This submission is based on research work conducted by the Employment Research Institute, Edinburgh Napier University on employee owned business in Scotland. It also draws from other academic and commercial sources of information on employee ownership.

The submission focuses on the role of employee owned business in society and looks at aims 1 (understanding the scale and growth of social enterprises and employee-owned business in Scotland); 3 (assessing the source of funding and support available); 4 (what public bodies are doing and should be doing to encourage these business models). The submission does not address aim 2 as this is specifically for businesses to address.

1. Understanding the Scale and Growth of Social Enterprises and Employee Owned Businesses in Scotland

1.1 In the UK there are no formal rules concerning the percentage of issued share capital to be owned by employees, or the percentage of employees owning share capital, needed for a business to be classified as an employee owned business (EOB). The Employee Owned Index (UK) includes UK-quoted companies that are over 10 per cent owned by employees (excluding main board directors) or employee trusts.

1.2 Based upon whether the shares are owned directly by employees and/or on their behalf through a trust, EOBs fall into one of three main categories:
1. Direct employee ownership: Using one or more tax advantaged and other share plans, employees become individual owners of shares in their company.
2. Indirect employee ownership: Shares are held collectively on behalf of employees, normally through an employee benefit trust.
3. Combined direct and indirect ownership: A combination of individual and collective share ownership.

1.3 The Employee Ownership Association (EOA), an independent, apolitical and not for profit members’ organisation representing EOBs across the UK, defines employee ownership as an organisation in which ‘members have, or are working towards, significant or total employee ownership. More importantly, their workforces are actively engaged in the management and development of their businesses.

1.4 Co-operative Development Scotland, the arm of Scottish Enterprise that supports company growth through co-operatives and employee ownership business models, quotes research stating that there are 71 EOBs in Scotland with 6,500 employee-owners generating £900 million turnover. These figures

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3 Co-operative Development Scotland. 2015. Available at: http://cdsblog.co.uk/
have been widely picked up across the media with articles on employee ownership appearing in The Herald⁴, the Daily Record⁵ and the Scotsman⁶.

1.5 The Employee Ownership Association (EOA) has called 2015, ‘the most successful year ever for employee ownership in the UK’⁷. The EOA states that the employee owned sector contributes £630 billion to the UK economy annually and that the number of EOBs is growing at an annual rate of about 10%⁸. Furthermore, the combined sales of the top 50 EOBs amounted to £21.5bn.

1.6 An alternative measure of EOB economic activity is available that tracks the share price of 70 companies listed on the main market of the London Stock Exchange which have more than 3% of their share capital held by or for the benefit of employees other than main board directors. The index was created to test whether businesses with substantial employee ownership perform well over the long term, due to their engaged staff, high governance standards and long term outlook⁹. The Employee Ownership Index is calculated by Capital Strategies¹⁰ and the London Stock Exchange and uses a methodology that draws from annual reports, regulatory disclosures and investor presentation to identify companies that quality as employee owned¹¹.

1.7 The Employee Ownership Index (EOI) demonstrates that EOBs have performed better than their non-EOB counterparts. Since 2003, the EOI 3% cohort has consistently outperformed the remainder of the FTSE All-Share Index¹² as shown in figure 1.

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⁵ Comment: Scotland’s employee ownership landscape. Daily Record. 19th October 2015. Available at: http://www.dailyrecord.co.uk/business/business-opinion/comment-scotlands-employee-ownership-landscape-6659216
⁹ UK Employee Ownership Index. Available at: http://employeeownershipindex.co.uk/
¹⁰ http://www.capitalstrategies.co.uk/
¹² The FTSE All-Share Index represents the performance of all eligible companies listed on the London Stock Exchange’s (LSE) main market, which pass screening for size and liquidity. The index captures 98% of the UK’s market capitalisation. FTSE Russell Factsheet. 31 December 2015. Available at: http://www.ftse.com/Analytics/FactSheets/Home/DownloadSingleissue?issueName=ASX
1.8 However, the methodology that underpins the EOI does not allow for the identification of possible Scottish based EOBs in the index. Given the small number of Scottish EOBs identified in earlier studies and their relatively small size, there is no evidence to suggest that any Scottish based EOBs form part of the FTSE based index used by Capital Strategies in figure 1. None of the 12 FTSE companies headquartered in Scotland are EOBs.¹³

1.9 However, research produced by the Employment Research Institute (ERI), Edinburgh Napier University, has highlighted the strong financial performance of a sample of Scottish EOBs. A comparison of the financial performance of 12 Scottish based EOBs with non-EOBs operating in the same sector and with of a similar size in terms of employees and turnover found that in general EOBs performed better than their peers. EOBs had significantly higher turnover, number of employees and return on capital than their peers. Regarding profit before tax, profit margin and the value added index, the EOBs performed about the same as their non-EOB peers.¹⁴

