rating.

While repayments will come out of company post-tax profits, it won't appear on the company's balance sheet if provided by the vendors.

The company will not want the full liability of the vendor loan on its balance sheet until afforded.

Funding an EOT

While options for financing an EOT may be (relatively) straightforward, funding the EOT relies wholly on current surplus cash and future profits of the underlying business.

Therefore, in thinking about future financing for growth, Trustees will also need to ensure that there are sufficient profits to fund the Trust going forward as any vendor (or commercial) loan repayments will rely on future profits.

This is another reason why it is important for all Trustees and Management to understand the financials, in order to understand how they both generate and benefit from value growth.

If the business generates greater profits than the repayment requirements, Directors then have a choice of either:

- Speeding up contributions to fund repayments
- Making modest contributions to the Trust or funding larger employee bonuses
- Re-invest in Trading company growth

Typically, speeding up repayments by larger contributions is preferred and advised particularly where the interest rate on any loan increases over time.

The Bank's view

Banks are able to support employee-owned companies in much the same way as they support other private companies. However, with an EOT, there is the additional opportunity for banks to lend for the purpose of acquiring shares on behalf of employees. Banks typically share the EOT lending role with selling vendors and as the vendors typically continue to be involved in the business, providing continuity, making this type of lending particularly attractive to banks to the extent that some are developing dedicated EOT financing units.

Therefore, there is a desire within the banking community to support employee ownership. However, in order for them to do so they need to be comfortable that they fully understand the funding position both currently and going forward. A strong set of financial projections that maps the performance of the business and how that will fund the EOT's repayment/ acquisition of shares over time is vital.

The Bank's view

In terms of any red flags, there are two major risk factors in the minds of the banks:

01

Capital gains tax liability

If the EOT's controlling interest requirement is not met, the vendor(s) of the shares will be liable if the disqualifying event occurs in the tax year of sale of the shares by the vendors and the following tax year. Therefore, for a sale in the tax year 2021/22 (year ending 5 April 2022), the vendors will remain liable for CGT for any disqualifying event from the date of sale of their shares up to 5 April 2023. However, after 5 April 2023, the EOT will be liable for the CGT on a disqualifying event (which is both what the vendors would be liable for + the increase in value at the date of the disqualifying event from what it paid for the shares). Consequently, to mitigate for the risk of this event occurring, banks can seek a guarantee from the company.

02

Key people

While banks understand that an EOT can be a good mechanism for founders to gradually step back and exit the business, some will be nervous about key people leaving the business which can make it harder to fund, not to mention the risk of money being stripped out of the business and leaving insufficient funds for repayment. Generally there is more confidence if the EOT's purpose is a partial exit mechanism with key people/shareholders retaining an interest in the business for the foreseeable future.

*If a subsequent transaction resulted in the EOT no longer having a controlling interest this would be classed as a "disqualifying event"

Case Studies

Case study | Damia Group

Damia Group, an international IT services and recruitment business formed in 1991, has grown to be an £18.5m revenue company under the watchful eye of Chris Bardoe and Pat Rodgers. After a number of years of working in a services industry, the time came for them to reduce their involvement in the business, an Employee Ownership Trust (EOT) was the preferred method.

An EOT provided an appealing exit option for the founders due to them being able to transfer anything from 51% to 100% control of the business to its employees; empowering them to drive growth and shape the future of the company; as well as providing some substantial tax benefits. Damia Group has bold plans for the future and as well as attracting future talented employees the EOT suited the company's next strategic steps. The company is adding managed services to its offering and engagement of staff was paramount to its success. EOTs provide a tool to unite employees for a common purpose, and as a result, put a business in a much stronger position for change.

Case study | Damia Group

Price Bailey's Strategic Corporate Finance team were instructed to advise on structuring and financing the transaction. A valuation had been completed prior to our engagement, which during our due diligence process displayed some discrepancies in its calculations. Our team made the necessary corrections, analysing previous transactions within the sector and a previous trade sale offer, and focused on producing a transparent, fair valuation of the business for both parties. Structuring the EOT for the long term benefit of the company was important to both parties and they were keen to explore all avenues. Once the structure had been confirmed Price Bailey created a detailed repayment schedule based on the businesses financial model providing comfort to the ongoing team they had sufficient liquidity to achieve their future strategy.

Utilising Price Bailey's experienced tax team, we ensured that the proposed structure and supporting documentation met all the criteria required for an EOT approval by HMRC.

The period from engagement to completion took four months. A lot of planning and thought goes into an EOT creation and execution, so it is by no means an exact indication of a timeframe. But one thing is clear the right advice and expertise does make the process much smoother.

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