EMPLOY OWNERSHIP TRUSTS.
AN INTRODUCTION.

vfdnet®

AN INTRODUCTION

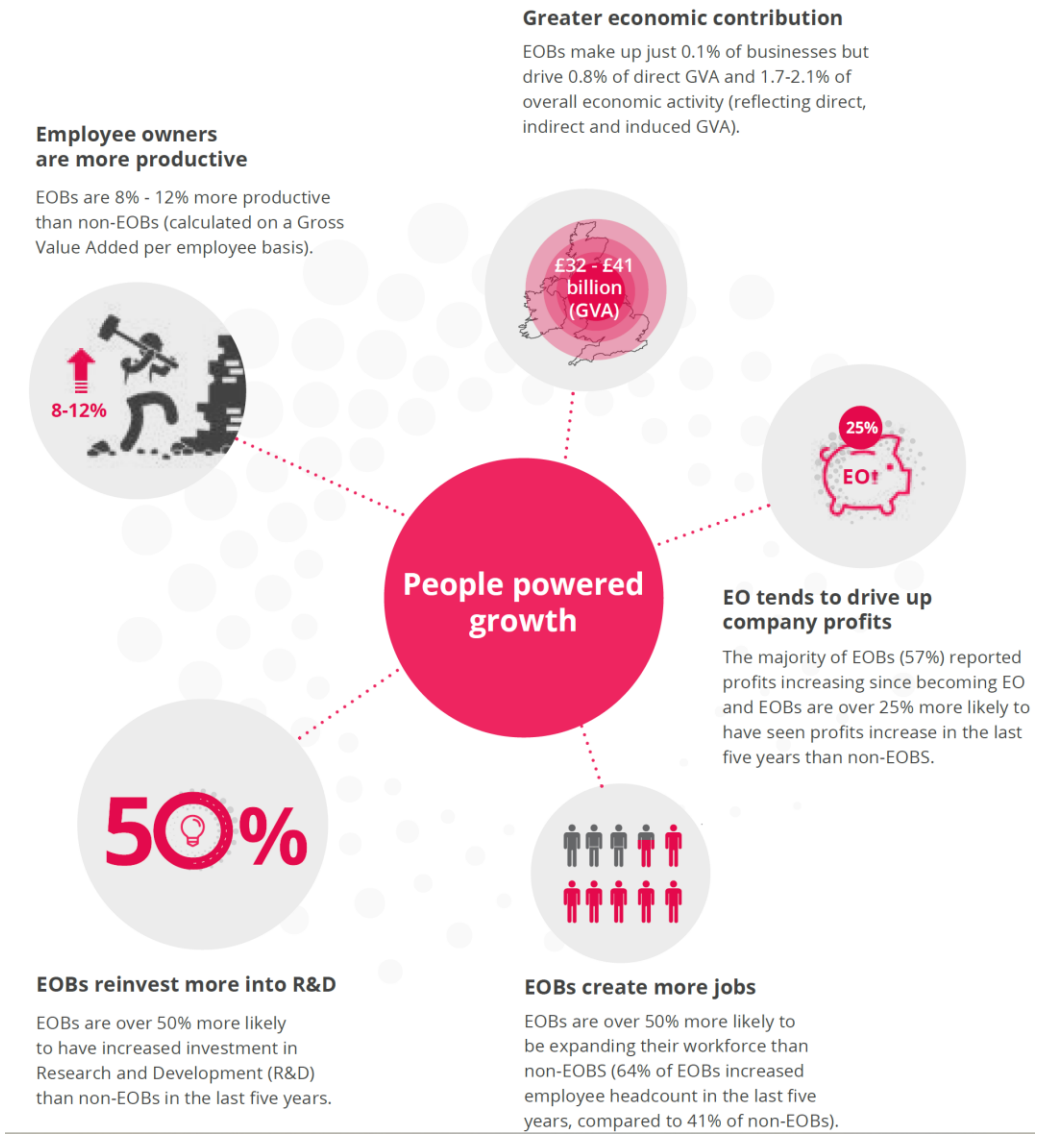
Introduction

This white paper has been written to help Business Owners better understand business sales into employee ownership. Although this is a relatively new business sale route, it probably represents the best chance of passing on your business legacy. Many business owners are appalled at the prospect of their business and legacy being ruined by new owners, typically trade buyers. Years of work, (often a lifetime of effort), can easily be risked in order for the business owner to realise his or her value. Does it have to be this way? What if you could realise a good valuation for your business while protecting the legacy you have so carefully built? Can you really 'have your cake and eat it'? The so called 'John Lewis' model presents a great option to business owners wanting to hand on their legacy, but it needs to be carefully evaluated, planned and implemented.

Employee-owned companies now include:

