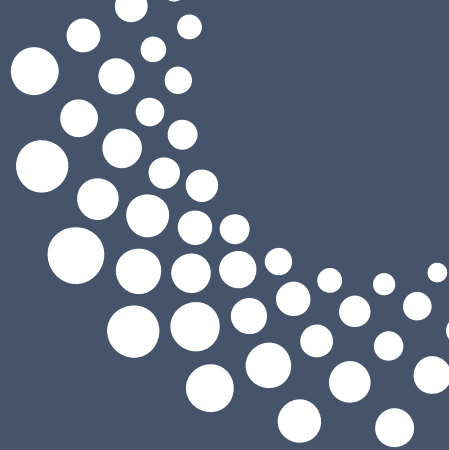
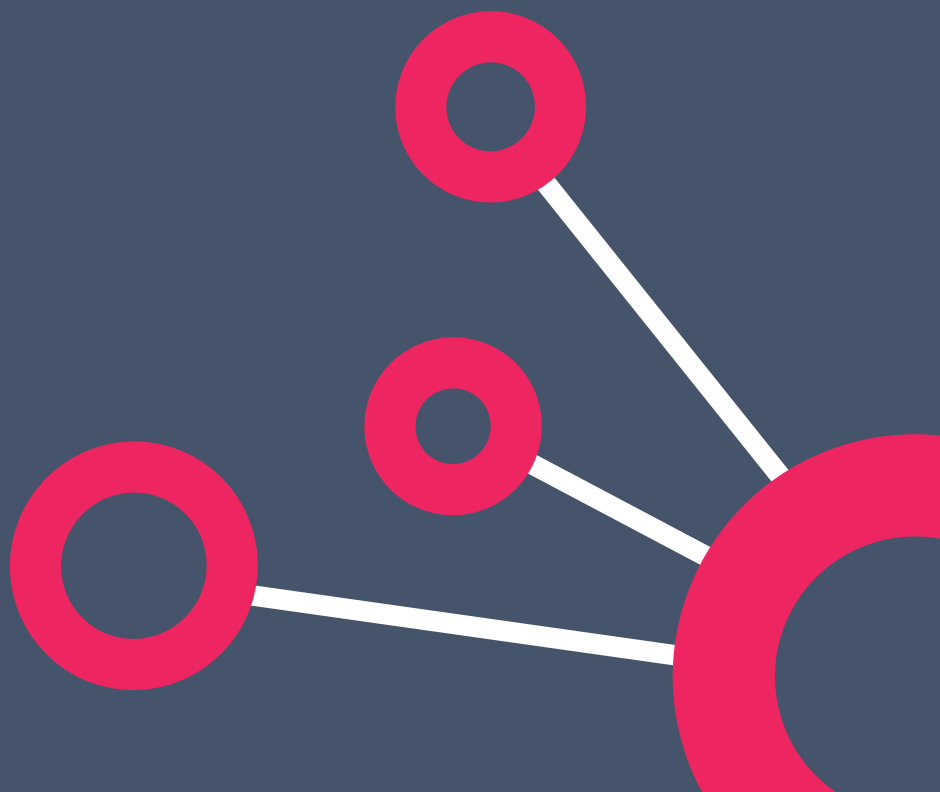


# FUNDING THE EMPLOYEE OWNERSHIP TRANSITION

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A ThinCats approach to external finance in funding  
employee buyouts through EOTs



## Introduction

The prospect of transferring ownership of a business to its employees via an Employee Ownership Trust (EOT) is an attractive option for many owners or founders planning their exit strategies: not only does their legacy continue via the ongoing business, but they are also able to protect the interests of their employees.

However, a perceived barrier to going down the employee owned route for some owners is the need to accept a lower initial payment and/or a longer deferred payment period. This means the owner is essentially making a loan to the EOT, which will be repaid from the business's future profits.

A solution to this conundrum is for the EOT to take a loan from a third-party lender with which to fund the payment to the former owner, which either replaces or sits alongside a smaller loan from the owner.

This document aims to help business owners and their advisers understand how using external debt provided by ThinCats can facilitate the transition to employee ownership.



**James de le Vingne,**  
Chief Executive, EOA



**Ravi Anand**  
Managing Director, ThinCats

“ThinCats, an EOA Supporter Member, has helped fund numerous businesses, particularly mid-sized SMEs, to transition to an Employee Ownership Trust (EOT) through the creation of bespoke funding solutions.

“The EOA is pleased to publish this helpful paper produced by ThinCats, which will raise awareness and showcases the variety of options available for financing a transition to employee ownership via an EOT.

