

Selling shares TO YOUR EMPLOYEES

International research suggests that employee owned businesses grow faster and are more profitable than conventional firms. They also provide a potential solution for business owners looking to sell down their shareholding in their businesses. **Stuart Frost** recounts his experiences in structuring an employment share scheme in his business.

IT MAKES SENSE that before you start a business you should plan the exit. But most business owners never do — do we? The problem is that when we're starting up, we're too excited about the blue sky prospects of the business to seriously weigh up the getting out options.

In the early days, we all think the business is going to be such a boomer that, when we are ready to sell, we'll get multiple offers from eager buyers keen to take over our brilliance — and that almost never happens either. Typically a trade sale — selling to a private or corporate business buyer — is the most likely way to exit a business.

There is an alternative and, possibly a better, option that could be infinitely more rewarding. That's a Share Ownership Plan and I would like to share my thoughts and experience with you.

The business that I started nineteen years ago with my wife Sue Hirst — who writes a regular column for *My Business* — is CAD Partners Pty Ltd which trades as CFO On-Call. It is a fairly unique service business, offering a monthly accounting and financial management service to SME businesses, typically with revenues of \$500K to \$10m. While it has some unique methodology and few competitors, the truth is that product or service is only as good as your ability to deliver it profitably.

If I am honest with myself, for fourteen of those years, we were treading water. We

had a franchise type of business model that had us reliant on selling franchises for our principal revenue. Profit was hard to come by because we genuinely felt we should spend as much as we could afford to support our franchisees. We often spent more! We barely kept our heads above the surface and slow sales impacted our income badly. The franchisees were doing well, but we weren't.

At that time we would have loved to have sold out. The business turned over one million dollars a year with not much profitability but plenty of potential — or so we reasoned. Deep down though, we knew you can't sell a business on potential and little profit. The only answer was to go back to basics. We down-sized and changed the business model to a more sustainable 'fee share' arrangement. This in turn changed our focus: it wasn't franchise sales that were so important, but rather helping the franchisees earn more because we would earn more in doing so.

Today we're a company with \$3m annual revenues and a healthy bottom line, and heading for \$10m with a projected \$1m profit within three years.

Do we still want to sell? Not desperately. The business is more exciting now we're making profits and the profits will increase year-on-year. But we've worked nearly twenty hard years for the rewards, so we don't want to sell out too

cheaply or too early. What we do appreciate is that it's time to put in place an exit plan that's a win-win!

Share ownership plan

The plan we elected to go with is a Share Ownership Plan (SOP), also called an Employee Share Ownership Plan (ESOP). How does it work? In theory it's quite simple, but the chances are you may need a specialist firm to help set up a Share Trust (which is just a Unit Trust) to get the necessary tax rulings to explain the tax implications for your people.

Our business has a team of 70, but in my opinion a SOP would suit a business with twenty times that or as few as six or seven. You may want to include all stakeholders, franchisees, employees, partners, distributors, managers. For this purpose I'll call them "people". The simple unmoveable truth is that those who have a stake in the outcome will care as much about the bottom line as you do, so that's a good reason to get them involved.

Daniel Cadart, a Brisbane based Partner with a knack for streamlining the profit and cashflow for his clients, joined CAD in August 2009 and has become a shareholder. He said about CAD Partners, "CAD has almost created a whole new industry. I think the potential is enormous and now it's going to be huge. Out of the businesses I have been with, this is the ►

most transparent opportunity that I have seen.”

Asked about why he became a shareholder Daniel said, “Apart from dividends and capital growth, this creates a great sense of belonging to something. Whether it's family, a tribe, a group or community – society is evolving and finding new ways to work together. It makes me feel part of this community. It provides motivation to invest yourself in the business.”

Costs of an ESOP

So how can you set up an ESOP in your business without it costing a fortune in consulting, legal and accounting fees?

Step one is get a valuation. Now valuations can cost many thousands if you go to, say, a second or first tier accounting firm. My experience is that accountants often differ on what is a fair valuation or valuation method. It's in their interests to make it sound confusing and highly intellectual. My advice is save your money.

Do some research on valuations and settle on a valuation that you feel is genuinely fair for both you and your people. In our case we agreed on a six times multiple of pre-tax profit plus a fixed figure for goodwill being intellectual property, brand value, the cost of establishing a database of over six thousand clients and contacts.

A website that may help is www.bstar.com.au See their Business Value Gap Calculator.

Step two is to decide how many shares you want to hold and issue. In our case we had a typical Pty Ltd company with one hundred shares. The one hundred shares were equal to the value of the company. We changed that with a share split so that one hundred (100) became four million (4M) shares which represented the same value. Now our plan is to sell down to a lesser shareholding over five years, so that the original shareholders will still hold around fifty per cent of the company for a



Daniel Cadart has become a shareholder in CAD Partners

while yet, but your circumstances will determine how you sell down.

For our business, the first share offer to our people was a further 400,000 shares which was nearly ten per cent of the company. Up to twenty people now have a small “stake” with an opportunity to buy more each year if they wish to. If you have key people, who you see as eventual successors, it may be better to offer them a larger share first before offering it to others.

Step three: avoid the hassle of having a lot of small shareholders – create one! You can do this by creating a Unit Trust. A unit trust has units, each of which can be equal to one share, so your people can buy their allocation of shares in the trust and that trust becomes the shareholder in your company. This means you only have to deal with one shareholder, not twenty or however many buy shares.

You may also choose to finance your people in. You may give shares in lieu of bonuses, part wages or other entitlements.

Before you start down this track, make sure your business is worth selling shares in. If you have doubts that you can sustain profitability, there are people who can help.

Every business category has performance benchmarks or KPIs (key performance indicators). Find out from such a person what yours are, so you know how much improvement you need to find.

Then there's the legal side. Whatever you do has to be within the *Corporations Act* which covers such things. The section that covers shares transfer in an unlisted company is Section 708 Chapter 6D. What we're discussing here is loosely know as the 20/12 rule. It means that, without a prospectus, you may offer no more than \$2 million worth of equity to no more than twenty (20) people, within twelve (12) months.

There are advisors who offer help to set up a share plan. You can go onto the website of the Australian Employee Ownership Association for names of advisory firms. Get a fixed price for setting up the unit trust and for the unit trust plan administration.

My conclusion is that there are many established businesses looking for a better option to a “trade sale”. It took me two years to get to understand what's involved with setting a SOP for our business and I'm still learning. Good luck with yours. ●

Stuart Frost is a co-founder and CEO of CAD Partners Pty Ltd, which trades as CFO On-Call with team "Partners" and shareholders throughout Australia and New Zealand. The company's partners help small to medium sized growth-seeking businesses with financial strategy and growth goals. CAD Partners CFO On-Call www.cfooncall.biz

*** For more information, contact the Australian Employee Ownership Association (AEOA) which was founded in 1986 to promote employee ownership (or co-ownership) of businesses. It was formed by 20 companies as a member-focused, non-profit, private sector association to assist members with their employee ownership and participation efforts Website: www.aeo.org.au**

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