RECENT STATISTICS

Recent statistics from the Employee Ownership Association, conducted by WPI Economics Limited in Oct 23



GROWING TREND

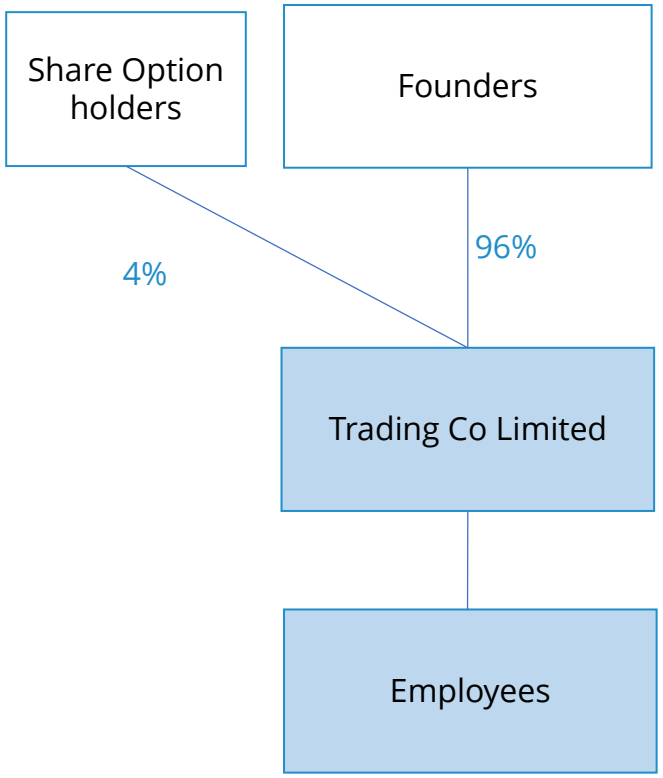
Year on year growth

The total number of Employee-owned companies grew by 30% in 2022, to over 1,400 by the year end. With over 330 businesses becoming Employee owned in 2022, this was a record year for Employee Ownership.

vfdnet recognises that all businesses are different, and that is why our deal experienced Directors spend time listening to business owners, to understand the unique background, people and motivations, before bringing their experience to the situation. **This white paper covers:**

- Business sale into employee ownership overview
- Top 10 misconceptions about Employee Ownership
- Business valuation models
- The Grand Bargain
- Tax treatment
- Business funding modelling
- EO deal project management
- Why is Due Diligence necessary?
- How not to communicate EO deals – top 10 mistakes

