



# Selling your business TO YOUR EMPLOYEES

With the number of businesses for sale likely to escalate in coming years, one option is selling the business to employees. By **Alan Greig**

**IS THERE A CRISIS** with business succession in Australia? With business assets worth \$1.6 trillion subject to ownership transfer in the next 10 years, the Federal Government has started to think so.

The figures available provide some justification towards the 'market crunch' in business sales that we are now starting to see. The typical small business owner is 57 years old, and 40 per cent of them are planning to retire in the next five years. The number intending to sell their business on the open market as an exit strategy has climbed to 38 per cent.

Anecdotal evidence suggests that only one business in four currently going to sale will be sold within twelve months. One study indicates that 30 per cent of business closures now arise from "succession failure" and only 15 per cent of family businesses are reaching a third generation.

Selling your business to your employees is an option that is increasingly being pursued around the world. It can maximise value from the sale and keep the business going as it is. In the groundbreaking article *The Ultimate Employee Buy-in* in *Inc magazine* (December 2005), the author, John Case, summarised the situation as follows:

"One of the great ironies of entrepreneurship is that many people spend years building their companies, only to undo all of that work at the very end by deciding to sell the business to the wrong person. Decisions like that

don't have to be made, especially today. Employee Share Ownership Plans, or ESOPs, have become a mainstream alternative for business owners who wish to sell their business but want it to remain largely intact. As recently as 10 years ago, employee ownership was considered a maverick strategy; it isn't anymore. ESOPs have now been around for more than three decades and about 10,000 US companies, most of them closely held, have ESOPs."

In Australia, the option of selling to staff is not one which most owners think about. They are being poorly advised because it can be an efficient route for business transfer. Small business owners without family successors face significant risks through a lack of proper succession planning.

They face erosion of business value on exit, the loss of key talent to competitors, and even the closure of their business. The ESOP can provide a solution to these challenges. Though new to Australia, the leveraged ESOP is an ideal tool for an employee buyout (EBO).

## Employee buyout process

An EBO is about transferring ownership of a company to the majority of eligible employees. Achieving this requires the staff to be able to purchase all – or at least a controlling stake – in the business from the previous owner. The mechanism to achieve this is the leveraged ESOP.

If the ESOP is leveraged (or 'geared') – which means that funds are borrowed from an external lender to buy out the

current shareholder(s) – the company can potentially obtain income tax deductions for not only the interest payments, but also repayments of the principal (refer ATO Interpretative Decision ATO ID2002/1074). An ESOP thus enables the buyout transaction to be accomplished out of future corporate earnings rather than current employee savings (though the employees can also make contributions to the ESOP trust from pre-tax earnings through salary sacrifice arrangements etc).

Box Built Australia Pty Ltd is one company that has successfully used ▶

## STEPS IN A TYPICAL EMPLOYEE BUYOUT

A typical ESOP based EBO:

- Shares are bought by an ESOP trust.
- The trust is financed by contributions from the company itself, or from a loan which is repaid from company contributions.
- If the trust is financed by the company over time, it may take some time before the trust has received sufficient funds to finance the purchase of all or even a majority of the issued shares in the company.
- If the trust is financed by a loan, this may enable it to acquire a majority shareholding or even all the issued shares in one go.
- The trust may retain some or all of the shares it has acquired on a long-term basis, or it may distribute shares to employees over time.



an ESOP to buy out an existing owner. Box Built is a manufacturer of timber crates and boxes, based at Acacia Ridge in Brisbane. It was formed by two founding directors in late 1995 and has 30 employees.

The oldest director and shareholder (who was 55) wanted to ease out of the business and enjoy semi-retirement with his wife. The task was – as with many business entrepreneurs who have as much as 90 per cent of their net worth tied up in their companies – turning his equity into cash on which to retire.

To be successful, ESOP owned companies – like all businesses – require sound management, adequate financing, good cash flow and a viable market for their products or services. Beyond that, employee-owned firms have two additional requirements: an effective, fair system for handling the mechanics of employee ownership (such a share valuation, procedures for selling or purchasing shares etc.); and a management culture which promotes communication and helps develop employee skills for participating in decision-making.

Research shows that if these requirements are done well, employee-owned companies will significantly out-perform comparable companies in the same industry. This has been the case with Box Built (see box) as described by their Finance Manager, Gary Davis.

There are many millions of employees throughout the world who have a direct ownership stake in the business that employs them. Employees generally welcome participation in such ownership. Setting up an ESOP to transfer your business to your employees may prove to be a sound investment for a better future not only for yourself, but also for the future of the business you have spent so much time and effort on. ●

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## BOX BUILT'S ESOP

By **Gary Davis**, Finance Manager

**THE BIGGEST PROBLEM** for today's small business owner is how to exit from the business. The choice is between selling the business (or their stake in the business) or transferring ownership to employees – people who may have insufficient funds to take up a shareholding or who cannot borrow the required funds from banks etc.

When one of our owners wanted to leave, no existing employee had the required funds to purchase his shares. Some employees however wanted to purchase this stake, with the support of the owner. As a result, an ESOP trust was set up with advice from Mybridge Pty Ltd, with ANZ Bank offering to provide finance to the level of 100 per cent of the value of the stake.

With the remaining directors/managers providing the loan guarantee and the exiting owner/director providing "collateral" as security, the ESOP trust borrowed the funds required to buy the owner's shares outright. Existing directors/managers remain shareholders while those full-time employees who have been participating in the ESOP since July, 2005 will become owners of the business over time.

Employee ownership will consolidate as Box Built contributes via profits and salary sacrifice schemes to the ESOP trust to pay the loan off over five years. Those employees involved via salary sacrifice will receive a portion of extra shares each year. Employees will also be given shares as a reward each year, depending on performance. The existing directors share the 'risk burden' and the employees get the benefit without forking out dollars from their own savings.

The employees in our workshop live in most cases, week to week, with superannuation and shares not really being a lifetime concern at this stage in their world. Feeding kids, paying child support, keeping the rent up-to-date and even keeping the phone on is a struggle, in some cases.

Our ESOP however is a good investment for the employees, allowing "the guys downstairs" to trade them back for agreed value after 12 months (or when they leave). This ensures that the company is seen as valuing what they are doing and that the shares are a reward which are "Truly Worth Something".

ESOPs are an interesting concept for a number of reasons. Gone are the days of running your business at breakeven while taking plenty of cash out and then selling it as a going concern. You cannot have the best of both worlds. Before an ESOP can commence, the company has to take itself seriously – it must have invested in sound systems, good staff, good products and services.

It must be able to demonstrate its ability to repay an ESOP loan through its cash flow and profits. It is simply not on to offload a loss-making business onto employees. For an ESOP to work, good employees and cashflow go hand-in-hand with sound financial information and broad communication.

From the retiring owner's point of view, an ESOP is living the great Aussie statement of "putting your money where your mouth is!" In this way, the retiring owner backs his loyal employees by putting up the security and the employee backs him by signing a trust deed loan document, committing to the loan repayment and staying on with the firm.

This generates more stability, care and trust amongst staff and leads to tremendous improvement in productivity and growth as employees have a vested interest in how the business is performing day-to-day. By keeping the business profitable, they can have a great asset they can receive income from. If things go really well, they can obtain more shares via the ESOP each year.

The ESOP is just another progression on where we are travelling within our business lives. In Box Built, we have a "true and fair ESOP", not one that most companies only talk about.