Wales Co-operative Centre

Employee ownership: Defusing the business succession time-bomb in Wales

William Davies & Jonathan Michie
Centre for Mutual and Employee-owned Business, University of Oxford

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FOREWORD

In the second of our reports on the role of co-operatives in the economy of Wales we look at business succession and employee ownership.

The Wales Co-operative Centre is the leading agency in Wales for supporting employee ownership and co-operative development. Now celebrating our 30th year we are still offering the same high level of support to social enterprises and SMEs across Wales.

Business succession is a ticking time bomb in Wales. Our economy is dependent on SMEs and micro businesses. In Wales our business owners stay with their businesses longer than other owners in the rest of the UK. If business owners do not have a robust exit strategy in place, they may find that the only option open to them is to close the company and make their employees redundant.

This report explores how employee ownership options can contribute to long term, sustainable succession planning with measurable benefits to both business owners and employees. It also explores the importance of considering employee ownership succession routes when employees are faced with a parent company's withdrawal.

The report calls for more awareness of employee ownership and worker co-operatives as important and sustainable business models for the Welsh economy and as a viable option for business succession planning.

Derek Walker, Chief Executive, Wales Co-operative Centre

FSB

As the champion of small business, we welcome this important piece of work. The Welsh economy is heavily dependent on SMEs and it's vital that there is adequate awareness amongst the business community of the benefits of early succession planning. Highly competitive businesses can fail as a result of bad transfer planning and this report shows that employee ownership is a viable solution to ensuring our indigenous enterprises are safeguarded for the future.

Iestyn Davies, Head of External Affairs, Federation of Small Businesses in Wales

Wales Co-operative Centre
Llandaff Court, Fairwater Road, Cardiff CF5 2XP
T: 0300 111 5050 E: info@walescooperative.org W: www.walescooperative.org

@WalesCoOpCentre
www.facebook.com/WalesCooperativeCentre
www.linkedin.com/company/wales-co-operative-centre

EXECUTIVE SUMMARY




Business succession occurs in Small and Medium-Sized Enterprises (SMEs) when founders or other manager-owners decide to exit a company, often because they have reached retirement after building up a business over decades. Many successful businesses fail every year because succession is handled badly. One estimate suggests that a third of all business closures can be seen as succession failures.

There are serious social costs associated with business succession failure. These could be avoided through more advanced planning of succession strategy, both financial and managerial. The Welsh economy is especially vulnerable because:

+ It is more reliant on micro-businesses of less than 10 employees, which are typically more dependent on the founder and harder to sell
+ Rural areas depend more heavily on the sustainability of key employers, who might either close or leave the area as a result of succession

The dominant routes for SME succession at present are trade sales (to competitors) or family ownership (leaving founder's equity in the business). Both of these have significant deficiencies, as a basis for sustainable competitiveness, reward to the founder and employment:

+ Family ownership is less sustainable than it appears, and typically fails to survive beyond the second generation
+ Trade sales help to realise some of the value of the owner's equity, but offer no continuity or security for the other stakeholders in the business

Employee buy-outs avoid these risks, offering a model for succession which is sustainable, viable and financially attractive to the exiting owner. This can involve indirect ownership (via an Employee Benefit Trust) or direct ownership, via purchase of shares by employees. Such buy-outs can be financed by debt, equity or retained earnings.

There is a role for the Welsh Government in raising awareness of both business succession as a potential cost to the Welsh economy in the coming years, and of employee ownership as an optimal route to succession for SMEs. The report recommends that policy-makers, politicians and business leaders:

+ Run an awareness-raising campaign, through the Wales Co-operative Centre, to highlight the benefits of planning succession earlier rather than later
+ Highlight the routes to employee ownership, thereby reducing confusion and complexity of this issue, and identifying standardised models
+ Provide and/or underwrite an equity finance fund, to facilitate more employee buy-outs
+ Commission more extensive research on this topic, so as to gain a clearer focus on the precise risks and costs of bad succession strategies, and the social and economic benefits of succession which keeps SMEs in Wales on a sustainable basis

BUSINESS SUCCESSION AND THE WELSH ECONOMY

Heavily dependent

The Welsh economy is heavily dependent on small and medium-sized enterprises (SMEs) for the creation of jobs and prosperity

10

Micro businesses, fewer than 10 people, represent a third of all private sector employment in Wales

£454,000

The average small business in Wales has less than 8 staff and a turnover of £454,000

A business is a complex social entity. Business success requires a web of relationships to be maintained over many years, between managers, employees, financiers, customers and suppliers. As the recent credit crisis has demonstrated, if a sudden shock afflicts any one of these various stakeholders, it can have a terribly damaging impact upon the others. The viability of successful, well-managed businesses can be threatened by unforeseen and unforeseeable turbulence in the economic environment. The knock-on effect for employees, local communities and general well-being can be profound and long-lasting. This is especially true for small businesses, which are less able to buffer themselves against external shocks.

But there is one source of turbulence that is entirely possible to foresee and avoid, just as long as businesses are thinking properly about the long-term future: the transfer from one set of owners to another. This is rarely a problem for large businesses, which are typically listed on the stock market, and whose owners are constantly changing without this affecting management unduly. It is a much greater problem for small and medium-sized enterprises, in which ownership and managerial control of the business are more often in the same hands.

For reasons that we will explore, the smaller a business is, the greater the potential threat of succession failure becomes.

The Welsh economy is heavily dependent on small and medium-sized enterprises (SMEs) for the creation of jobs and prosperity, with over half of private sector employment in firms of fewer than 250 people. Just 0.1% of businesses headquartered in Wales are classed as 'large'.[1] Micro-businesses, of fewer than 10 people, represent a third of all private sector employment, and this sector of the Welsh economy has been growing faster than the UK average over the past decade.[2] Recent research suggests that the average size of small businesses in Wales has shrunk further in recent years, with an average of less than 8 staff and a turnover of £454,000.[3] Many of these businesses are firmly embedded in their local communities, with 60% of their sales to local customers.[4]

These small businesses are typically owned and run by their founders, on whom much of the identity and the reputation of the business depends. In some instances, founders of businesses might want to exit because they have lost interest or because they want to withdraw their investment. Some businesses are established in order to be sold only a few years later. But this is not

TABLE 1:
SIZE OF WELSH BUSINESSES[5]

BUSINESS SIZE	CONTRIBUTION TO TOTAL PRIVATE SECTOR EMPLOYMENT
Fewer than 10 people (micro-business)	**33%**
10-49 people (small business)	**14.6%**
50-249 people (medium-sized business)	**12.4%**
249+ people (large business)	**39.8%**

typical in the Welsh context, where small business owners hold on to their firms for longer than the UK average, and a fifth have been running their business for over 20 years.[6] In rural areas of Wales, the average length of tenure is higher still.