What is Employee Ownership (EOT)? 1of 3



Ownership

Owners:	**Founders** Share Option holders

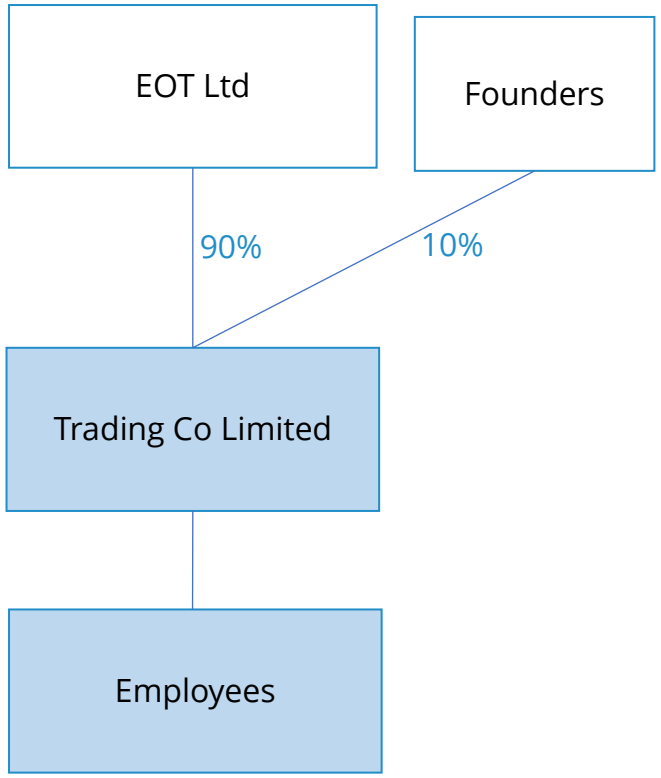
Directors

Directors:	**Trading Co Limited** Executive Directors (as current)

Employees

Employees	Employed by Trading Co Limited

What is Employee Ownership (EOT)? 2 of 3



Ownership

Ownership:	Founders sell [90%] of their Shares to the Employee Ownership Trust (EOT), in exchange for: * Initial Cash consideration * Loan

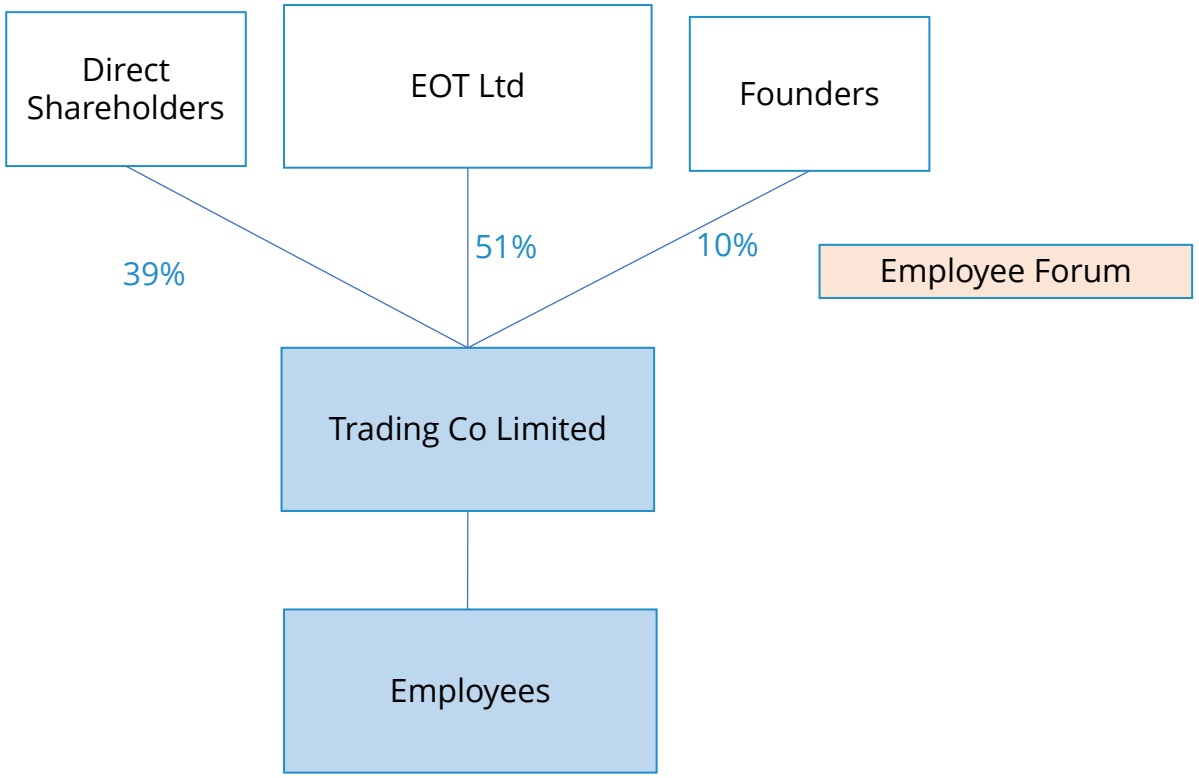
Directors

	Trading Co Limited
Directors:	Executive Directors (as current)

