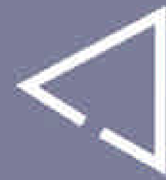

EQUITY
INCENTIVES
LIMITED

Revitalising Equity Incentives in Smaller Quoted Companies

March 1999

Foreword

These are challenging times for smaller quoted companies.

All but the few high flying companies in favoured growth sectors are feeling unloved and neglected by investors. Despite great efforts by management to sustain profitability and growth, share prices are languishing, with the result that share options are "underwater" and equity incentives have little or no motivational effect in the short to medium term. Investors and directors should be concerned about this. It is in no one's interests that executives and employees have little to gain from their hard work other than their pay check.

More worrying still is the belief that fundamental changes in investor sentiment towards smaller quoted companies make this more than a temporary phenomenon. It may not be enough to wait for the mood to improve. Some fresh thinking is required.

Some smaller companies are taking the radical route and going private through venture capital backed buyouts. Others are attracting suitors amongst overseas trade buyers who are tempted by the value to be unlocked in many UK small companies. But the vast majority want to retain their quoted status. They will need access to new capital in future and they want a degree of liquidity in their shares. For these companies, how can equity incentives be restructured to reflect current market conditions, in a way that is fair to investors?

In this report, we offer some solutions. We invoke some of the well tried and tested incentive principles of management buyouts. Few would argue that MBO's fail to reward management and investors for good works. We base our analysis on a survey of the engineering sector, one of the most depressed sectors on the Stock Market.

We hope our ideas will strike a chord with management, with non-executive directors and with locked-in investors alike.

This report is intended to provide a summary only and does not purport to give advice. It is not a substitute for specific professional advice and no responsibility is accepted for any loss resulting from any person acting or not acting as a result of any statement made in the report.

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1. EXECUTIVE SUMMARY

Capital Strategies has surveyed the current state of equity incentives for managers and employees in the Small Cap engineering sector. From this sample, we draw some conclusions and extrapolate them to smaller quoted companies generally.

We set out below our main findings:

- **Share options** are by far the most common form of executive incentive in the companies surveyed.

- The majority (over 60%) of executive options **are granted to non-directors**.

- At the time of the survey, nearly half of executive options (47%) were **underwater**.

- For these reasons, it is possible that equity incentive schemes in many of the surveyed companies currently **have little or no incentive effect**.

- Few surveyed companies have long term incentive plans (LTIPs). Unlike options, LTIPs are not necessarily dependent on share price increases to deliver benefit to participants and can **be less vulnerable to external factors affecting share price**. Whilst they may be a more suitable form of executive incentive than share options, they are not necessarily suitable for all companies.

- In relation to all-employee share incentives, the **position with Save As You Earn (SAYE) share options is little better**. 36% of companies with SAYE schemes **have *all* their SAYE options currently underwater**.

- In designing equity incentives, we believe that some engineering companies may increasingly need to regard themselves as "**knowledge companies**", and should aim to provide material equity incentives for all employees whose talents are essential to business growth.

- Many directors of surveyed companies may feel that their businesses are undervalued and see little benefit in remaining quoted. However, a public-to-private buyout will not always be possible, and we think this **creates a demand for a fresh approach to equity incentives** designed to emulate the effect of a buyout (on managers, employees and investors) without the company being taken private. The **leveraged co-investment plan** is one way of achieving this.

- Most Small Cap companies have high payroll costs compared to market capitalisation. Therefore, incremental improvements in labour cost efficiency should in theory feed through directly into improvements in profitability and hence share price. This suggests that a strategy of **reducing employment costs in return for new equity granted to employees** could increase share prices and long term shareholder value.

- Although our survey has focussed on smaller engineering companies, we believe its conclusion will equally apply to **many smaller quoted companies in other sectors**, and that this trend will continue as institutional investors increasingly focus on the FTSE 350.

2. INTRODUCTION

2.1.Background

This brief report analyses the scope and quality of equity incentives in smaller quoted engineering companies. We have carried out this research after looking at the following evidence:

- UK-based engineering companies suffer from low stock market valuations. Over the last two and a half years, values have declined by nearly 40% relative to the FTSE All Share Index[1].