Business succession is an inevitable and foreseeable challenge, because eventually retirement of founders will occur. The Welsh Government's Economic Renewal plan notes that the Welsh economy faces a problem of a comparatively high proportion of the workforce nearing retirement – but this same problem affects small businesses, as a problem of ownership succession.[7]

The Economic Renewal plan recognises that the Welsh economy is failing to keep up with the rest of the UK in two major areas, of employment and productivity. It also notes that Wales faces a distinct economic challenge in being comparatively less urbanised than most European nations. Each of these factors only heightens the urgency of addressing business succession, which can be especially damaging and liable to fail in regions where economic activity is already weaker. As a report for the UK government found:

"Failed business transfers of potentially viable businesses in areas of high unemployment and low activity rates thus involve much higher social costs… than is the case in more economically buoyant geographical areas, especially when the impact of their closure upon other local firms, regeneration etc. is taken into account. Similar arguments could be made in relation to firms facing business transfer that are located in remote rural areas. The highly localised nature of the market for small firms poses particular problems for such businesses, and business transfer failure can deprive local consumers of a valuable service – leaving alternatives that cost more and/or are less appropriate to local needs".[8]

Equally troubling, is that more productive businesses, creating investment and good jobs, may achieve *successful* ownership transfers, but to new owners outside of Wales who then move jobs and R&D elsewhere. This does not count as a business transfer failure, but it is a type of succession that brings costs to Wales, often at a very local level. This is also true of parent companies that decide to relocate operations outside of Wales.

60%

Many businesses are firmly embedded in their local communities, with 60% of their sales to local customers

1/5th

One fifth of business owners have been running their business for over 20 years

BUSINESS SUCCESSION AND THE WELSH ECONOMY

Succession

Business Succession is likely to go wrong if it is ignored and badly planned

Many existing business owners in Wales have a commitment to their employees and to local communities that can be impossible to replicate under subsequent owners. Welsh SMEs are noted for being more locally rooted than elsewhere in the UK.[9] This commitment brings spillover benefits, on which local economies can depend. For example, it is well-known that manufacturing firms have above-average 'multiplier effects', creating more jobs for their surrounding economies. Remote areas of Wales are especially vulnerable to the social costs of individual firms moving elsewhere, and therefore benefit from the on-going commitment of engaged, long-term owners. Given these externalities, the quality of ownership should be a matter of policy concern for the Welsh government.

But at present business succession, and the particular challenge it poses to small firms, receives scarcely any public or policy discussion in Wales. For example, the issue was overlooked in the recently published report of the Micro-Business Task and Finish Group. This is despite the fact that all the evidence shows that business succession is most likely to go wrong – resulting in the failure or decline of otherwise successful businesses – if it is ignored and badly planned by the businesses concerned.

This report aims to raise awareness of the business succession 'time-bomb' in Wales. It seeks to highlight the many benefits that employee buy-outs can offer to current owners of businesses, who, reluctantly or otherwise, are considering how to exit a business. It also aims to raise the awareness of employee ownership as a viable option when businesses are threatened with closure in a crisis situation, such as when a parent company restructures and decides to withdraw from the market place and relocate business elsewhere.

With the right know how and forethought, employee ownership can enable more businesses to avoid an unnecessary disruption, ensuring continuity and the preservation of jobs in Wales. But before addressing the benefits of employee ownership, we first need to understand more about how succession works, and why it is liable to fail.

WHAT IS BUSINESS SUCCESSION FAILURE?

One of the characteristics of a capitalist economy is that new businesses are constantly being born, and older ones are dying off. This is viewed by economists as a good thing, and an indicator of economic dynamism. A competitive and efficient economy will see businesses being closed because they are badly managed and less productive. The birth-rate *and* death-rate of businesses in the UK are higher in its more prosperous regions. The rate of business births and deaths in Wales is slightly below the UK average, which signals marginally lower levels of competitiveness.[10] Policy-makers in Wales should not be opposed to business failure *per se*, as regrettable and painful as many individual closures are.

But business failure is not the same thing as a business *transfer* failure. It is possible for businesses which are viable or even highly competitive, to close as a result of bad succession planning or a failure to preserve business success following the departure of a founder or owner. One study suggested that as much as a *third* of closures in Britain might actually be 'transfer failures'.[11]

Very few founders give much thought to business succession when they set up a company. Equally, they are unlikely to give much initial thought to how they might release their equity at a much later date, even though this could be highly lucrative for them. An entrepreneur who founds a business in their thirties may spend twenty or thirty years nurturing the business, building its reputation, generating trust amongst customers and employees, to the point where the company is worth several million pounds – but never give any thought to what will happen when they reach retirement, until the moment arises. Lack of preparation is the single biggest contributing factor to succession failures, and many owners under-estimate how long a successful transfer will take.[12]

The dilemma facing an owner in this situation involves weighing up the relative values of *preserving continuity* and *realizing the monetary value* of the business. Preserving continuity means minimizing the disruption to the business of the owner exiting, such that jobs remain secure, the reputation and brand remains unaffected, and customers and suppliers still feel they are trading with the same business. It may also mean maintaining the business as a legacy for the local community in which it is embedded.

Realising the monetary value, on the other hand, involves a founder receiving an appropriate economic reward for many years of business growth and entrepreneurial risk-taking. This might be necessary for founders to retire on. However there is a significant difference between realizing the maximum price that the market can offer, and realizing an adequate price, calculated on assets and balance sheet. Owners who seek to exit a company by *maximizing* the value of their equity may find that, in order to do so, they cannot also secure the continuity or long-term viability of the company, in the form that they have left it in. But there are alternative exit routes that facilitate better managerial and ownership succession, on a slightly lower business valuation.

1/3rd

One third of UK business closures may be transfer failures

Preparation

Lack of preparation is the single biggest contributing factor to succession failures

WHAT IS BUSINESS SUCCESSION FAILURE?