1.10 The difficulty around gathering reliable data on the number of Scottish EOBs has already been highlighted by the Nuttall Review of Employee Ownership. A recommendation of the Review was that there needed to be an improvement in the way in which data on the EOB sector was gathered. Gaps in data on the sector are evident in national surveys that the Scottish Government uses as a source for its own calculations. The Review recommended the inclusion of specific questions on EOB status to existing surveys conducted by the Office for National Statistics, the Workplace Employment Relations Study and

¹³ http://www.cityam.com/1410879431/scottish-independence-how-well-would-scottish-stock-exchange-perform
Presently, there is no widely accepted methodology to identify the total number of Scottish EOBs. This is due to problems of data gathering highlighted in the previous paragraph but also due to different definitions of what constitutes an EOB. For example, the 3% minimum employee ownership stake used by Capital Strategies is different to the definition used by Co-operative Development Scotland whereby an EOB is ‘one in which the employees, rather than external shareholders, hold the majority of the shares’.

2. Assessing the Source of Funding and Support Available

2.1 The ERI was contracted by Co-operative Development Scotland and Scottish Enterprise to respond to the question, ‘what are the main growth bottlenecks faced by EOBs, such as access to funding?’ Most of the growth bottlenecks cited by EOBs did not appear to be specific to EOBs. Rather, they were issues that were also likely to be experienced by businesses without employee ownership. Growth bottlenecks cited by businesses owners included: the difficulty of recruiting skilled staff; skills gaps in the existing workforce; workforce capacity. However, in a small number of cases business owners perceived that there had been occasions when access to finance had been more difficult because potential investors were uncertain about the implications of investing in an EOB.

2.2 Other research on access to funding for EOBs has shown that for firms considering employee ownership, the majority reported positive relationships with banks. Interviews with banks highlighted how although few had dealings with EOBs, ‘all were keen to work with these firms in the future’. Firms financed the transition to EO using vendor finance through retained earnings and specialist intermediaries such as the Baxendale Partnership.

2.3 The research also showed that for working capital, EOBs used retained earnings that were supplemented by bank overdraft, credit cards and other loans. Reinvestment of retained earnings was the primary method of growth.

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funding used by EOBs\textsuperscript{20}. The research found a reluctance among EOBs to use external sources of equity, even though this could potentially constrain growth of the business. This reluctance could in some cases be attributed to the effects of loan repayments that ‘saddled employee owners with debt and also reduced their share dividend payments. There was thus a collective debt aversion and an individual earnings consideration\textsuperscript{21}.

3. What public bodies are doing and should be doing to encourage these business models.

3.1 The Scottish Government and public bodies with responsibility for the promotion of business activity should establish an ongoing census of EOBs in Scotland. The Nuttall Review has already recommended improvements to the way in which data collected by the ONS and the Workplace Employment Relations Study (WERS) is conducted to determine the extent of employee ownership. The then Coalition Government stated that it ‘partially accepted’ these recommendations\textsuperscript{22}. The Scottish Government should consider ways in which data from Companies House, Scottish Enterprise, Co-operative Development Scotland, the Small Business Survey and other publically available sources could be used to conduct a census of EOBs. The Businesses in Scotland survey, itself the result of ONS data, does not differentiate EOBs as a distinct legal entity from the broader categories of non-profits and mutual associations\textsuperscript{23}. Scottish Enterprise through Co-operative Development Scotland has already commissioned work to identify Scottish EOBs but findings would be more robust if based on national government survey data from the ONS and WERS.

3.2 The Scottish Government and public bodies should look at evidence on growth bottlenecks described by EOBs. Although many bottlenecks were not unique to EOBs, for example difficulty in recruiting skilled staff and skills gaps in the existing workforce, in a small number of cases business owners perceived that there had been occasions when access to finance had been more difficult because potential investors were uncertain about the implications of investing in an EOB\textsuperscript{24}. The Nuttall Review recommends the development of an ‘awareness raising programme aimed at promoting the concept and benefits of EO’. A similar information campaign could reduce barriers to engagement with EOBs from potential sources of investment.

\textsuperscript{24} The Growth of Employee Owned Businesses in Scotland. Employment Research Institute. 2013. Available at: www.scottish-enterprise.com/
3.3 The Scottish Government should make the case for employee ownership as a potential solution to business succession issues and the use of EO status as a potential life-line to companies that are having financial difficulties, considering asset sales or restructuring. Local authority economic development officers, Scottish Enterprise and Skills Development Scotland, all involved in the delivery of the Partnership Action for Continuing Employment (PACE), could promote the use of EO as an alternative form of business ownership that may, in some cases, remove the threat of redundancies or closure. There are several examples of Scottish firms moving to employee ownership as a way of securing jobs.25

3.4 The Cabinet Secretary for Fair Work, Skills and Training should take on an employee ownership portfolio with the aim of creating a single point of responsibility for Government actions in relation to EOBs.

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