Buzzacott

Succession planning – a spotlight on employee ownership

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Questions	Answers
Please can you talk through debt in the company again: In this highly uncertain business environment, is there a risk of over-burdening the company with debt in order to 'buy out' current owners? This could really harm the business ability to grow (which in turn in required to buy the owners out!)	There is a risk in any circumstance overburdening a business with debt. Of course, this risk increases in the current environment. In an EOT transaction, it is important to balance rewarding the exiting shareholder for their work and risks taken but also the longevity and success of the business going forward. Not only for the legacy of the business but also because future deferred payments are dependent on its continued success. In EOT transactions, it is therefore usual to see lower leverage than in other transactions. When working with clients, we collaboratively forecast and model future cash flows of the business to understand the ability to pay debt to ensure it does not hinder the growth and success of the business.
John Lewis has always been the 'darling' of the EO sector. Don't their current problems demonstrate some of the issues for EO businesses when there is a need for significant change?	The issues John Lewis have been facing are not necessarily because it is an EO business, but because of the wider issues facing the entire retail sector. There are plenty of case studies for where the collaborative culture of an EO business has enabled sustainable action to be taken in the face of difficulties, rather than short term actions.
I presume employees can still receive profit share during the 'tail' of buying out shareholders?	Absolutely. Depending on the amounts and timings of any deferred payments to shareholders, additional profit can be received by employees during the tail period.
Do selling founders/ owners selling to an EOT have to anticipate a lower exit valuation? Is there any data around how much that discount might typically be?	In terms of the range of valuations under different exit routes, founders selling to an EOT should expect to achieve a maximum of the market value and anticipate accepting the lower end of that value range. Whereas, with a trade sale an owner should expect to maximise their valuation. Typically, for those looking to sell to an EOT, maximising valuation is not the greatest priority or motivator; the culture, legacy and the opportunity for employees to be valued and

	have increased participation are at the forefront. In EOT transactions, valuation is not frequently an issue, but it should be a consideration if you are contrasting your exit options. It is also important to note that there are significant tax benefits such as no Capital Gains Tax on proceeds, which particularly given reduced Entrepreneur's Relief limits (capped at £1m), can counteract the potentially lower value compared to other exit options in terms the net cash received.
What is the average tail length?	This can really vary. Typically in an EOT scenario, we see tails being between 3-6 years and aim to ensure that this is always kept under 10 years. It needs to be a balance between the company's ability to pay out shareholders without hindering growth while also managing exiting shareholders' expectations of value. The sooner the tail is paid out the quicker the profits are available to be fully distributed between the beneficiaries. Having a flexible tail for the payments is one of the benefits of an EOT compared with a trade sale for example with an earn-out, which typically would not exceed 3-5 years.
Given that exiting shareholders can't have formal security in place in respect of deferred consideration have you seen any other mechanisms used to give comfort to exiting shareholders in respect of deferred to be paid?	There are mechanisms that can be applied to provide comfort. However, these tend to conflict with the basis of the EOT.
What would you say the pros & cons with respect to management team incentivisation between Management Buy Out & EOT?	An EOT (indirect share ownership) does not financially incentivise a management team in the same way that an MBO would, as the management team would not directly own the shares, though there is the opportunity to benefit from distributions and tax benefits. However, there are many variations such as direct employee ownership, or a hybrid ownership i.e. a partial sale to an EOT alongside direct share sales or options– these variations can provide much more equivalent levels of financial incentivisation to management teams as MBOs. There are other implications such as an MBO leaves open the option for a later trade sale. Also, more widely the impact on the overall culture of the business.

Would it make sense to set up an EOT from the inception of the company and would it be preferred to an EMI Scheme if you can compare the 2 setups?	While an EOT and EMI both relate to employee ownership, they are quite different. EMI schemes act as an incentive to key employees and provide options over shares – there is no ownership until the options are exercised. EMI schemes also carry certain caps in terms of how many options can be issued and the value of these. An EOT, by contrast, indirectly transfers a majority shareholding in the business to a trust through which all employees indirectly own the business. An EOT has a much greater impact on the culture and future legacy of the business than an EMI scheme. Although an EOT can also motivate employees, it will financially benefit all employees as opposed to just key management personnel.
Can selling founders become beneficiaries of the EOT if they stay with the business? And if you leave a firm as an EOT beneficiary, do you have to lose your entitlement to distributions immediately?	The selling founders are likely to be considered Excluded Participators and therefore not qualify to become beneficiaries. Although, they may qualify for qualifying bonus payments. Employees cease to be beneficiaries of the trust on exit from the business.
If a company has to borrow to fund a share sale into a Trust, who provides PG's to allow that to happen?	There would be no PG's and the lenders have come to accept this position in EOT transactions, part of the reason for the generally lower level of gearing and lower valuations achieved.