30%

Less than 30% of family-owned businesses make it into a third generation

Private equity

Equity buy-outs experienced a boom in the years leading up to 2007. They have various advantages, but also have some major defects that could have a negative effect on the Welsh economy

Table 2 represents the dominant exit routes for owners and founder-owners of companies. The first three options are the dominant ones for SMEs, each bringing their own advantages and disadvantages. Generally speaking, owners who are primarily concerned with preserving the continuity and identity of the company they have built will be more likely to aim for family ownership. Meanwhile, owners who are more concerned with realizing the monetary value of their equity are more likely to opt for a trade sale or private equity buyout. Stock market flotations are rarely appropriate for firms of under 250 people. Finally, owners who seek to balance business continuity with some monetary reward for themselves are most likely to pursue a management or employee buy-out. They may have to accept a slightly lower price for their equity in doing so, based on the company's balance sheet rather than the potential market price of its equity.

For SMEs, family ownership and trade sales are the dominant exit routes, although private equity buy-outs experienced a boom in the years leading up to 2007. While these have various advantages, they also have some major defects that will have a negative effect on the Welsh economy, once the current generation of small and micro business owners reaches retirement. These can be understood as follows:

+ **Family ownership:**
  Where small businesses are concerned, family ownership generally means selecting one member of the next generation to take over running of the business. But a lack of aptitude or enthusiasm of the younger generation is a severe problem, and less than 30% of family-owned businesses make it into a third generation.[13] Often the business is a burden on the younger generation, who feel the inheritance is an offer they can't refuse. A third of family businesses see lack of interest or inadequate management skills in the family as an 'extensive constraint'.[14] These risks can be alleviated by appointing professional managers to run a business on the family's behalf, but this is more suited to medium-sized enterprises. For example, many German 'Mittelstand' firms (medium-sized enterprises) are family-owned, but without day-to-day family involvement in the business
+ **Trade or private equity sale:**
  Surveys suggest that most small business owners still view a trade sale as their preferred and most likely exit route. However, these owners tend to over-estimate how easy it will be to find a suitable buyer, and under-estimate how important they are personally to the business as a going concern. These problems become more acute, the smaller a firm is. As a result, owners are often surprised to find that they cannot get either the price or the type of sympathetic or local buyer that they hoped. Very often, the announcement that a company is up for sale can have a negative impact on relations with customers, suppliers, employees and local community. The sale itself may further weaken the confidence of these stakeholders in the business

TABLE 2:
EXIT ROUTES FOR EXISTING OWNERS AND FOUNDERS

	WHAT IS IT?	ADVANTAGES	DISADVANTAGES
FAMILY OWNERSHIP	Pass on ownership and control to a younger member(s) of the family.	Preserves continuity and avoids need to finance a buy-out; gradual management transfer possible.	Founder does not realize any monetary value of business; younger generation may not be disposed or qualified to run the business; bad family relations can affect business.
TRADE SALE	Sell to a competitor, either as going concern or as assets.	Potentially maximizes monetary value; swift exit possible.	Difficulty of finding buyer; jobs, stakeholder relations and business reputation put at risk; exit can be too swift.
PRIVATE EQUITY BUYOUT	Sell to an investment fund, as a going concern.	Potentially maximizes monetary value; swift exit possible.	Jobs, stakeholder relations and business reputation put at risk; exit can be too swift; short-term focus (2-3 year exit strategy) of the fund, adds risk of asset-stripping.
FLOTATION	Sell shares publicly via the stock market.	Potentially maximizes monetary value; rapid increase in capitalization; avoids subsequent succession issues.	Potential loss of control; short-term focus on quarterly financial results; mainly suitable for much larger firms.
MANAGEMENT BUYOUT	Sell to managers.	Realizes monetary value; preserves continuity; gradual exit possible.	Requires management taking on significant debt, which needs securing; succession issue then recurs a few years later.
EMPLOYEE BUYOUT	Sell to employees, either via shares (direct ownership) or into a trust on employees' behalf (indirect ownership).	Realizes a monetary return; potentially avoids succession issues recurring; gradual exit possible; results in higher levels of business performance, engagement and wellbeing.	Difficulty in financing buy-out; inadequate knowledge and understanding of employee ownership models; risk with direct ownership of employees investing savings in own business.

WHAT IS BUSINESS SUCCESSION FAILURE?

41%

41% of previous owners were still involved in a company they had exited after one year

26%

26% of previous owners were still involved in a company they had exited after five years

Successful transfers require several years of planning on the part of founders, and are best done through a gradual handover process. One survey has shown that 41% of previous owners were still involved in a company they had exited after one year, and 26% after five years; in most cases, this was deliberately planned, but in others it was due to a transfer going wrong.[15]

Owners and managers typically under-estimate how long an effective succession process will take. They also under-estimate how long to spend planning it, and small firms are more likely to neglect planning. In terms of senior management, it helps if future successors are identified early, and decision-making is gradually transferred over a number of years. A gradual management transfer process can ensure that relations with employees, customers, suppliers and the local community remain intact, once the founder has exited entirely. It is especially crucial that customers feel they are still dealing with the 'same business'.

Selling a business to complete outsiders (either as a trade sale or a private equity buy-out) is not necessarily incompatible with a gradual transfer, and the new owners will certainly have some interest in maintaining the reputation and employee engagement built up over time. But they will not be party to these business relationships themselves, and be consequently less sympathetic to the culture, ethos and local importance of a business.

At worse, they may seek to asset strip the business for maximum short-term gain and usurp existing management, as various private equity funds have been accused of doing in recent years.[16] What's more, should a founder themselves seek to exit rapidly (both financially and managerially), the new owners may be powerless to stop them, and find that the business reputation and management culture deteriorates far more rapidly than they could have foreseen.

Small businesses currently suffer from inadequate awareness of these issues, which is not helped by the advice they receive from accountants, lawyers and auditors. Professional advisors rarely take into consideration the 'social' sides of the business, that is, the relationships, tacit knowledge and reputation that have built up over time, and often work around the assumption that owners simply want to exit for the highest price possible. In the absence of a carefully planned alternative, many of them will take this advice, with consequences for their businesses and local economies that they later regret.

The employee ownership route is equally a viable option when businesses are threatened with closure in a crisis situation, for example when a parent company restructures and decides to withdraw from the market place and relocate business elsewhere. This form of business closure has the same negative economic impacts as described above, and often can be amplified given that many of these businesses are larger employers, and may have absorbed many small businesses in the area. This can result in large scale redundancies and significantly impacts on the stability and continuity of the local business infrastructure. Often in this situation employees feel the only option available to them is finding alternative employment. However as Primepac Solutions demonstrates, employee ownership could give employees in this situation the opportunity to turn redundancy into a future of business ownership. This not only safeguards jobs, but keeps businesses and services in the local area, maintaining the business infrastructure and keeping the Welsh economy competitive.