Employees

Employees	Employed by Trading Co Limited

What is Employee Ownership (EOT)? 3 of 3



Ownership

Ownership:	EOT Ltd retains its shares Founders retain residual shares Direct Shareholders awarded new EMI Share Options

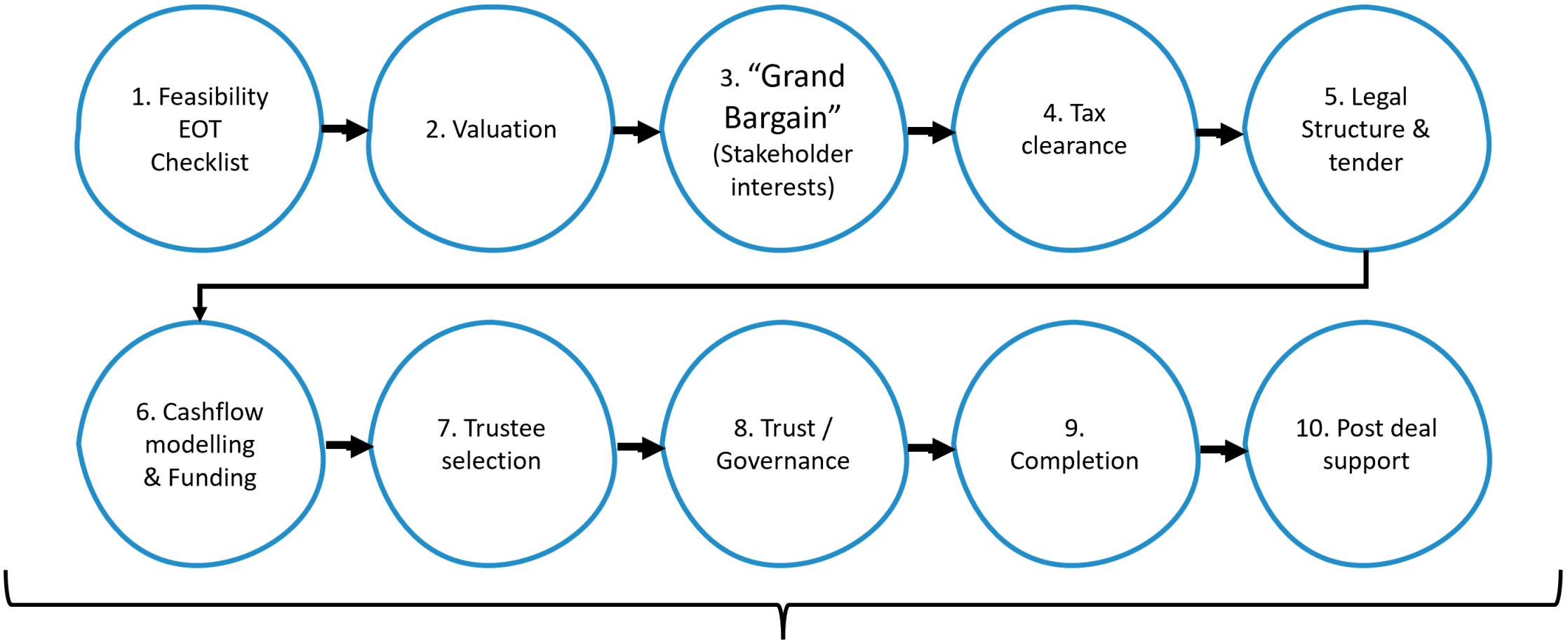
Directors

	Trading Co Limited
Directors:	Executive Directors (as current)

Employees

Employees	Employed by Trading Co Limited Employee Forum set up Profit Share scheme introduced (tax free)

vfdnet PROCESS



TOP 10 MISCONCEPTIONS

Q: I will have to give away my business to the employees
A: No, as normally your business will be sold to the employees.

