SI SOCIAL INNOVATION SOCIAL FINANCE

Investment Readiness Case Study

Employee Ownership Trusts

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This case study is part of a social finance case studies series on investment readiness. Through a partnership with Investment Readiness Program (IRP), SI Canada is working with ten entities (SPOs non-profits, co-operatives, for-profit social enterprises) that have achieved investment readiness and provide them with an opportunity to share their journey and profile this work through a case study and a virtual event.

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Background

About Employee Ownership and the Canadian Employee Ownership Coalition

Employee ownership is not a new idea. Pioneered in the mid-70s with progressive legislation, a thriving ecosystem of employee-owned businesses has grown in the US, currently numbering more than 6400 employee-owned companies and 13.9 million employee owners[1]. In 2014, the United Kingdom followed suit. Today, one in every 20 business sales in the UK is sold to company employees[2]. In both of these countries, employees become owners without contributing any money out-of-pocket, making it available and accessible to all. Canada doesn't have legislation like this, making employee ownership very difficult to achieve.

Here in Canada, Social Capital Partners (SCP) has been leading the charge for several years, pushing for legislative change and the formation of an Employee Ownership Trust. Rewrite Capital joined forces with SCP, along with BMO and a group of passionate business owners, to form the Canadian Employee Ownership Coalition (CEOC) to push for legislative change.

What is the rationale for employee ownership and Employee Ownership Trust?

Like most countries, Canada has an inequality problem, with a small percentage of people holding most of the wealth. Our capitalist model can create enormous benefits for those who hold and deploy capital. But individuals who don't have money to invest are excluded from these benefits. People who are wealth insecure have the fewest options to become more secure.

Canada's increasingly progressive redistributive role of government has been accompanied by an expansion of wealth-holding by the middle class, but it has not been accompanied by increased wealth in the bottom half[3]. The share of wealth in the bottom 50% is static, with no change in its composition over the last forty years. Households that are wealth insecure also tend to be low-income. Those with low incomes are unable to accumulate and transfer wealth, making wealth inequality persistent over time.

Significantly, racialized women are the most likely to be in the lowest-paying occupations, with over one quarter of racialized women in the lowest 10% average earnings[4]. Even more concerning is that

1 https://www.nceo.org/articles/employee-ownership-by-the-numbers#1

2 https://www.brabners.com/blogs/growth-employee-ownership-uk

3 Di Matteo, Livio. "Wealth distribution and the Canadian middle class: Historical evidence and policy implications." Canadian Public Policy 42, no. 2 (2016): 132-151.

4 Block, Sheila, Grace-Edward Galabuzi, and Ricardo Tranjan. "Canada's colour coded income inequality." (2019).

intergenerational income mobility in Canada is decreasing. This makes it harder and harder to earn more than your parents did, and it traps women and racialized individuals in intergenerational poverty.

But when employees from all income levels become owners, individuals at the bottom of the income curve can accumulate capital, participate fully in our economic system, and benefit from their contributions at work.

Employee owners have been shown to have 33% higher incomes and 92% higher median household wealth[5]. But the benefits are not just financial: employee ownership results in longer employee tenures, fewer layoffs, improved productivity, faster company growth, and better resilience through a downturn[6].

Business owners also benefit from selling to their employees. After years of building the business and its culture, owners often have deep relationships with their staff and the community at large. Selling their company to an outsider comes with fears of how their team will be treated and how their community will be affected after the sale. It is not uncommon for companies in smaller communities to be bought by larger industry conglomerates, which can result in closed factories or relocation. By selling their business to employees, owners protect their legacy and maintain loyalty to the people they've worked side-by-side with for years.

Over the next 10 years, three out of every four small and medium businesses in Canada will change hands. This presents Canada with a golden opportunity to change wealth distribution and access: by enabling owners to sell to their employees, and using company revenues- not worker savings- to pay for it. For Social Purpose Organizations (SPOs), employee ownership is a powerful way to create well-being for all employees while improving organizational productivity and profitability. Everyone is a participant in the success of the business.

What does this structure look like?

Some forms of employee ownership, like Employee Share Purchase Plans and worker co-operatives, already exist in Canada, but they do not function like an Employee Ownership Trust (EOT).

At the core of an EOT is the Trust, which can hold the shares on behalf of the employees. This Trust becomes the buyer of the company, administers the company on behalf of the employees, and holds the shares. Employees gain financially by receiving the economic benefits of the shares, either as dividends/ profit or in the form of growing equity. But the most powerful element in this structure is the way the shares

5 National Centre for Employee Ownership. "Employee Ownership & Economic Well-Being Household Wealth, Job Stability, and Employment Quality among Employee-Owners Age 28 to 34." (2017) https://www.ownershipeconomy.org/wp-content/uploads/2017/05/employee_ownership_and_economic_wellbeing_2017.pdf

6 National Centre for Employee Ownership. Research on Employee Ownership | NCEO. (March 17, 2023) Retrieved from http://www.nceo.org/employee-ownership-data/academic-research

are acquired. Employees don't need to buy those shares themselves. That means all employees can participate, including those with low incomes and low savings.