PrimePac Solutions Ltd

PrimePac Solutions Ltd, is a worker co-operative that fills bottles, sachets and tubes for clients including leading brands in the health and personal care sector.

The co-operative was formed when their parent company decided to withdraw from Wales following a major fire which destroyed their packing facilities. Until the fire in 2005, 140 people were employed by Budelpack Rumney. When the news broke that the company was not going to reinvest in the area, a group of employees contacted the management of Tower Colliery, who had famously formed a worker co-operative to buy their pit from the National Coal Board, who pointed them in the direction of the Wales Co-operative Centre.

Knowing Budelpack's strategy of high volumes and low margins the group were able to put together a business plan based on low volumes and high margins and staff members decided to invest their redundancy payment into setting up a new employee owned company. 19 employees were needed to start up the new company and they were oversubscribed by 100%. After much negotiation, the employees managed to purchase necessary equipment from Budelpack and began trading in October 2005. The company now employs 22 permanent staff and between 10 and 20 temporary staff.

With manufacturing jobs on the decline in Wales the staff were keen to preserve their livelihoods and keep jobs in the local area. The Wales Co-operative Centre provided legal and business planning advice and helped the company access funding from Co-operative and Community Finance, Finance Wales and the Welsh Government.

"Establishing our business co-operatively means that all employees feel that they can become masters of their own destiny and develop our company into a real success story for South Wales", commented Steve Meredith, Managing Director of PrimePac Solutions Ltd.

Since 2007, PrimePac Solutions Ltd has seen a year on year increase in both turnover and budget. It is now a £1.8million turnover business and has paid out dividends to shareholders greater than the amount invested at the start.

THE EMPLOYEE OWNERSHIP SOLUTION

Employee ownership

Employee ownership, can safeguard continuity, offer long term sustainability, ensure a gradual transfer and realise owner's equity

Both family ownership and trade sales have significant defects as paths for business succession. The former may ensure continuity for the business, but does not guarantee longer-term sustainability. The latter may appear like a simple and lucrative exit route, but brings far more complications than many owners expect, in terms of finding a trustworthy buyer and then facilitating a successful transition. Both owners and firms can benefit, if all parties to a succession are both well acquainted with the business and enthusiastically committed to its long-term success. Sadly, this is not the case for many business transfers at present.

Selling a business to its management is one viable alternative. Partnerships, as seen in many professional advisory firms, are an ownership model that relies on each new generation of senior management buying out the previous one. The advantage is that the culture of an organisation can potentially remain unaffected by ownership transfers, and future owners can be identified with sufficient time to plan a succession well. But management buy-outs have their own shortcomings.

Firstly, they require individual managers to take on large amounts of debt to buy out the owners, which will often need to be secured against their own homes or other assets. Secondly, there is an inevitable risk that the new owner-managers will be less committed to the business than the founder, and pursue their own exit route that may not be to the benefit of the business. Finally, management buy-outs (and partnerships) potentially create an insider/outsider culture within an organization, splitting those who are to become equity-owners from those who are not. Restricting ownership to such a small minority of employees, albeit the most senior ones, can mean forgoing the benefit of more widespread employee engagement.

Employee buy-outs alleviate many of the risks of business succession, and avoid many of the various defects associated with the exit routes already discussed. In particular, employee buy-outs achieve various goals of effective succession plans:

+ **Safeguard continuity:** Employees, customers, suppliers and local communities gain the assurance that the business will retain its identity and culture. Reputation, ethos and tacit knowledge are thereby preserved, with both business and social benefits
+ **Long-term sustainability:** Once transferred into employee ownership, the ownership of the business may be held in this form indefinitely, without further succession risks (depending on the precise ownership model – see table 3)

TABLE 3:
SUCCESSION ROUTES INTO EMPLOYEE OWNERSHIP

	'INDIRECT' OWNERSHIP VIA A TRUST	'DIRECT' OWNERSHIP VIA SHARES
HOW DOES IT WORK?	Owners sell and/or gift shares to an Employee Benefit Trust (EBT) or Share Incentive Plan (SIP) trust.[17] Trustees, usually including an employee representative, oversee how shares are voted, with a fiduciary duty to promote the long-term interests of current and future employees. Trusts may have particular constitutional and voting mechanisms to prevent them being dissolved and company sold. Profits can be distributed to employees as beneficiaries of the trust, typically in proportion to salary.	Owners sell and/or gift shares directly to employees. Employees vote their shares and receive dividends from them. Employers may use HMRC-approved tax-advantaged schemes, such as a Share Incentive Plan, to encourage employee share-ownership.
HOW IS IT FINANCED?	Bank loan to EBT, secured with company assets; loan to EBT from special purpose lenders such as Co-operative and Community Finance; equity finance from special purpose funds; debt or equity finance from Finance Wales; retained earnings paid into EBT.	Employees' savings and earnings; bank loan to employees, secured against own assets.
ADVANTAGES	Employees' savings not at risk; democratic governance model gives equal stake to all employees; company cannot be sold or asset-stripped by employees or managers; flexible model can be combined with other ownership forms; buy-out can be phased over several years (necessary if financed by retained earnings).	Employees have direct stake in success of business; buy-out can be phased over several years.
DISADVANTAGES	EBTs no longer receive tax relief, creating major tax inefficiency; HMRC-approved SIP trusts receive tax relief but can only hold shares for 10 years at present; lack of awareness of indirect ownership models amongst professional advisors; some may not view indirect ownership as 'real ownership'.	Employees have job and savings tied up in single entity; potential lack of liquidity for employees wanting to increase or reduce equity; potential inequality in voice and stake, may be closer to management buy-out.