“At the EOA, we’ve previously highlighted that businesses can sometimes be reluctant to consider external funding as an option, and that there is a perception that there aren’t lenders out there that will support an EOT transaction. This document demonstrates some of the options available, and provides valuable insights into the role investors or banks can play.

“There is no ‘one-size-fits-all’ approach when it comes to employee ownership and how you finance an EOT transaction. This document provides inspiration and examples of routes that could work for businesses and, in doing so, ensure their future viability and the prosperity of their new employee owners.”

“The combination of UK demographics and a robust SME sector means there will continue to be a large wave of retirement-age owners looking to exit their businesses over the next 5-10 years. Although these owners are becoming increasingly aware of the option to sell their business to their employees, they are less aware of how external finance can facilitate the funding of the transition.

“ThinCats specialises in cashflow lending to mid-sized SMEs with specific expertise in funding changes in business ownership, so is ideally placed to fund EOTs based on their future income streams.

“This document provides information on funding options for those considering a move to employee ownership. It also covers the main steps in the funding process and the key information lenders will need to know when assessing an EOT funding proposal.

“EOT transactions are not necessarily more complex to fund than other changes in ownership, such as Management Buyouts or third-party acquisitions. However, we always recommend that owners receive specialist professional advice on funding and the overall transition process.

“We hope this document helps owners recognise that selling their business to their employees may be a more attainable route today than they might previously have thought.”

## Selling your business to an EOT: an increasingly popular choice

Once you have made the significant decision to sell your business, the next challenge is to identify the right succession plan. As a business owner, you have a range of potential paths to exit, each with different tax, commercial and emotional implications.

An Employee Ownership Trust (EOT) enables a company to become owned by its employees via a trust, which holds a controlling stake in the underlying firm.

Employee ownership has gained traction over recent years as a highly efficient succession route for founders who also want to protect their company's core values - and the staff who helped build them - once they relinquish control.

### EOTs: tax

Schedule 37 of the Finance Act of 2014 introduced generous tax reliefs for employee owned firms with indirect employee majority share ownership through EOTs. The most significant are:

#### For the owner/vendor:

- Total capital gains tax (CGT) exemption on all gains made when a majority interest is sold to an EOT.

This compares with shares sold outside of the structure - in a trade sale or MBO for instance - which are charged at 10% CGT after business asset disposal relief (BADR, formerly entrepreneur's relief) to the first £1m of lifetime qualifying gains by individuals, up to £100,000.

#### For the employee/buyer:

- The company can pay annual income tax-free bonuses of up to £3,600 per employee.

Since the UK government introduced the EOT scheme in 2014, growth in employee ownership has increased dramatically. Significant tax relief for employee owned firms (with indirect employee majority share ownership through EOTs) undoubtedly is a factor, but the appeal runs much deeper.

A desire to empower and reward the staff of the business is another big factor behind EOT transactions. Continuity is another key driver - both in terms of commitment to existing clients and retention of the business values. These factors all link to supporting the future resilience of the business, with evidence suggesting that employee owned businesses typically outperform those bought by third parties.

As of June 2023, there are now an estimated 1,300-plus employee owned businesses in the UK, with the sector having more than doubled in size since 2020.

### The initial payment hurdle

One key hurdle to opting for an EOT sale can be the lack of initial payment to the vendor. A business owner selling via an MBO or a trade sale would typically expect to receive the majority (or sometimes all) of the acquisition proceeds at the point of sale. An EOT outcome differs, because vendors are typically paid out in instalments, sometimes over multiple years. The business owner essentially provides the financing for the transaction via a vendor loan note or deferred equity payments (known as 'deferred consideration').

An external loan to the business offers a solution to this problem. The deferred consideration and debt from the third-party lender is then repaid out of the future profits generated by the business. Business owners who are unaware of this facility - especially its wider availability through alternative lenders - can overlook the multiple benefits of EOTs and instead opt for a trade sale or MBO to secure an upfront payment.

## How can the EOT fund the purchase from the current owner?

As a business owner, it is vital that you are aware of all the funding options now available to you and that you understand each funder's criteria.

The most typical route to employee ownership is from private owners - an individual entrepreneur or a family business. Studies have shown that many family owned businesses and SMEs often do not have a succession plan, and that this lack of planning can sometimes result in a distressed succession process later on - for instance, due to illness or financial pressures.

Transitioning to employee ownership via an EOT, however, should be seen as an opportunity to plan for succession. Today, there is a strong emphasis on getting the business ready for sale and resolving any problem areas before making the sale.

