

Life is interdependent. Transition to Employee Ownership. Bring work to life.



Your weekly blog on all things EO
with Barry Horner

Episode 9 | Series 1

The Art of the Handover - Cash Flow Planning for both the Vendor and the EO Business

When a business transitions to employee ownership (EO), the sale is most often structured with deferred consideration (DC). This means the selling owner, or vendor, receives a series of staged payments over several years, rather than a single lump sum upfront. This approach is fundamental to how employee ownership trusts (EOTs) are funded, as it allows the business to buy itself out of its own future profit stream.

While deferred consideration is a powerful tool for a smooth transition, it can create complex cash flow challenges. For the deal to truly succeed, both the vendor and the newly formed employee-owned business must engage in meticulous financial planning and understand how their respective cash flows are deeply interconnected.

For the Vendor - Navigating the phased DC payments

For the vendor, the sale to an EOT is most probably a life-changing event. Their cash flow shifts from a regular salary and dividends to a structured sequence of payments,

most often stretching for years into the future. This creates both opportunity and anxiety.

The primary challenge for the vendor is planning for a phased income stream that may not be guaranteed. They must answer two critical questions:

- How will I cover my personal living expenses until the final payment?
- What happens if the business underperforms and the planned DC payments are delayed or reduced? What is my fallback plan?

Anecdotally, my experience would suggest that businesses are typically over-optimistic when setting the DC payment profile and somewhat struggle to keep to the agreed payment schedule. We would encourage caution when setting expectations with vendors, hope for the best, but plan for the worst.

Effective planning for the vendor involves three key steps.

- 1. Personal Financial Plan.** Those transitioning their business to an employee ownership trust (EOT) need to work with a financial planner to create a long-term plan that accounts for the deferred consideration payments as a central component of their retirement or future investment strategy. This long-term plan is core to the service offered by the EO team at Paradigm Norton.
- 2. Understanding Risk.** The vendor's financial security is now directly linked to the health of the business they have sold. It is crucial to have a clear understanding of the risks, especially if payments are tied to performance metrics.
- 3. Tax Efficiency.** EOT transactions most often qualify for Capital Gains Tax (CGT) relief, but the timing and structure of payments can impact a vendor's tax situation. Professional advice is essential to ensure a tax-efficient exit.

For the Employee-Owned Business. Balancing Growth and Obligation

The EO business inherits a significant financial obligation in making the deferred consideration payments to the vendor. For the new employee-owner leadership, this becomes a critical line item in their cash flow planning. It's not a standard expense, but rather it is a debt repayment that must be managed alongside day-to-day operations, capital expenditures, and, crucially, the employee owner profit share.

The key challenge for the business is to forecast and manage its cash flow to meet this

obligation without:

- **Stifling Growth.** The business must have enough retained earnings to invest in new equipment, technology, or expansion. If all profits go to the vendor, the business stagnates.
- **Undermining Morale.** The very purpose of an EOT is to share the spoils of success. If the deferred consideration payments are so high that they leave little or no money for annual employee bonuses, the fundamental principle of shared ownership is weakened, leading to discontent and a lack of motivation.

A successful EO business will integrate the deferred payments into a robust, multi-year financial model that scenarios out different levels of profitability. This model helps them proactively manage the ‘squeeze’ between paying the vendor and rewarding the employee-owners.

The Interrelation and the Triple Squeeze

The real challenge lies in how these two plans interrelate. The vendor’s retirement plan depends on the business’s success, and the business’s ability to thrive depends on its cash flow remaining healthy after vendor payments. The core friction point is a phenomenon that can be called the Triple Squeeze.

This squeeze is the most significant challenge of a deferred consideration deal, where the business’s cash flow is simultaneously pressured by three forces:

1. **Vendor Payments.** The fixed or performance-based obligation to the selling owner.
2. **Operational Needs.** The ongoing requirement for cash to run and grow the business.
3. **The Digital Dividend/Employee Bonus.** The need and desire to pay out bonuses to maintain the spirit of employee ownership and share the profits.

If the business’s cash flow is not carefully managed, one of these three areas will suffer. For example, a bad year could lead to a choice between delaying a payment to the vendor or potentially cancelling the employee profit share/bonus. This is a challenge and creates a difficult position for the new leadership and can, if not managed well, sour the entire transition.

Best Practices for Navigating Deferred Consideration

To mitigate these challenges, both parties should focus on the following:

- **Conservative Cash Flow Modelling.** The initial financial projections for the deal should be realistic and conservative, accounting for potential downturns. It is always better to over-deliver on payments than to struggle to meet them.
- **Communication is Key.** The vendor and the new EO leadership team should maintain an open, honest dialogue. The vendor, even after stepping away from day-to-day operations, should remain an engaged stakeholder who understands the business's financial realities.

Professional Guidance. Both parties should use experienced legal, financial planning and accounting professionals who specialise in EOT transactions. Their expertise in structuring deals and planning for future cash flow is invaluable. E.g., EO transitions are complex, so a business navigating this transition may not realise the importance of appointing a specialist EO professional adviser until issues arise. At Paradigm Norton, we understand how poor advice - often from advisers lacking EO experience - can lead to costly mistakes, reinforcing the value of our deep expertise.

EOT transactions are nuanced and complex with the rules being quite specific and unforgiving if you get it wrong. Without an expert to guide you, you could easily fall into a disqualifying event, causing the tax relief to be clawed back, resulting in a huge, unexpected tax bill for the seller.

Transitioning to EO is a cultural shift, not just a legal transaction. An expert firm understands this and will help you build a robust governance structure. Without this guidance, firms can face significant cultural problems.

By approaching deferred consideration with a clear understanding of its challenges and a commitment to people-first planning, both the vendor and the new employee-owned business can ensure a successful and sustainable future.

For more information or to discuss anything in this latest Know-How;

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