THE EMPLOYEE OWNERSHIP SOLUTION

£1bn

Employee-owned companies are worth £1bn to the Welsh economy

7,000

7,000 people are employed in employee owned companies in Wales

57%

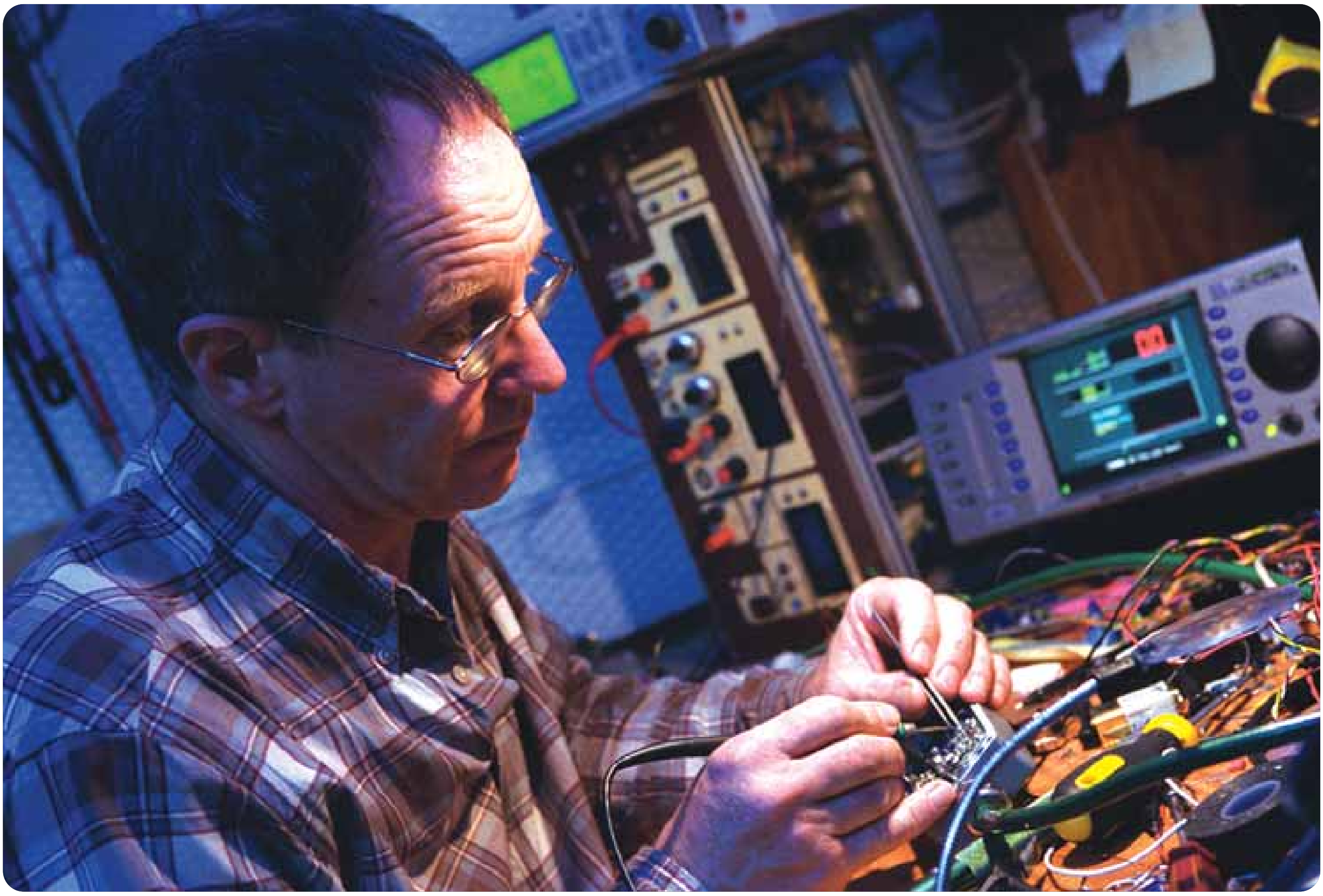
57% of co-operatives in Wales expect to grow over the next 12 months

+ **Gradual transfer:**
  Succession is best carried out gradually over a number of years and with considerable long-term planning. Employee buyouts also work well as gradual mechanisms for ownership transfer
+ **Sale of retiring owner's equity:**
  Existing owners can realize monetary value for their equity, through selling to employees. The valuation of the business may be slightly lower than what the market would offer, and the buyout may be a phased one. But this is still a more lucrative option for the founder than family succession and a more stabilizing one than sale to an outsider

Employee-owned companies are already worth £1bn to the Welsh economy, employing 7,000 people.[18] Quite aside from the benefits of employee ownership as a route for business succession, a substantial body of evidence indicates that these businesses out-perform their competitors by a range of measures, including productivity and sustainable job creation.[19] A study by Cass Business School of employee ownership across Britain discovered that employee-owned businesses were more resilient to the recent recession than their competitors, and emerged from it quicker.[20] In Wales today, 47% of SMEs overall expect to grow in the next 12 months, while 57% of co-operatives and social enterprises expect to do so.[21]

These businesses do better at engaging with their employees, utilizing the knowledge and skills at their disposal. The benefits of employee ownership are also discovered by management, in terms of reduced staff turnover and reduced levels of sickness absence.[22] Employee ownership facilitates a virtuous circle in the creation of social and economic value, where one reinforces the other.

One of the most significant findings from research on employee ownership around the world is that the ownership model only delivers productivity gains if employee-owners have some form of collective voice within the organization.[23] This may be as simple as electing a single representative to a non-executive role in the company, to facilitate dialogue and trust between senior management and employee-owners.[24]
While managers must still exert authority over an employee-owned firm, the cultural division between managers and employees is likely to be weaker. This can take time to adapt to, and remain a challenge for managers who feel accountable to the owners on a daily basis, but can ultimately lead to a far more energized and productive working environment.



Aber Instruments

Aber Instruments was founded in Aberystwyth in 1988, producing measurement instruments used for fermentation in brewing. Today, Aber has 28 employees, with 95% of its customers overseas. It was initially owned by four partners, each with an equal stake. These partners were keen to instill an ethos of engagement and dialogue within the business from the start.

In the 1990s, the founders decided to widen share ownership amongst employees, using HMRC's tax advantaged share ownership schemes. This meant individual employees acquired a direct stake in the business, by receiving an allocation of free shares. The founders knew that business succession would eventually become an issue. They were aware of the dominant exit routes available to them, but didn't like them. As Managing Director Barry Wise explains:

"Most of those routes involved an equity stake sitting outside the company. We didn't want that. We'd always been an independent company owned by members of the company. We wanted to guarantee jobs in Aberystwyth. We wanted to guarantee engagement by staff".

Thanks to advice from the Wales Co-operative Centre Aber's founders started to look into employee ownership as a solution.

An Employee Benefit Trust was established (alongside existing direct share ownership) which could be used to buy the shares of founders or other employees, as they left the company. From 2004, a proportion of profits began being paid into the EBT, where they were used to gradually buy out the shares of the founders. One of the founders left in 2007 but by 2009, that founder had been completely bought out by the EBT.