Q: The Banks would not want to fund the new team.
A: Banks are prepared to lend if you know how to unlock funding and who to go to.

Q: If I sell to Employee Ownership everything will be fine!

A: Changing the ownership is no guarantee of business success – as ever, there is no substitute for good leadership.

Q: Transfers to Employee Ownership are more risky, due to the possibility of unsuccessful negotiations leading to the loss of key employees.
A: The stakes are high and need careful management, but with experienced help these risks can be minimised.

Q: Selling my business to our employees must involve Private Equity.
A: Not necessarily true, as many can be funded through other sources. Specialised funders prefer to invest in employee-owned companies with a good strategy.

Q: My employees don't have the cash.
A: Most business sales to employee ownership will be funded through cash in the business, vendor loans and bank funds.

Q: All the cash needs to be paid upfront.
A: No, a typical structure has some cash upfront but with the former owner paid over several years.

Q: I will suffer from a tax viewpoint as the taxman disapproves of these deals.
A: The tax rules changed in 2015; in fact, Capital Gains Tax is nil to the Founder, as long as the transaction is handled correctly. That said, the tax tail should never wag the commercial dog.

Q: Changing the ownership structure will mean that employees will become more engaged and motivated.
A: Unless employees are already fully engaged, they are unlikely to change their attitude and behaviour due to the change in ownership alone.

Q: My position as former Owner can't be protected.

A: Of course, trust is always fundamental, however legal protections can be built into the agreement.

Selling your business to your employees can achieve almost all your valuation expectations while enabling your leadership and employees to build on the legacy you are passing them. There is good evidence that employees in EO companies are more motivated and engaged than otherwise; a key competitive advantage as skill shortages become more apparent.

BUSINESS VALUATION MODELS

Business valuation models

How much your business is worth depends on who is asking: the owner seller is trying to sell the future, whereas typically a buyer seeks to pay for historic results. A fair valuation is the value agreed between a willing third-party buyer and a willing seller. However, what about the occasions when there is no external buyer – what should the value be then?

A third-party buyer is missing for many deals, such as a Management buyouts, a shareholder selling on exit or even a business sale into Employee Ownership.

Formal valuation reports can miss key facts or facets about the deal, which is why we prefer to prepare a business valuation model for discussion with the current shareholders, with the express aim of settling on a valuation which can be perceived as fair by both sellers and 'buyers'. Thinking through how you will communicate the business valuation to employees is a great way of sense testing the business valuation model.

It is essential that the business valuation assumptions are all fact checked, both by the current owners and also by a deal experienced person. The business valuation model enables discussion on each of the assumptions or drivers to the valuation. Business valuations need to be informed by someone with strong deal experience, as otherwise the business owner may not achieve proper value, or the ongoing business may suffer from an excessive debt burden. A good business valuation model typically includes:

- **Historic results** balanced by the
- **Forecast** for the current year, with both
- **Exceptional costs** adjustment and
- **Directors market rate adjustment,**
- **Profit multiple review** and adding
- **Excess net assets** value

Well prepared business valuation models provide:

- Fair representation of 'normalised profit'
- Transparent model with clear assumptions, so ultimately:
- **Fair Valuation**

THE GRAND BARGAIN
(for all stakeholders)

The grand bargain

Getting the cash flow priorities right is not just good business, it can make or break the success of a business sale to an Employee Ownership Trust (EOT). When key stakeholders' interests are not properly addressed, distributable cash flow will not be allocated to the right stakeholders, causing the business significant harm. This might be through de-motivated senior leaders, a lack of funds for critical business investment, or lack of engagement from employee owners. Our vfdnet Grand Bargain is a methodology to consider all the different stakeholder financial interests, reconciling them to generate a fair 'bargain' which can then be communicated at the chosen time.