Setting up an EOT structure involves the following key participants:

The Seller
The decision to convert a business to employee ownership rests in the hands of the existing owner/seller. That individual (or group) shareholder has the sole authority to choose the buyer.

The Buyer/EOT
For the employees to become new owners, an EOT needs to be formed. The EOT allows employees to own the shares as a group in a tax-effective way, without requiring individual employees to purchase and manage them. The EOT becomes the purchaser and manages the responsibilities of ownership on behalf of the staff.

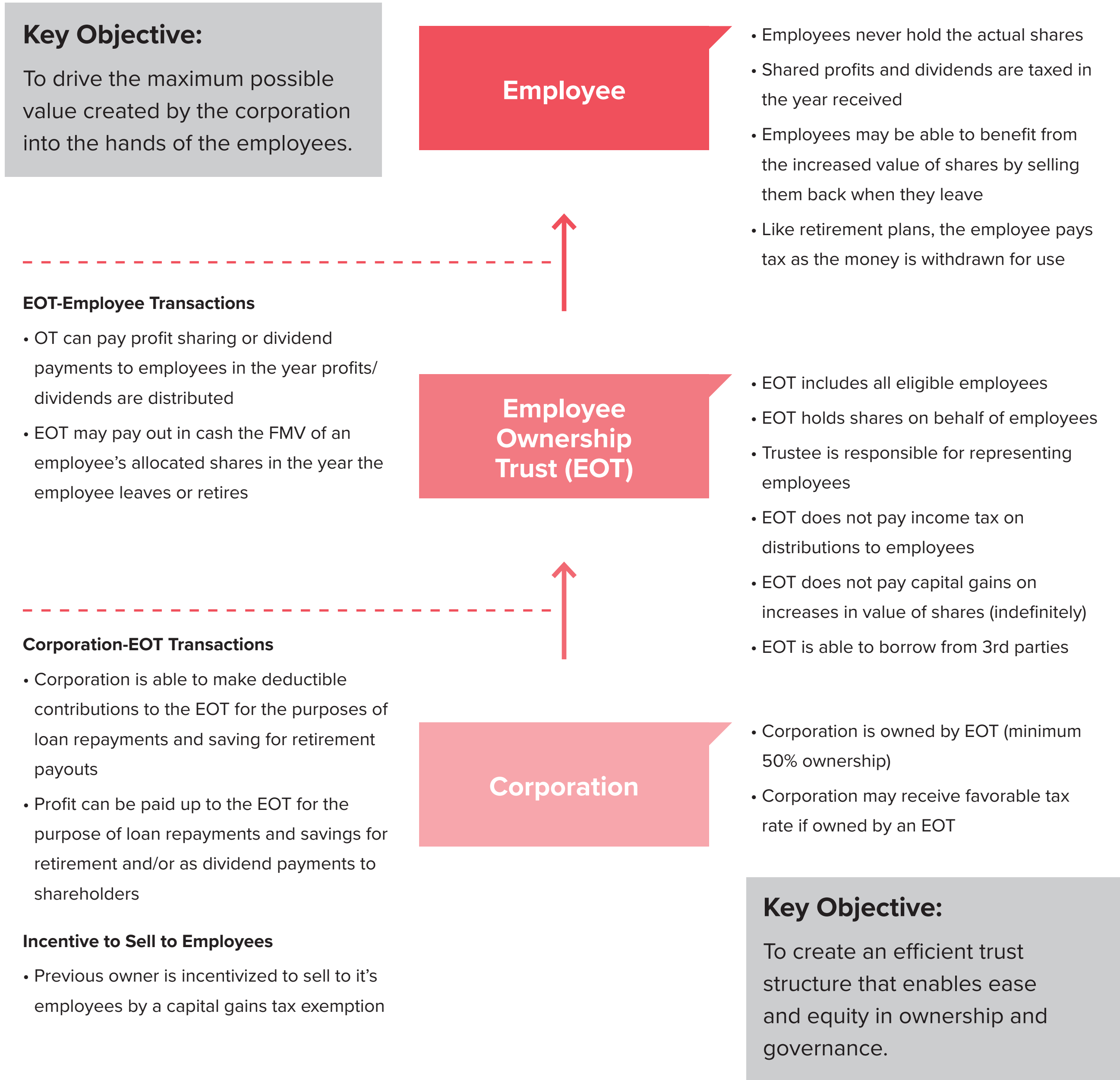
The Corporation
Is the thing being sold. It will provide the cash flow to service the buyout debt, and later to generate profit and company growth.