This succession process was delayed by the recession, which affected the profits that could be distributed into the EBT. Aside from the EBT, employees are still permitted to buy equity shares directly (which they receive a dividend on), though nobody is allowed to own more than 5% and all are obliged to sell shares back to the EBT when they leave. Shares can be traded amongst employees at an annual 'dealing day', and their value is set in agreement with HMRC – their value has roughly doubled over the last ten years.

Today, Aber is 85% employee owned, of which 55% is held in the EBT and 30% is held directly as shares by employees. The remaining 15% is still held by founders, all of whom will have exited within another 2 years. Barry Wise recognises that the founders have extracted less money from the business than they might have done, *"but that is balanced against being able to work for the company and pass it on to safe hands, rather than to someone who can asset strip it".*

The managerial and cultural transition to employee ownership is not without challenges. Aber established a new governance structure to offer a collective voice to the employee-owners, and it took time for employees to understand that this new ownership model meant giving real responsibility to employees. But the benefit, in terms of reduced staff turnover, knowledge sharing and sustainability, is now clear to all.

THE EMPLOYEE OWNERSHIP SOLUTION

60%

Welsh SMEs do 60% of their business locally. What is their value along the supply chain and in their own communities?

2/3rds

2/3rds of employee-owned companies in Wales were established as employee ownership companies from their inception

These research findings suggest that increased employee ownership is something that policy-makers in Wales should be pursuing *anyway* as a route to greater economic competitiveness.[25] This ownership model is proven to work successfully for the SMEs which are so important to Welsh job creation and prosperity. There are many examples of high value-added and knowledge-intensive producers in Wales being owned by their employees, of which three are examined in the case studies. Anecdotal evidence would suggest that employee ownership is particularly suitable for firms which invest heavily in R&D, where long-term, less transactional relationships are more valuable. At present, 2/3 of employee-owned companies in Wales were established under that ownership model from the beginning. But the other third were converted to employee-ownership through buy-outs.

When these buy-outs are achieved, this potentially achieves a number of positive outcomes. The business is saved from the risks associated with trade-sales, which include the risk of new owners moving the business elsewhere against the wishes of employees. The founder or previous owner receives the comfort of knowing that the business will continue to trade in the same way, and in the same location. Given that Welsh SMEs do 60% of their business locally, the value of retaining individual businesses and preventing their failure has knock-on effects. Where businesses represent important local institutions, and the founders are well-known individuals, this is one of the most important motivations for pursuing an employee buy-out. And finally, once the business is employee-owned, there are good reasons to expect this to translate into higher productivity.

EMPLOYEE BUY-OUTS: THE AGENDA FOR WALES

There is good evidence that employee ownership delivers better economic and social outcomes, which have spillover benefits for local communities and local economies. It is already feasible for founders, owners and parent companies to take this exit route, as the case studies demonstrate. So what is the broader public or policy interest in this, if any? Or as is so regularly asked of employee ownership – if it's so great, why doesn't it just happen of its own accord?

To identify the agenda for Wales, we need to take three questions in turn. Firstly, why should this be a matter for policy interest? Secondly, what is currently preventing more employee buy-outs? And thirdly, what might the Welsh government and the business lobby do in order to reduce some of these obstacles and further this agenda?

The public interest in sustainable business succession

The Welsh government and industry bodies must accept that a high rate of business births and deaths is a symptom of a healthy, competitive economy. However, there are a number of factors in business succession which make this a matter of policy interest:

+ **Market failure:**
  There are a number of ways in which business succession suffers from problems of market failure. SMEs, and micro-businesses in particular, often find it harder than they expect to find appropriate external buyers. There are additional difficulties in the need to cost the 'social' value of a business into a sale: SMEs have various positive external benefits, upon employees, communities and local economies, which are not included in the valuations used in trade sales and private equity buy-outs. There is therefore a case for government in supporting business succession which secures sustainable social value of this kind. Government should also be keen to promote employee ownership as a sustainable succession route when parent companies withdraw from the welsh market place.The withdrawal of a parent company may generate an opportunity to create an innovative and viable employee owned company which provides local jobs and enhances local wealth

EMPLOYEE BUY-OUTS: THE AGENDA FOR WALES

Employee ownership

Employee ownership contributes to higher levels of wellbeing amongst employees

Ownership

Wales needs ownership forms that have a long term investment orientation

+ **Equity and wellbeing:**
  The Welsh Government's Economic Renewal document notes that "we want a strong economy, not as an end in itself, but for the integral contribution it can make to the quality of life and the economic, social and environmental wellbeing of people and communities in Wales".[26] There is good evidence that employee-ownership contributes to higher levels of wellbeing amongst employees. Exit routes involving a sale of SMEs to external owners are more likely to result in stressful transitions and uncertainty, which rebound on wellbeing, and also correlate to higher levels of internal pay inequality within firms. In contrast to management buy-outs and some forms of employee share ownership, indirect ownership (via an EBT) has progressive implications for the distribution of profits

+ **Productivity and regional competitiveness:**
  SMEs are vitally important to the Welsh economy. Micro-businesses, of under ten employees, are especially prevalent in Wales, and especially vulnerable to business succession failure when a single individual reaches retirement. Yet many of these firms are engaged in the forms of high value-added, export-oriented production that are crucial to the future prosperity and competitiveness of Wales. Even highly productive firms can suffer succession failures. If more R&D is to be privately financed within businesses, reducing reliance on universities (as per the Economic Renewal plan), Wales will need ownership forms that have a long-term investment orientation, and not one of short-term profit-maximisation. Firms whose value resides largely in knowledge and social capital (as opposed to tangible assets) can be harder to sell and then harder for an outsider to manage effectively. Selling to outsiders may also mean high quality, high value-added jobs moving out of Wales

Current obstacles

Employee buy-outs currently suffer from a number of cultural, regulatory, financial and professional hindrances. These are largely common to the entire UK, and some are a consequence of UK-wide policies. The most significant ones are:

+ **Lack of awareness and understanding:**
  The first barrier preventing greater use of employee buy-outs is that few founders or owners have heard of this exit route. The Wales Co-operative Centre, through its business succession and consortia project, is actively working with a number of other organisations to raise awareness of employee ownership as an exit route for owners. But it is vastly outnumbered by the professional advisors and bank lenders who either don't know about employee ownership, or are skeptical towards it. Often the skepticism comes from the misconception that employee ownership necessarily involves employee management of a business and adherence to a particular ideology. Where owners do get to hear about employee ownership and its possible benefits, they then face a further struggle in identifying a model that suits their needs, in terms of governance, financing and exit strategy. Finding a lawyer to support this process can be difficult and expensive. The Wales Co-operative Centre can provide support to owners, helping them identify an employee ownership model to meet their withdrawal expectations, and pointing them in the right direction of professional advisers, experienced in the employee buyout process

SCS Group

Allan Meek established SCS Group with one other partner in Caerphilly in 1993, to produce ventilation and smoke control systems in new residential buildings. He bought out the partner ten years later, leaving him as the sole owner. The business was successful, growing to 30 members of staff and a turnover of over £5m, with offices in London and Birmingham. By the early 2000s, Allan was beginning to think about succession planning, with a view to leaving the company within five years.