For most EOT sales, the owners are primarily paid based on the future profits of the business, and it's therefore very much in the owner's interest to ensure the company is in a healthy position before the sale occurs. While previously it might have been acceptable for the acquirer to secure financing after a price had been accepted, funding certainty is now deemed a vital part of the overall transition process.

### There are three core routes to funding your EOT transition:

1. Employ excess cash in the business
2. Loan from the vendor (subordinate debt)
3. Loan from bank/alternative lender (senior debt)

#### 1. Employing excess cash in the business for upfront payment

If the company has retained profits or surplus cash on the sale date, this sum can be gifted to the EOT and used to fund part of the purchase price upfront.

**Vendor position :** Some or all of the upfront sum is paid but they retain full risk to the deferred consideration component coming from future company profits.

**EOT position :** this represents a low-risk option. The EOT only pays for the company shares it acquires from future company profits.

#### 2. Getting a loan from vendor (subordinate debt)

The vendor converts a portion of equity interest into a loan to the EOT. In effect, the owner is foregoing some of their initial payment by making a loan to the EOT in exchange for a deferred payment and interest payments over an agreed timeframe.

**Vendor/EOT position :** One advantage of this funding option is that it provides above-market returns from an asset for which they understand the risk better than anyone. Given the idiosyncrasies of the transaction, it is vital that buyer and seller hire corporate advisers and loan capital providers that are familiar with this sort of deal. Otherwise, the risk of delay - and failure to complete - increases.

#### 3. Getting a loan from bank/alternative lender (senior debt)

The perceived complexity of EOT transactions, potential unequal sharing of risks between the lender and the EOT, as well as reliance on future cashflows, can create reluctance amongst some lenders who are unfamiliar with the EOT model.

For this reason, some businesses can find it difficult to identify sources for funding an EOT, but alternative lenders, including ThinCats, are filling this gap in the market.

If you decide to work with an external lender, they will deal with the employee trust or the operating company (or sometimes both).

**Vendor position :** this option resolves the problem faced by many business owners who are attracted by the idea of transitioning to an EOT but also require the certainty of an initial payment. It also transfers the risk of business failure post-transition away from the founder.

**EOT position :** External funding can speed up payment to the exiting owner(s)/shareholders and fast-track the EOT transition. Upfront funding for the EOT can also help maintain the stability and cashflow of the business.

Lenders will, however, want assurances that the EOT has been structured to sustain the business's profitability, as more responsibilities for running the business pass from the owner to the employees.

### How much will it cost the EOT to buy a controlling stake in the company?

The price agreed for the sale of the controlling share in the company is full market value, based on an independent assessment.

## How does external funding work?

External cashflow loans operate in a similar way to other business loans but are focused on future profits, which will deliver interest and capital repayments to the lender.

The amount that can be funded by external cashflow loans is typically up to 3x sustainable earnings before interest, tax, depreciation, and amortization (EBITDA), depending on the strength of the underlying business, and this is usually on a 1-5 year term basis.

As with all loan facilities, the lender will be keen to understand potential risks that could impact the EOT's ability to service its debt. This will encompass a range of factors from general economic growth prospects to sector and company specific considerations.

The difference for cashflow lenders is that they cannot assess risk against the value of specific assets as security in the way asset-backed lenders can. Instead, they must take a more holistic view to analyse the wide range of risks that could limit the borrower's (in this case the EOT and owner's) capacity to repay its debt. Cashflow lenders therefore adopt a long-term perspective to ensure that they have an adequate understanding of the risks and opportunities faced by prospective borrowers.

### Typical lending terms - ThinCats



### Key steps in the EOT process

By preparing their business for sale to an EOT, an owner can manage the risks associated with the sale. In doing so, the business will also become more attractive to a lender.

1. Ensure the proposed structure of the EOT meets the qualifying conditions:
  - The business must be a trading company or the main company of a trading group.
  - The EOT must retain a controlling interest in the business.
  - The number of continuing shareholders (and any other 5% participators) who are directors or employees (and any persons connected with such employees or directors) must not exceed 40% of the total number of employees of the company or group.
  - The EOT's trustees must ensure that the profit is distributed among all eligible employees on the same terms.
2. Make an employee engagement plan
3. Establish new governance structures
4. Prepare leadership teams for a new style of leadership
5. Ensure information flow
6. Appoint and train the trustees

## What do external lenders need to know when assessing a loan to an EOT?

Lenders are looking to make the process as transparent as possible. The more information the business owner can give to their lender, the faster the lending facility can be arranged and the more the repayment profiles and covenant structures can be aligned with management plans going forward.

