WORKER TAKEOVER

AARDMAN, CREATOR OF WALLACE & GROMIT, IS ONE OF THE LATEST BUSINESSES TO GO FOR THE INCREASINGLY POPULAR EMPLOYEE-OWNERSHIP OPTION. MARC MULLEN ASKS IF IT'S A LONG-TERM TREND OR JUST FLAVOUR OF THE MONTH

For the founder of a business, saying goodbye can be the hardest thing to do. So tough, in fact, that some never do it. Often, founders will know every single employee. Another tie binding the owner to the company can be that it is an integral part of the local community.

Research by insurer Legal & General found that only 42% of the UK's family-run firms have planned succession. Today, for a plethora of reasons, the next generation is perhaps less willing to take over at the helm of the family business. And sometimes an owner-manager has so much control over the company they founded that the next generation of management has not been able to come through. Second-tier employees may not have any significant equity stake, or the means to re-mortgage their house to acquire such a stake.

"Owners must have a succession plan," says Deb Oxley, chief executive of the Employee Ownership Association (EOA), who was awarded an OBE in the 2019 honours for services to employee ownership. "And that plan must be about changing ownership and managing leadership succession."

42%

of the UK's family-run firms have planned succession

AF ARCHIVE\ALAMY STOCK PHOTO

Buy-outs are tricky without a proven management team. And buy-ins or trade sales might not appeal to a founder, because they may want the firm they have created to retain its identity. They will also feel protective of the employees who helped build it and fear the impact on loyal staff.

Employee ownership, which in many ways was pioneered by the John Lewis Partnership, can address many of those issues. The EOA has been trumpeting about this way of doing things, but word of mouth and what seems like a greater appetite for employee ownership has seen the number of such businesses increase. Since the UK government's introduction of the employee ownership trust (EOT) schemes (see 'The Tax Incentive', below) in 2014, uptake of the model has grown by about 10% a year, according to EOA figures.

John Lewis is the largest employee-owned company in the UK. The model is mostly popular among architect firms. But a scan of the UK's 50 largest employee-owned companies shows a broad range of industries: engineering consultancies (Mott MacDonald, Arup, CH2M, BMT, Black & Veatch); logistics (Unipart, Steer Davies & Gleave); social care and healthcare services (Shaw Healthcare, Bristol Community Health, Medway Community Healthcare, Locala Community Partnerships, Care & Share Associates One); retail (Riverford Organic Farmers and Oldrid & Co); manufacturers (Gripple and Scott Bader); and leisure (Alfa Leisureplex).

In November 2018, Aardman made a high-profile transfer to employee ownership. The Bristol-based stop-motion animation studio behind *Wallace & Gromit* and *Shaun the Sheep* transferred 75% of its shares into an EOT.

"Owners must have a succession plan"

Deb Oxley OBE,
CEO, Employee Ownership Association

"One potential disadvantage is the inability to get cash out"

Martin Cooper,
director, RSM

THE TAX INCENTIVE

In 2014, to encourage the uptake of employee-owned business structures, the UK government introduced the employee ownership trust (EOT) legislation. It encourages a genuine transfer to company employees. Unipart (pictured) has embraced this model, with more than £750m turnover and over 6,000 employee-owners.

To qualify for the tax advantages, a controlling interest (more than 50%) must be sold to the trust, which holds the shares on behalf of the company's employees.

The shares are sold at no more or less than 'market value', which requires a robust commercial valuation. The beneficiaries of the trust must exclude individuals who hold or have at some point held 5% of the company's equity. And employees must all be treated by the trust on an equitable basis.

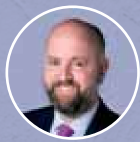
Provided the structure meets these requirements, the vendors will be given relief from any capital gains tax that otherwise would have been due. This is a tax break for the founder or owner-manager. Income tax-free bonuses (up to £3,600) can subsequently be paid annually by the company.

Where less than 100% but more than 50% is sold to the trust, the owner-manager or founder has some options for their remaining shares. They can retain them, and perhaps sell down over time to the EOT, or they may be sold to management to further incentivise them to drive the business forward. This may even be done through another tax-advantaged share plan, such as the Enterprise Management Incentive scheme (see the case study of Arbuckles, page 19).