- This is due to a number of factors, including lack of commitment among institutional shareholders to smaller companies, strength of the pound, and increased competition from larger international engineering groups. It may also be because smaller companies have been perceived as having lower prospects, although there are signs that this may be changing.

- Reduced investor interest is not unique to engineering companies. The launch of the Euro, lack of liquidity, consolidation of fund managers and growth of tracker funds focussed on larger companies, combine to discourage institutional investment in smaller company shares and encourage a focus on the largest quoted companies.

- Earlier this month, the DTI published a report[2] expressing concern that investor neglect of the UK's smaller companies may force them from the Stock Exchange.

- Companies most able to enhance share price performance appear to be those that can add most value before their products leave the factory gate. This leads to increasing reliance on new and frequently updated skills, placing new demands right across the workforce.

New and constantly changing demands on directors, managers, engineers and skilled workers creates a need for strong performance incentives. If those engineering companies that wish to thrive are increasingly to become part of the knowledge economy, as arguably they must, then they need to be confident they have the right kinds of incentives to attract and retain talented people, and to encourage those people to perform.

This report examines the scope and style of equity incentives in Small Cap engineering companies and offers our views on whether they are effective motivators of the people upon whom they depend for future business growth.

Our conclusions are not limited to the engineering sector. Many other smaller quoted companies currently face precisely the same difficulties, and will be equally concerned to find solutions.

[1] Financial Times, [2] Creating Quality Dialogue, DTi

2.2.Questions

We have set out to answer the following questions:

- What kinds of equity incentive are established for directors and senior managers?
- What value of benefit are they intended to confer?
- What performance incentives do they contain?
- How effective are they likely to be?
- How common are equity incentives for employees generally?

Because we conclude that equity incentives in many companies are unlikely to be ineffective, we have also considered what approaches might be more effective.

2.3.Companies surveyed

The report reviews equity incentives in Small Cap quoted UK companies in the engineering sector. A list of the 34 surveyed companies is set out in Appendix 1. Unless otherwise stated, the reference date for information is 18 January 1999.

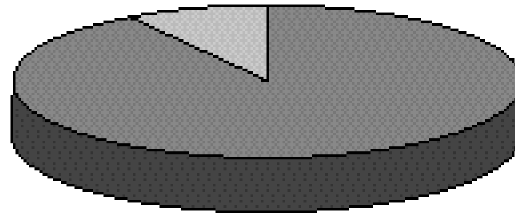
The survey is based on information in the public domain only.

3. Incentives for directors and senior managers

3.1.Prevalence of share option schemes

Discretionary share option schemes are by far the most common equity incentive for directors and senior managers, present in 91% of the companies surveyed.

91% of companies have discretionary share options



We found that three companies out of 34 surveyed had no discretionary share option scheme, or LTIP or other form of equity incentive.

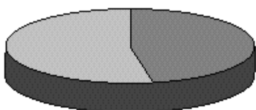
3.2.Underwater options

We have reviewed the extent to which existing share options are "underwater", that is to say where the exercise price is greater than the current share price. Where options are not underwater, we use the term "in the money".

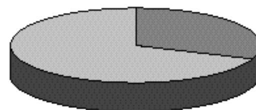
We find that:

- of all discretionary executive options, 47% are currently underwater;
- 31% of companies surveyed had all their discretionary options underwater;
- the average increase in share price needed to render all discretionary options in the money is 137%;
- the majority (61%) of discretionary options are granted to non-directors.

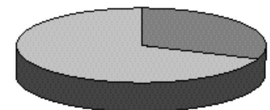
Underwater discretionary options (47%)



Companies with all share options under water (31%)



Options granted to non-directors (61%)



Not surprisingly, the few companies that have outperformed the FTSE All Share generally have no underwater options, apart from one company, which has 27% of its options underwater.

Comment

This does not of itself mean that all the companies surveyed have suffered significant and lasting damage to their executive incentive arrangements. Approximately 19% of them have no underwater options, and for a further 15%, a 20% rise in share price would render all options in the money.

However, this still leaves over 60% of companies with options that are substantially underwater, and therefore of questionable value as a performance incentive, not just for directors, but in particular for the non-directors who make up the majority of option holders. Underwater options are as much a problem for middle managers as they are for directors.