Each business will be assessed on its individual merits, but there are core criteria that lenders will assess:

### 1. Robust financials

Financials including business performance and earnings before interest, tax, depreciation, and amortisation (EBITDA) indicate the overall profitability of the business. Crucially, a lender is looking for evidence that profitability can continue in the future so the loan can be repaid.

### 2. Customer concentration

A reliable customer base and recurring diverse revenues. By understanding the risks to a business's future income streams, lenders can create flexible loan structures suited to the borrower's needs and meet the cash generation of the business.

### 3. Competitive advantage

Strong growing businesses with good potential that are taking advantage of their market position and hold a key position in the value chain.

### 4. Management expertise

Skilled management seeking sensible funding terms that are aligned with the company's strategic objectives.

### 5. A well-constructed engagement plan

A strategy for sharing the news with the leadership team and for transitioning control to them. The company fundamentals should be clearly mapped out - what is important about the business once the founder steps away? This should also include the flight risk of key staff.

### 6. Clear terms of exit

Management alignment with the terms of the transition and the role of the founder going forward. Where relevant, lenders might look for 'skin in the game' through co-investment or deferral.

### 7. Cultural change management

Managing the transition to EOT involves an important cultural shift. Lenders need to see that the business has laid adequate foundations to smooth the transition. This element is particularly important for public sector spin-outs where not-for-profit businesses must ensure they engage employees in a new commercial environment.

### 8. Robust governance structure

An assessment of the strength and effectiveness of the governance structure including details of the roles and responsibilities of the Main Board and Trust Board.

### 9. Other considerations

A framework for ensuring ongoing provision of market intelligence to the lender throughout the loan term. The EOT must be registered on the HMRC's online Trust Registration Service and the trustee and company must undertake careful due diligence to ensure all criteria are - and continue to be - met.



## Case studies



**Cheetham Jackson**

### Funding:

ThinCats provided funding to help Cheetham Jackson (CJL), an independent financial planning business, transition its ownership structure to an EOT.

### The business:

CJL specialises in wealth management for the long term, delivering services related to investments, pensions, ISAs and inheritance tax. The company, which was founded in 2009 by Stuart Jackson, worked hard to build up a strong reputation and presence, with 10 offices across the north of England. Its employees share a passion for providing independent financial planning advice, with high levels of personal service.

### The EOT plan:

Having successfully led the team for more than a decade, Stuart sought a succession solution that could retain this positive culture as the business continues to grow while also allowing the company to play an important role in all the communities in which it operates. Transitioning to an EOT was the most logical next step.

“When we started planning for this transition, we identified the need to build an exceptional leadership team, providing the depth of experience and breadth of scope to carry the business into its next period of sustainable growth,” says Stuart. “As the business moves to an EOT model, the culture of collaboration that being employee owned brings is vital and I am delighted that all 77 of our employees will now benefit from the new structure. ThinCats played a key role in structuring an appropriate funding package for us.”

Full operational running of the business will transition over the next five years as Stuart and Nikki Jones, Managing Director, continue to develop the leadership group within Cheetham Jackson.



**DOT Surveying**

### Funding:

ThinCats helped Dot Surveying Ltd with funding to become the first employee owned company in its field in Scotland. The company transferred a majority shareholding to an Employee Ownership Trust so that it could continue to provide a professional, expert service to clients and to maintain the company’s unique company culture. The company works across the UK, including remote islands, and is headquartered in Edinburgh.

### The business:

Dot Surveying is a multi-disciplinary property surveying company specialising in the Telecoms sector, and working across land acquisition and development, renewables, dispute resolution and town and country planning. The 21 employees comprise chartered surveyors, property managers, town and country planners, and support staff. There are also a number of freelance consultants who support the company’s operations. The consultancy was founded in 2020 by Tom Gallivan who was the sole shareholder until the EOT was implemented.

### The EOT plan:

Explaining his reasons for choosing to sell a majority shareholding in the business to its employees, Tom says: “The business has performed so extremely well over the years, surpassing my expectations on what could be achieved in a relatively short time. This success can be attributed to the fantastic employees we have in place, and it felt right that they should own the future of the company. I also have to thank our loyal clients who have supported us over the years. I believe that employee ownership will reinforce our partnership approach to doing business and allow us to continue to provide the expert service our customers are used to. We were delighted that ThinCats understood our needs and were able to put the necessary funding in place.”



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