He began to consider a few options, including a trade sale or a management buy-out, but was uneasy about how little long-term sustainability these models offered. As Allan puts it, *"I could have made a lot more money if I'd been in it for the money, but we've always been about growing something for the future"*. SCS had a reasonably decentralised management structure already, but Allan had never been involved in co-operatives or employee-owned companies before. Employee buy-outs seemed to provide exactly the type of succession route that he was after, in putting the interests of the business first.

An EBT was established in 2005 to buy company shares using retained earnings, in addition to shares being sold and gifted to individuals directly. By 2007, 15% of the company's shares were either directly or indirectly owned by employees. But in the same year, the housing bubble burst, and with 85% of SCS Group's business in residential new-build property, the business had to make some rapid changes just to stay afloat. The core business was shifted towards other areas of construction, offering integrated systems for fire protection, ventilation and heating, which could be used in offices and car-parks. The business shrank to 25 employees and there were no profits available with which to continue the employee buy-out plan.

Like Aber, SCS Group's succession route was dependent on business growth, which ceased as a result of the recession. Ironically, in the face of such severe challenges to the business model, Allan now feels more energized and committed to the business once again. He is in no hurry to leave, and so feels no need to explore other exit routes – the employee buy-out should still go ahead, but over a longer period of time.

Allan's primary concern is to leave behind a successful business, with rewards going to those who have committed their energies to the company. Realising a decent monetary value for his stake is important to him, but secondary to the more urgent task of setting the company on a stable path, which he believes has now happened. With adequate growth over the next ten years, the transition to employee ownership should be completed. He's hopeful that many of his remaining shares will be sold directly to employees, especially if the company can start hiring again soon.

The great luxury of Allan Meek's position is that that there is no urgent necessity for him to exit, which allows him to focus on what's best for the business.

EMPLOYEE BUY-OUTS: THE AGENDA FOR WALES

£139

Every £100 of company shares bought by an EBT costs £139 in company cash

+ **Access to finance:**
  Some employee buy-outs may not require external finance, if retained earnings are high enough, as the case of Aber Instruments highlights. But a self-financing buy-out can take longer and be vulnerable to fluctuations in profit margins. Loans to EBTs, either from banks, from Finance Wales or specialist funds such as Co-operative and Community Finance, are feasible, but need to be secured somehow, which requires a business to have sufficient assets. Often banks will be suspicious of employee ownership. Businesses without significant assets such as property will typically need some equity investment, in addition to a loan; this will either need to come from employees themselves (with the risks associated with that) or from a specialist equity fund, such as Finance Wales

+ **Tax inefficiency:**
  Until 2003, EBTs were subject to tax relief, such that profits could be paid into them prior to corporation tax. This was being abused by companies that were not committed to long-term employee ownership, and the tax relief was removed. However, companies owned indirectly via such trusts are now effectively taxed twice on their profits: once as they enter the EBT, and again when they are distributed as dividends. At present, every £100 of company shares bought by an EBT costs £139 in company cash.[27] The current tax situation isn't simply a lack of incentive to employee buy-outs, but a positive *disincentive*. Entrepreneur's relief on capital gains tax is also skewed in favour of selling to outsiders, and against employee buy-outs

+ **Mindset of owners:**
  Every founder or owner will have their own unique relationship with a business, which influences their exit strategy (and whether they even have one). This can be understood in terms of a spectrum of 'stewardship'.[28] At one end of the spectrum are owners who have nurtured and grown a business over decades, and are deeply reluctant to ever depart; at the other, are owners who view a company in purely financial terms, as a vehicle to produce profits and grow in market value. The latter mentality will create a problem of owners tending to over-value their business, and under-appreciate the subtleties of successful business transfer. But Welsh SME owners are likely to be closer to the former mentality, especially micro-business owners and especially those in more rural areas. These owners will often be willing to accept a lower price for their company equity, if that guarantees a sustainable future for the business. Their mindset is more problematic where it is resistant to the entire notion of business succession, and they are reluctant to plan their exit

Recommendations

With the exception of EBTs' tax inefficiency, which is an issue that can only be dealt with via the UK government and HMRC, many of these obstacles can be tackled by the Welsh Government and the Welsh business lobby. Welsh policy-makers should be particularly concerned by the possible impact that business succession failures could have on an economy that (like the rest of the UK) is still struggling to grow and generate jobs, and is uncommonly dependent on very small employers. Rural areas are particularly vulnerable. Business leaders and advocates have an important role to play, in conjunction with the work of the Wales Co-operative Centre, in raising awareness of the issue and the benefits of employee ownership.

We make the following recommendations:

+ **Business succession awareness-raising:** Business succession failure is caused largely by inadequate or rushed planning. Politicians, policy-makers, the Wales Co-operative Centre and the Federation of Small Business in Wales (FSB) have a strong role to play, in encouraging owners and founders to start planning early, ideally at least five years before an owner hopes to have exited. Good succession occurs slowly, meaning that long-term planning pays dividends. A campaign to highlight the benefits of early succession planning, and the risks of badly planned successions, should be run across Wales, aimed especially at small and micro-businesses
+ **Highlighting routes to employee ownership:** Politicians have huge power to raise the profile of employee ownership, simply through speaking publicly about it. The Welsh Government should publish and publicise clear guidance on the main routes to employee ownership, defining two or three possible 'off-the-peg' models of how employee owned companies can be structured and financed. The Wales Co-operative Centre can support this work, based on its significant experience of working with business owners and supporting employees through the employee buyout process. This needs to be accompanied by information on how to access finance and legal advice, integrating the knowledge from Wales Co-operative Centre, FSB Wales, Finance Wales, Co-operative and Community Finance, and the Employee Ownership Association, to create a single one-stop-shop for any founders and owners contemplating an exit strategy

Five years

Encourage owners to start planning at least five years before they hope to exit

One-stop shop

Create a single one-stop-shop for any founders and owners contemplating an exit strategy

EMPLOYEE BUY-OUTS: THE AGENDA FOR WALES

Equity Fund

There is a need for an Equity Fund to facilitate micro business buy outs

Data

Not enough data – how much is business succession failure costing the Welsh economy?