The EOT Grand Bargain considers the financial interests of all stakeholders:

- The **Business** itself – what are the likely working capital needs? Also the business needs for capital investment?
- **External bodies** – what are the bank payments commitments, and forecast corporation tax payments?
- **Employees** – outline of Profit share payments to employees.
- **Senior Mangers** – level of bonus payments required to motivate the senior managers to lead the business well (particularly post founders exiting).
- **Direct shareholders** – consider issue of performance driven share options for the key leader eg new MD or CEO.
- **Sellers** – determine Deal day cash consideration, and timing of deferred consideration payments, also interest income on deferred consideration.

TAX TREATMENT

Tax treatment

The tax treatment of business sales into employee ownership changed in 2014, and now, providing the right conditions are met, the current tax treatment is beneficial in 2 key ways:

- Business owners can sell their shares 0% Capital Gains tax, although this CGT is not avoided completely, as it will be payable by the EOT should the EOT sell its shares later. This represents a considerable benefit to business owners.

- Employees of employee owned businesses can benefit from income tax free payments of up to £3,600 pa.

These are significant benefits, however business owners are advised to take proper tax advice to ensure that their business transfer meets all the relevant conditions for their circumstances. In addition, it is advisable to obtain advance tax clearances, by applying to the Revenue, and disclosing all relevant facts.

BUSINESS FUNDING MODELLING

Business funding modelling

It is often assumed that business sales into employee ownership can not attract funding, however this is not the case. A thorough review of the business' financial performance and prospects is an essential pre-requisite to evaluating whether funding is possible and an attractive option.

Business funding from lenders can take many forms, including:

- Asset finance
- Debtor finance (disclosed or confidential)
- Property loans
- Cash flow lending

Banks are risk averse, so relationship managers appreciate well prepared narrative and financial modelling. We have a business plan template which asks key questions which bank managers would typically ask. Your financial modelling needs to be rigorous, with properly integrated Profit & Loss, Cash flow and Balance Sheet, with a single set of assumptions consistently applied through all statements. Doing a sensitivity (or what if) analysis can really help bank credit committees to understand the key risks in the business, and so make it more likely they will offer funding on attractive terms.

Sound businesses with a well-prepared business plan and integrated financial modelling should be able to secure funding offers from more than one lender, allowing detailed comparison of terms, including bank covenants required, and also any security requirement (including personal guarantees).

EOT DEAL PROJECT MANAGEMENT

EOT deal project management

So, you have set your sights on selling your business to your employees or managers, but what is the best way to manage it? This will probably be the biggest deal that you will have to do, so you will want to get it right.

In addition, you are wanting to pass on your legacy which you have built up over many years, and you dearly want the deal to be fair, respecting the value built by the owners but not over-burdening the new team with excessive loans and onerous payments.

You could manage the deal yourself, but at what cost if that leads to 'deal distraction' with a loss in strategic direction or operational focus, so that results are hit, possibly jeopardising the deal, or damaging future prospects?

As business owner you will want an effective deal process, ensuring that the right deal is done on time and on budget. Key deal management elements include:

- EOT feasibility checklist completion
- Arriving at a **fair business valuation**
- Designing in fair treatment for all Stakeholders through the **Grand Bargain**
- Scoping the EO Lawyer work, organising quotations and **selecting the specialist EO lawyer**
- Planning the right time, the right message to help effective **employee engagement**
- Proposing and agreeing an overall deal costs budget
- Preparing business plans and forecasts to **secure bank or equity funding**
- Organising **reverse 'due diligence'** ready for the warranty disclosure letter
- Preparing bespoke 'Questions and Answers' ready for employees to ask all their questions!

Key benefits from vfdnet EOT deal project management

- Allows the founder to focus on the strategic direction of the business.
- Deal experienced Directors who have done many Manager Buyouts and business sales into Employee Ownership.
- Completing the deal on time and on budgeted cost.

SELECTING YOUR TRUSTEE BOARD (I/II)

Designing the Trustee Board

Designing the structure and nature of your Trustee Board is a key step in your EOT journey. Every business is different, and so will have different concerns to factor in, however these guidelines are to help you arrive at the right Trustee Board for your situation.