50%+

A controlling interest of 50%+ must be sold to the EOT in order to gain tax advantages

ALAMY



"In almost any exit, debt coming into the structure somewhere does limit the ability of the business to invest"

Ewan Hall, director, Baxendale

"With an EOT, the trading company effectively funds the transaction itself"

Richard Cowley, director, RM2 Corporate Finance

In a joint statement, Peter Lord and David Sproxton, who together founded the company in 1972, said: "We're not quitting yet. But we are preparing for our future. The creation of an employee trust is the best solution we have found for keeping Aardman doing what it does best - keeping the teams in place and providing continuity for our highly creative culture. Those that create value in the company will continue to benefit directly from that value."

Sproxton will continue as managing director (MD) for now, accountable to the EOT, but a new MD will be appointed some time this year, when Sproxton will move into a consultancy role.

"Employee ownership requires two things," explains Oxley. "There must be a mechanism where the ownership can be shared among all employees. Equally the business has to have a culture and a structure where employee influence and voice can be shared. The two are intrinsically linked." Otherwise all of the benefits will not be achieved.

NOT A PANACEA

In July 2018, the business-led Ownership Effect Inquiry published its report, *The Ownership Dividend*. Chaired by Baroness Bowles of Berkhamstead, the Ownership Effect Inquiry is overseen by a number of business organisations, including ICAEW.

According to the report, the employee-owned 'sector' accounts for well over £30bn of turnover in the UK. In her foreword, Baroness Bowles wrote that the sector is "thriving and fertile", but noted that the model is not necessarily "ideal". Nor is its impact automatically and universally

John Lewis, Birmingham

The EOT model is particularly popular with architects and other professional practices. But a scan of the UK's 50 largest employee-owned companies shows a broad range of industries

★ TOP 10 EMPLOYEE-OWNED BUSINESSES

#1 John Lewis Partnership
(84,500 employees, revenue £10.2bn)

#2 Mott MacDonald Group
(14,730 employees, revenue £1.5bn)

#3 Arup Group
(13,346 employees, revenue £1.5bn)

#4 Unipart Group of Companies

#5 Hyperion Insurance Group

#6 CH2M Europe

#7 AT Kearney Holdings

#8 Shaw Healthcare (Group)

#9 PA Consulting Group

#10 Control Risks Group Holdings

SOURCE: EMPLOYEE OWNERSHIP ASSOCIATION

transformative - it "must be worked for".

The report found that among employee-owned businesses, there were increased levels of productivity and efficiency, improved workforce retention, easier recruitment and employee-driven innovation. And longer-term decision-making seems to lead to greater resilience.

WHAT'S NOT TO LIKE?

One EOT characteristic for the selling founder is that they usually will not get full payment on completion. Another is that a philanthropic owner may compromise on price. And then there is how the deal is funded.

Richard Cowley, a director at RM2 Corporate Finance - a specialist adviser on EOTs - explains: "With an EOT, the trading company effectively funds the transaction itself, so the majority of transactions are funded by vendor loans or deferred consideration.

"These are repaid by the trading company, although excess cash could be used to make a repayment at completion. A minority will also get third-party bank debt again taken out by the trust, which will also be repaid by the trading company. Taking on third-party debt will allow vendors to receive a larger payment on completion. Vendor loans would be expected to be subordinated to the third-party lender."

Because of the leverage the trust - and by extension the trading company - has taken on, raising capital for growth can be limited. Being people-heavy and asset-light, there may be little security against which to raise debt for growth.

FACTS AND FIGURES

£19.8bn
Combined sales of the top 50 employee-owned companies in 2018, up 6.5% on 2017

9.2%
Median increase in operating profits year-on-year

7.3%
Median increase in productivity year-on-year

171,000
Employees in the top 50 employee-owned businesses

54%
of employee-owned companies are debt free

350+
Number of UK employee-owned businesses

200,000
People in the UK are employee-owners

50%
Proportion of professional services businesses in the sector

SOURCE: EMPLOYEE OWNERSHIP ASSOCIATION/WHITE ROSE EMPLOYEE OWNERSHIP CENTRE

CASE STUDY: BCS Consulting

In July 2018, management consultancy business BCS Consulting was acquired by its employees. BCS had delisted from AIM almost a decade before. Immediately following that, staff owned only 3% of its issued ordinary share capital. Over the next eight years there was a gradual buy-in, and by January 2018, 55% was owned by employees.

Since delisting, the number of consultants increased from 22 to 156, and the board believed that increased employee share ownership had contributed to the successful growth of the business.