+ **Equity finance for employee buy-outs:**
The Welsh Government has already made available various sources of business finance, such as the Wales Economic Growth Fund. This has been followed by the recent announcement of a £6m Micro-Business Loan Fund, which will begin operating in 2012. In view of the many benefits of employee buy-outs as a route for business succession, there is a strong case for the Welsh Government to provide and/or underwrite an equity fund, dedicated to facilitating micro-business buyouts. Specialist equity finance which enables owners to sell their equity to a fund, which then gradually sells on to employees (often via an EBT), at an agreed rate of return sufficient to ensure replenishment of the fund, would be extremely valuable. This type of finance is crucial for employee buy-outs of firms without significant assets to secure loans against

+ **Evidence gathering:**
At present, there is inadequate evidence on the potential costs of business succession failure to the Welsh economy. There is also too little data on the exit routes that are being selected, including on employee ownership. The Welsh Government and FSB Wales, working with the Wales Co-oprative Centre can assist with evidence gathering on the current state of business succession and planning, especially amongst micro-businesses

Skye Instruments

Skye Instruments was founded by Gill Wilde and her husband John. It produces electronic instruments which monitor the impact of micro-climatic variations on crops. Skye Instruments employs 18 people, with a turnover of £850,000. Its products are in extremely niche markets, though are increasingly used to research climate change. 70% of Skye Instruments' sales are exports.

The owners hadn't considered a succession plan, but came across employee ownership via the Wales Co-operative Centre. One of the most attractive aspects of an employee buy-out concerned securing the business's location. As Gill says, *"What John and I were really keen on was keeping the company here, in Powys. If you were buying a high tech company, you wouldn't keep it here. You'd move it to Oxford or Cambridge. And the people here have made it what is".*

The immediate difficulty they faced was in accessing affordable and clear advice on how to facilitate an employee buy-out. There seemed to be too many different models, and no clear indication of which one was most suitable. In the end, Gill and John presented different forms of employee ownership to the staff (including direct ownership via a SIP and indirect ownership via an EBT), who voted for an EBT model. The equality of employee voice offered by indirect ownership was an important factor in this decision.

The EBT was set up in 2009, and the following year 10% of the company's shares were sold to the EBT using retained earnings. A further 30% were sold using a bank loan to Skye Instruments, secured against company assets. The Wildes benefited from a twenty year relationship with the same bank, which was sympathetic to their aims. They expect to sell the remaining 60% of shares into the EBT over the next six years.

Having examined other employee-owned firms, Gill and John put rules in place to uphold the commitment to employee-ownership for the long-term. The EBT has five Trustees, who play an active role in holding management to account, and must consult staff on major decisions affecting the business. Company profits must first of all be used to buy shares for the EBT – the rest is split between a dividend payment to employees and retained earnings. While the Wildes expect to have exited financially in six years time, the management hand-over process will be ongoing, and they will retain involvement in the business.

Continuity and local identity are clearly strong motivations for this business succession route. But the Wildes feel that they've had to struggle, not only in the face of often unhelpful professional advisors, but also in the face of a tax regime which makes EBTs unreasonably inefficient. They do feel that they've benefited from support of organisations dedicated to employee ownership. They could have made more money via other routes, and received offers to sell to outsiders. Within a few years, they'll have withdrawn their equity stake and left a sustainable business in Wales.

NOTES

About the authors

Dr William Davies is Academic Director of the Centre for Mutual and Employee-owned Business, University of Oxford. He is author of *All of Our Business: Why Britain needs more private sector employee ownership* (EOA, 2012), ‘Bringing Mutualism back into Business’ (Policy Network, 2010) and *Reinventing the Firm* (Demos, 2009). He is a regular advisor and speaker on the topic of employee ownership, has discussed it on BBC Radio 4’s In Business and Today, and written on the topic in The *Financial Times* and *The Scotsman*.

Professor Jonathan Michie is President of Kellogg College, University of Oxford, and Director of the Centre for Mutual and Employee-owned Business. His publications include ‘Employee share-ownership trusts and corporate governance’, *Corporate Governance*, 2001; *Employees Direct: shareholder trusts, business performance and corporate governance*, Mutuo, 2001; *Ownership Matters: new mutual business models*, Mutuo, 2001; *Employee ownership, motivation and productivity*, The Work Foundation, 2002; and *Shared Company: how employee ownership works*, Job Ownership Limited, 2005. He was a founding director of Mutuo.

The Centre for Mutual and Employee-owned Business is based at Kellogg College, University of Oxford. You can follow it at @meob_ox

[1] FSB Wales (2007) Globalisation and Its Impact on Wales

[2] Micro-business task and finish group report (2012)

[3] Federation of Small Businesses (2012) The FSB ‘Voice of Small Business’ Survey. A year earlier, the average business turnover was £458,000 and average staff size of just under 9

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[12] DTI (2004)

[13] McKinsey (2010) ‘The five attributes of enduring family businesses’, McKinsey Quarterly, January 2010. DTI (2004) puts this same figure at under 15%

[14] DTI (2004)

[15] DTI (2004)

[16] For a case of this, see W. Davies (2012) All of Our Business: Why Britain needs more private sector employee ownership. Employee Ownership Association

[17] Employee Benefit Trusts are trusts created to hold shares in a company on behalf of its employees. The employees are beneficiaries of the trust and no individual employee owns shares in it

Share Incentive Plans were introduced by HMRC to give employees tax and NICs advantages when they buy or are given shares in the company they work for

The plans work by keeping the shares in a trust for the employees until they either leave their job or decide to take the shares from the plan. The shares must be kept in the plan trust for a specified number of years to give the full tax benefits

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[26] Welsh Assembly Government (2010) Economic Renewal: A New Direction

[27] See N. Mason (2009) A Matter of Trust: How to create more employee owned businesses. Employee Ownership Association

[28] For variations of stewardship forms, see Tomorrow’s Company (2009) ‘Tomorrow’s Owners’

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