The Employees
Are the ultimate beneficiaries of the corporation's profit and/or value. All employees are included in these plans at no cost to them personally.

The Financier
Since employee owners do not bring their own equity to the purchase of the company, employee ownership transitions are 100% debt financed. Lender participation and affordable financing is essential to make these transactions possible.

The most common structure is a 100% Employee Ownership structure, where the EOT owns 100% of the Corporation on behalf of the employees. It is important to note that the employees are not shareholders- the EOT is the shareholder, with the benefits of the EOT flowing to the employees. Employee owners are not involved in the governance or management of the company, and do not exercise voting rights. They simply go to work, do their job, and earn the benefits of the company's success.

The sale of the business to employee owners is in the form of a leveraged buyout: using debt to finance the sale. Since employees are not contributing any equity to the purchase, the company is sold at 100% leverage. Senior lenders, like commercial banks, will usually finance a sale transaction to no more than 30-40% of the value of the company. The remaining 60-70% of financing usually comes in the form of a seller's note. This means the seller will leave 60-70% of the value of the company in the company and be paid out over time after the bank loan has been repaid.



What is the state of this work in Canada right now? Who are the big players involved?

- The **CEOC** was formed to bring together parties in the finance and business communities who are already involved in or passionate about employee ownership. Most of those involved have been active in the employee ownership space in the US, due to the lack of an equivalent Canadian model.

- **Social Capital Partners** has been involved in bringing the first ever Pension Fund to invest in a US Employee Stock Ownership Plan (ESOP) buyout transaction.
- **BMO** has extensive experience in financing employee ownership buyouts in America.
- **Friesens Corporation** developed a workaround legal structure to become employee owned several decades ago, and has grown to be a major industry player.
- **Rewrite Capital** is a private investor in employee ownership transitions.

Opportunities

Tell us about Rewrite Capital's journey in this space. What are the opportunities?

Rewrite Capital is a private investment and advisory firm dedicated to converting businesses to employee ownership. Rewrite Capital is committed to helping create 100% employee-owned companies.

Rewrite Capital was formed by a successful media and technology entrepreneur and a financial strategist who were looking for a way to make investments with positive social impact for women and racialized minority workforces. Employee Share Ownership Plans (ESOPs) in the US were delivering great results for the employees involved. We realized that one of the keys to unlocking additional conversions to employee ownership was to share the mezzanine financing with the seller, and began to look at opportunities to invest in this way.

Challenges

What is a made-in-Canada employee ownership trust? What are the challenges right now in moving toward employee ownership?

What is missing in Canada is an EOT entity under the Income Tax Act. Currently, there is no simple or tax effective way for employees to take over and hold a business without purchasing and owning the shares individually. A successful EOT would:

- need clear and simple rules to protect taxpayers and employees
- be inclusive of all employees in a company

- be provided at no cost to the individual workers

This should be accompanied by a capital gains tax exemption for sellers on the sale value, to encourage business owners to sell to their employees instead of to the highest bidder.

The Federal Liberal Government has made steps toward creating such a Trust in the last two budgets, but so far has not produced draft legislation. The CEOC has proposed the following four critical steps:

1. Create an EOT under the Income Tax Act in Budget 2023.

2. Introduce clear and simple rules for an EOT that protect taxpayers and employees, while encouraging understanding and adoption by the business community.

3. Ensure the benefits of EOTs are broadly shared by adopting the approach of both the US and the UK, which require benefits to be provided to all employees at no cost.

4. Improve the likelihood of widespread adoption by following the UK's model of providing a Capital Gains Tax exemption to owners who sell a majority of their company to an EOT.

The first three steps are about the legal structure, but the fourth is about incentivizing the transition. The only person(s) who has the authority to decide to sell to employees is the current or existing owner(s). While many owners may want to sell to their employees, there are disadvantages to doing so.

The first disadvantage is a potentially lower price. When owners sell to their employees, they must do so at Fair Market Value, which is a value determined by a professional valuator. This price is often less than the owner could get if the business was sold to a competitor, a larger strategic acquiring corporation, or private equity. It is much like a house: every year you receive an assessment value for the purpose of paying your property taxes, but if you were to list your house you could likely sell it for more than its assessed value. Likewise, selling to employees often returns a lower price than selling to an outsider.

The second disadvantage is the need to offer seller financing. The business owner(s) will leave up to 70% of the value of the corporation in the business until the bank loan is paid off and there is sufficient cash to pay out the remaining value. Depending on the business, this often takes five to seven years, and sometimes longer. Compare that with selling to an outsider, who is offering the full amount in cash immediately, and the sale to employees begins to look less attractive.