A BDO team led by Matthew Emms (above, left) advised the company. "This transaction allows BCS to benefit from the numerous advantages of being employee-owned," says Emms. "As the company's workforce is its most significant asset, an employee ownership trust (EOT) was an obvious cultural fit and a way to improve engagement, innovation and business performance."

A separate BDO team, led by partner John Stephan from the firm's Birmingham corporate finance practice, acted as financial advisers, as required under Rule 3 of the Takeover Code, which it was still subject to because it had delisted nine years previously.

Once the trustees had received acceptance from 80% of the shares, they declared the offer wholly unconditional and those shares were transferred to the EOT. The remaining shareholders either accepted after this date or were 'swept up'.

In July 2018, when the majority of the shares were transferred to the trust, BCS's market value was £52m. The initial consideration for the shares was £7.5m, financed from BCS's existing cash resources. Cash generated from future trading will finance the £44.5m consideration still to be paid. The time period is therefore not definite. But it is anticipated that it will be paid annually over a number of years post-completion.

BCS's CEO Paul Brock (above, right) says: "Employee ownership offered a very attractive solution to a complex ownership succession problem. Acquiring the entire issued share capital of the company by an EOT proved to be the perfect method of achieving this, by providing an exit for all shareholders on equal terms, financed out of future profits, while also securing a long-term ownership model, which enabled the business to continue on its chosen path under the same management."

"An EOT offers an attractive route for those prioritising the legacy and culture of the business. It's more a philosophical decision than a financial one"

"An EOT is an attractive alternative succession option"
Anna-Louise Shipley, corporate finance manager, Buzzacott

However, providing it is well structured, there will be headroom in the repayment schedule, which allows for operating cash to fund growth.

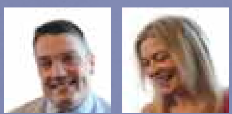
"In almost any exit, be it an MBO or employee buy-out, debt coming into the structure somewhere does limit the ability of the business to invest," says Ewan Hall, director at Baxendale, which advises on employee ownership transitions. "It is inevitable, and it will be the case for a period of time."

Another solution, says Andrew Rutherford, commercial director at Arbuthnot Commercial Asset Based Lending (ABL), is to use an ABL facility to fund growth. "It's good that employees are investors in the business, and by working harder can grow," he explains. "The capital requirements for that work well with our facilities because they are revolving and grow as the business grows. The challenges are making sure the management team are locked in so that they can drive the business forward to repay us."

Martin Cooper, RSM director, says: "One potential disadvantage is the inability to get cash out. It may be too early to see the sales of EOT businesses. But it's long-term patient capital, which is what the founder wants, because they want to see the name remain and their business continue to grow."

This is a sentiment echoed by Anna-Louise Shipley, a corporate finance manager at Buzzacott. She says the employee ownership model is presented as an alternative option when speaking to owner-managers: "Rather than just being a stepping stone to a trade sale or a private equity buy-out, it's an alternative succession option. An EOT offers an attractive route for those prioritising

CASE STUDY: ARBUCKLES



In December 2018, John and Maxine Murphy, the founders of Arbuckles, sold the restaurant business to its staff through an employee ownership trust (EOT). Arbuckles is an American-style diner restaurant and bar, which has two outlets. The couple opened the first Arbuckles in Norfolk in 2008, before opening a second in 2016.

By the end of 2017, the business was making about £1.7m EBITDA, but the job had become all-consuming. The couple began thinking about an exit. They wanted a change of lifestyle, to cash in some value for their hard work and reward the staff. "I wanted the responsibility for the business to be handed over to the people who would be running it," said John Murphy.

He met Garry Karch, managing partner of EOT specialist adviser, RM2. "I thought it was too good to be true to be honest. It was a leap of faith," John Murphy said. The EOT option matched the Murphys' requirements for an exit. RM2 advised on profit projections and scenarios.

The company was given a market valuation of £7.6m – the lowest valuation of several that were carried out. "This was the most reasonable valuation in my view and would allow the loans to be repaid within about five years," explained John Murphy. "This monetary value, plus the value we attached to rewarding the staff, amounted to fair payment to us. It was also one that was accepted by HMRC."

51% of the shares were put into an EOT for the benefit of all staff. The other 49% went into an Employee Management Incentive scheme – the Murphys' youngest son Daniel had 15%, the operational director and MD had 5% each, assistant managers, chefs and other key staff 2%. For management, a 1% share in the company was worth £76,000, but they had option to buy each 1% at £1,400. Jeremy Glover from Jurit provided legal advice.