The Trustee Board should not take daily or monthly executive decisions, as this will continue to be the role of the Company Board of Directors. Rather the Trustee Board should be the body to approve the business strategy and budgets, being responsible for the appointment and ongoing accountability of the CEO or MD.

The Trustee Board has a fiduciary duty to the EOT beneficiaries, ie. the company employees, and must take all decisions based on their best interests.
We hope that these guidelines are helpful into design your EOT Trustee Board, particularly achieving the right balance of Trustees.

- **How many Trustees?** Having an odd number of Trustees is beneficial, as it helps avoid an equal votes stalemate! Most EOTs tend to have between 3 and 5 Trustees.
- **Who can control?** The stipulation is that the former owner or owners can not, directly or indirectly, control the Trustee Board.
- **Can Trustees be resident outside UK?** No, Trustees of EOTs must be UK resident.
- **What are the different types of typical Trustee?** Here are the typical types of Trustee and the value they tend to bring to the Trustee Board:
  - **Founder Trustee**, typically a former owner of the business, who normally bring sector experience, and strategic insight. The Founder Trustee May also seek to represent the former owners, however they need to beware their potential conflict of interest on the ELT Board.
  - **Financial Trustee**: a Trustee with a financial background, typically a qualified Accountant, who can firstly ensure that the Trust does not pay more than the market rate for the business, and secondly help the EOT comply with its financial contractual commitments.
  - **Employee Trustee**: a Trustee selected to represent the concerns and interests of the employees, providing a two way communication link between the employees and the Board of Trustees; this may or may not be in conjunction with an employee voice group.
  - **Independent Trustee**: a Trustee who is selected for their independence. Good independent Trustees will be able to listen to all stakeholder views, apply their own strategic thought, and to seek to take wise decisions.

SELECTING YOUR TRUSTEE BOARD (II/II)

- **First Trustee requirement?** This is to ensure that the EOT does not pay above the market rate for the business, and the Trustees can fulfill this duty in a couple of ways:
  - Being comfortable that the valuation is properly independent, that the assumptions employed are sound, and that the methodology has been accurately employed. Also ensuring that the valuation is addressed to the EOT Trustees as well as the Founder owners.
  - Commissioning their own Trustee valuation, however should this generate a different valuation, then how will the proper 'market value' be ascertained? We would not recommend this route, as appears confrontational, and unlikely to result in a deal fair to all stakeholders. It might even result in the need for a third 'indpendent valuation' a costly exercise for all parties!
- **Should there be a Chair of Trustees?** A chair of Trustees can be useful, particularly if the character of stakeholders make it likely that disagreements might arise, where the chair could provide a helpful bridge building role.
- **How can Trustees minimize their liability?** Trustees can be Directors of a Corporate Trustee, and this provides some limitation to their liability. In addition, each EOT Trustee should ensure that the Trustees provide a balanced Board, with key attributes of Strategy, financial commitments and employee engagement are all covered. Trustees must ensure that the EOT does not pay more than market value for the business. In addition to these steps, Trustees should ensure that appropriate Trustee Liability insurance is taken out (similar to Directors and Offices insurance).

WHY DO YOU NEED DUE DILIGENCE? (I/II)

Normal Due Diligence

In a traditional trade sale deal, the commercial agreement established through the Heads of Terms will normally be subject to Due Diligence, when Auditors review extensive information on the company, in an attempt to check whether the company is 'clean' and that skeletons in the cupboard are revealed.

Reverse Due Diligence

So, when the business is being sold to its Managers or Employees, why should Due Diligence be required at all? So, to answer this we need to ask:

- Will there be any external funding introduced?
- Who is the buyer?
- How to attract talented Trustees?

Will external funding be introduced?

The business may consider external funding, which could either be Bank funding or Equity funding.

If Equity funding is required, through Private Equity or Venture capital funds, then these parties will commission formal Due Diligence which is likely to be at least as stringent as a prospective purchaser would require. Detailed Due Diligence will be requested, based on a standard information requirement, necessitating the setting up of an electronic data room to securely manage the sharing of such confidential data.