To counter these disadvantages and encourage sellers to transfer ownership to their employees, both the US and UK have implemented tax policies either deferring or exempting the paying of taxes on the capital gains from the sale. This means that although the seller may get less money and have to

wait longer for it, they will make up some of the difference by paying less tax. This incentive cannot be underestimated as a driver of conversions to employee ownership, and it should be implemented in Canada as well.

With most of Canada's businesses selling in this decade[7], there is great urgency for an EOT to be created now, and that it be clear, simple, and efficient at allowing the transition to take place.

Measuring Impact

How does employee ownership help Social Purpose Organizations and smaller social impact businesses?

Values in the business community are changing. It used to be enough for companies to take care of their employees and drive profitability for their shareholders. Then came the rise of Corporate Social Responsibility (CSR), where the business community was asked to contribute to socially beneficial activity. This wasn't necessarily an integrated part of the company's operations but more of an add-on, doing some good for others from the gains it made for itself. More recently, we have seen a shift to Environmental Social Governance (ESG) requirements and a demand to see how these important aspects are embedded within a company's operations.

Social Purpose Organizations have in their DNA a desire to contribute to society. They already provide a service that improves on existing conditions while making a financial return. Their staff are often passionate supporters of their mandates, and can share in the passion for the work. For these organizations, employee ownership may be the most powerful for-profit structure they can implement, empowering their teams not only through shared values, but through shared financial outcomes. It also harnesses the collective intelligence of teams to find ways of creating value in the world that creates wealth for them too.

What are the considerations for business owners moving their company ownership structure to an employee ownership trust?

Selling your company to an EOT is not the right decision for every company. Prerequisites include a strong existing management team that can run the organization, healthy profitability, and stable, non-cyclical cash flows that can be used to repay the buyout debt. In addition, it is not suited to companies with less than 20 employees – the average size of a new employee-owned company is usually 200 employees or more.

7 https://www.cfib-fcei.ca/en/research-economic-analysis/succession-tsunami-preparing-for-a-decade-of-small-business-transitions

In almost all cases, owners will also be required to offer significant seller-financing, meaning they will not be able to exit with the full value of the business immediately. Depending on the growth and profitability of the business, they can structure their seller loan over several years, sometimes lasting a decade or more.

Owners must also be prepared to truly hand off the business when they sell it to their employees, and not expect to be able to continue to have control over its operations. In most cases, owners remain available to consult with the management team in the first years of the transition until new habits are in place; but they must realize that the sale has changed their role in the organization and be willing to help a new leadership team take over.

How would a Canadian employee ownership structure work?

A Canadian employee ownership structure will depend very much on the legal EOT framework that will be included in the federal Income Tax Act. This legal framework will determine employee inclusion and participation, and Trust governance and management. It will also determine how and when employees will receive financial compensation for the shares held on their behalf, and how that income will be taxed. These decisions have not yet been made.

We can expect a general structure that looks as follows:

- An EOT owns the company, which employs the employees.
- All employees who are eligible to participate are beneficiaries of the Trust.

Challenges and opportunities for smaller communities?

Employee ownership is a major opportunity to keep local businesses local. Often, small communities only have one or two major employers. When a business owner is ready to retire and needs to sell, they likely agonize over the fate of the company and its employees. Outside buyers are often competitors, or much larger enterprises who don't have ties to the company or the people. Many owners will negotiate with buyers to keep the business in the community but at the end of the day when the shares have been sold, the decision is out of their hands.

By selling to employees, owners in small communities can preserve the legacy of their business and show their loyalty to their team and community. Now owned by the employees, the business can remain indefinitely in the community and the financial benefits of the company's success can be shared by all. It's a win-win-win situation.

The most significant challenge faced by smaller communities is finding expertise that is knowledgeable about employee ownership transitions. Before making the sale, it is very important to conduct a feasibility study in order to understand if the business can be successful as an EOT financially, operationally, and culturally. A team of expert advisors familiar with EOTs will also be needed, including a lawyer, an accountant, a Trustee, a bank, and ideally an employee ownership consultant to guide the owner-seller through the process. It is recommended to not rely on local or existing relationships when making this transition, and to be sure to speak with those who are specialized and current on the structure. This will help owner-sellers avoid costly or fatal errors when designing their new entity.

Next Steps

At the moment, we anticipate that the federal government will release draft legislation this year and, with luck, companies can begin to transition to employee ownership under this new model in early 2024.

If employee ownership resonates with you, please reach out to Tiara Letourneau, CEO of Rewrite Capital Advisors, at tiara@rewrite.capital. The CEOC will be fighting to make sure the legislation meets our minimum requirements as listed above, and we are grateful for anyone who wants to add their voice to ours.

If you think that employee ownership is something that you might want to consider for your business, you don’t have to wait for the official legislation to get started. The first step to making the transition is to learn more about employee ownership, how it works, what structure would be best for your company, and what it takes to be successful. Transitioning in part or in whole starts with designing a plan to get there.