Of the share acquisition price, £1.5m was paid out of the company's cash flow, £4.4m was a loan from ThinCats and £1.7m came in the form of an interest-free loan from the Murphys.

John and Sharon Collins, who have taken over as managing director and operational director respectively, plan to retire in six years. By then, the loans will have been repaid in full. The repayment calculations were based on the business performing at 20% less than 2018.

"We will advise the board for free effectively," said John Murphy. "It's a way of easing ourselves out of the business. The tax incentives were a sweetener. Maybe we could have got more money, but if that meant selling the staff short then we never would have done it."

the legacy and culture of the business. It's more a philosophical decision than a financial one."

Hall says EOT businesses are approaching an interesting point: "There was a bubble of businesses that transitioned to an EOT structure in 2014 (as most organisations looking to transition in 2013 waited until 2014), that are now coming out of the repayment period. It'll be interesting to see what those businesses do now they have more cash. They can take some more risk and invest for growth, save some for a rainy day or crank up the dividend. Or they can do a blend of all three." ●

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"The whole point is that the EOT is taking over from day one"

Neil Palmer,
corporate partner, Fieldfisher

CASE STUDY: PARFETTS

AG Parfetts, a cash-and-carry business set up in Stockport in 1980, became employee-owned 10 years ago. Steve Parfett, who was a graduate trainee at Waitrose before joining the family business, rose to managing director and then chairman. He stepped down as chair last year. The company now has seven depots across the North of England. Profits for 2018 increased 54% to £5m, while the number of employees was 560. Employees received two bonus payments in 2018 after surpassing targets.

Parfetts holds employee meetings to discuss the direction of the company. It has a process of continuous improvement for staff and has a lower than average employee turnover rate of 15%, which it credits to its employee ownership trust (EOT) structure.

James Wild (pictured, left), corporate finance partner at RSM, carried out the initial strategic assessment of Parfetts ahead of the sale to the EOT. "Initially the trust acquired a controlling interest. Later the company became fully owned by it," he explains. "The non-financial aspects were important to Parfetts, particularly rewarding employees over the long term and retaining independence. Obtaining bank funding was a critical obstacle. The bank was interested in governance and how management were rewarded and retained. The model was a real passion for Steve Parfett at the time and still is."

LEGAL OPINION

"The tax benefit is often a key motivator for any founder who wishes to sell their business to an employee ownership trust (EOT)," says Neil Palmer, a corporate partner at Fieldfisher, who has advised on many such deals. "The legal challenge is then designing something that meets all the legal requirements so that the seller gets tax relief but also delivers meaningful employee ownership." But the tax benefit is not the only driver for selling a business to its employees.

There are three requirements that the EOT ownership structure must meet. First, all employees must benefit. Second, they must benefit on an equitable basis. And third, there is the 'controlling interest' requirement – essentially the trust must have control in different ways over voting rights and profits.

"One challenge is how to balance the EOT legal requirements versus the concerns of the founders," Palmer explains. "For example, the founder says 'I'm not being paid in full for X years, because the consideration is through vendor loans or deferred consideration, so I want to control the company during that period'.

"You cannot cut across the rules. You cannot give control to founders. The whole point is that the EOT is taking over from day one. So you need to find mechanisms to give assurance to the founders which comply with the requirements."

This balancing act can prove the main hurdle for the lawyers. It will often depend on how the founder has come to the EOT decision. If letting go is a particularly big problem, then perhaps an EOT – or even an exit full stop – is not the answer that the founder is looking for. A sale to a private equity investor would significantly reduce the founder's control, as would a trade sale or initial public offering.

"Private equity will always want influence, even in situations where it puts in growth capital and just takes a minority stake," says Mark Gearing, a Fieldfisher partner who specialises in equity incentives. "Private equity comes with strings attached. It is more aggressive in looking to accelerate growth. This is not to say that employee-owned businesses are not looking for growth, it's just a different culture and model."

Gearing points out that many of the EOTs set up just after the legislation was introduced in 2014, will now be looking to the next stage of growth having paid off the original founders, and potentially investing to grow. "We'll see what happens," he says.

Fieldfisher has been very prominent in the creation of EOTs because much of the UK coalition government's thinking was shaped by *The Nuttall Review of Employee Ownership*, written by Fieldfisher partner Graeme Nuttall.