If Bank funding is required, then the providing bank is highly likely to insist that the Management team or the EOT Trustees commission Due Diligence, again which is likely to be considerably more detailed than would be requested otherwise.

The results of the Due Diligence in either situation is likely to determine whether the external party continues to invest / lend, and indeed what the terms are for such involvement.

WHY DO YOU NEED DUE DILIGENCE? (II/II)

Who is the buyer?

In a trade sale the buyer is obvious and will negotiate hard. If the sale is to Managers via a Management Buy Out, then it is also clear who are the buyers to negotiate with. But what about a business sale to Employee Ownership - who is the real buyer then? Ultimately it will be the non-management employees who will be the buyers, albeit probably only 'owning' the business indirectly via an Employee Ownership Trust (EOT).

If a Trust is being set up to acquire the business, who then is the buyer? In this situation it will be the Trustees who have a fiduciary duty to protect the interests of the employees (assuming the Trust deed is drafted to this end). Indeed, following the Budget changes in October 2024, there is a requirement 'that the trustees have taken all reasonable steps to secure that the consideration for the disposal does not exceed the market value'.

How to attract talented Trustees?

If the Trustees (both employee and external) are the custodians of the long-term strategic direction of the business (which they should be), then it will pay to try to recruit the best, most experienced Trustees available to help the new Employee-Owned business flourish and be sustainable in the long term.

So how best to attract good Trustees? Put yourself in the shoes of a newly appointed Trustee for a moment, fast forward 6 months and something comes to lights that the new Trustee is very unhappy about. He or she might say 'if I had known about this before, I would certainly not have accepted this role'. This is the nightmare scenarios which should be avoided at all costs, as it would de-stabilise the fledgling Employee Owed company at a critical time.

So how to avoid unpleasant surprises for Trustees? To combat this, even though the Trustees may not specifically request it, it is best to make full disclosure of any skeletons that might be hiding. So, this is where the 'Reverse Due Diligence' comes in. It is best to allow someone experienced, like our deal experienced Directors pose Due Diligence questions to help reveal any smoking gun. This is best done through drafting a seller 'Disclosure letter', which is written in response to the request for seller warranties. In fact, it is not unusual for the VFD to ask the EO Corporate lawyer to add additional warranties so that 'self-disclosure' points can be made.

HOW NOT TO COMMUNICATE EOT DEALS

How not to communicate EOT deals?

Attending the annual Employee Ownership conference for several years, it has been a huge advantage to hear about businesses mistakes, so that learning can be embedded, and lessons learned for future deals. One such lesson was from an Employee-Owned company which did not get the communication to employees right, in fact the relationship between the former owner and new Trustees became so bad that they had a massive celebration when the final debt repayment was made to the former owner!

The business sale into Employee Ownership is not just a deal, but the beginning of a new entity, one which every employee should feel invested in, so that they are more motivated, more loyal, and more united for the good of the group of employees. So, what are the key mistakes to avoid regarding the transition to Employee Ownership?

Top 10 mistakes

- Treating it like a normal deal, when the owners work hard towards the finish line, then realise that it was actually the start line!
- Not appointing experienced Employee Engagement advisers to help navigate the journey.
- Not carefully planning the governance structure of the new set up, thinking through the roles of Trustee, Leadership team and Employee representative groups.
- Not being transparent about the deal struck with the former owners.
- Agreeing a payment profile which puts working capital under stress.
- Not planning for training and development of employee Trustees so that they can contribute at the right level.
- Not identifying the right people key performance indicators because they are harder to measure.
- Not treating the communication as two way, listening to the question's employees have and providing answers where possible.
- Not tracking the people KPIs throughout the deal process.
- Thinking that your emotions as owner and then former owner won't go through considerable upheaval through the transition.

The sceptical employee should be the target audience right from deal inception, through to valuation and loan repayment timeframe. This will really help when organising the communication of the deal to all employees. The fundamentals of the deal will become common knowledge within time, so would be wise to plan to carefully communicate the key facts of the deal, against the reference point of other alternative types of deal that might have been contemplated.

vfdnet