3.3. Long term incentive plans (LTIPs)

Long term incentive plans (LTIPs), typically involving the grant of free shares to participants conditional on achievement of pre-set performance targets, are common in many, although by no means all, quoted companies. At the end of 1997, 57% of the FTSE 350 operated an LTIP. The reasons for their popularity are:

- LTIPs allow companies to deliver greater potential value to employees for a given amount of share capital. The benefit under a share option is the difference between market and exercise price, whereas the benefit under an LTIP is simply the value of the shares. Given the constraints imposed by the ABI on the numbers of shares that may be used in an equity incentive scheme, LTIPs have allowed companies to deliver more value within the ABI guidelines;

- The Greenbury Committee favoured LTIPs over share options as an executive incentive;

- LTIPs offer scope for more sophisticated design;

- LTIPs are not necessarily dependent on increase in share price for delivery of benefit to participants.

However, LTIPs are not universally popular. For some companies, their impact on the profit and loss account makes them unattractive. They can be more complex than share options and they are less tax efficient, particularly for smaller companies for whom the ability to grant income tax free approved share options up to a £30,000 limit is valuable.

We found that eight companies (24% of those surveyed) had established some form of long term incentive plan. Of those eight companies, the following types of LTIP were found:

- five have relatively simple LTIPs, involving the gift of free shares conditional on achievement of performance targets;

- two (Quadramatic and Hall Engineering) operate their LTIP as a matching deferred bonus plan, under which participants invest annual bonus (paid only after achievement of performance targets) in shares; if those shares are held for a fixed period, the participant then receives additional free “matching shares”;

- one company (Alumasc) operates a plan involving both the gift of free shares conditional on achievement of performance targets and the conversion of any annual bonus over 30% of salary into shares, which are released to the participant only if they remain employed by the company after three years.

Comment

LTIPs are substantially less prevalent among the companies surveyed than in FTSE 350 companies. However, share options arguably serve the smaller engineering companies relatively badly, given the large number of underwater options. Those companies seeking an effective equity incentive that rewards strong corporate performance, but does not risk being wholly undermined by lack of a corresponding increase in share value or by a flat or falling stock market, might wish to consider whether a plan more like an LTIP could be more effective and less vulnerable to these external factors.

Companies with depressed share prices may take the view that this provides an opportunity to reduce long term remuneration costs. By establishing an ESOP trust and funding it to make market purchases of shares a company can capture relatively cheaply a substantial amount of equity for future use, through an LTIP, as a performance-linked incentive.

Some companies, however, may feel the need to do something more ambitious to revitalise management and employee drive and investor interest. We refer to some more radical proposals later in this Section.

3.4. Performance targets

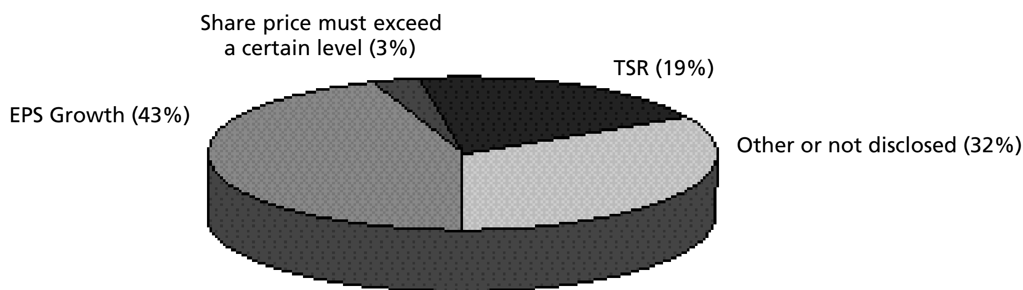
It is now essential for any new executive share option scheme or LTIP to include performance targets. This is a requirement of the ABI, the NAPF and the Greenbury Committee, as well as being considered best practice by the Stock Exchange.

Readers of this report may find useful for benchmarking purposes our information on performance targets for both discretionary share options and LTIPs.

3.4.1.Share options

By a significant margin, earnings per share (EPS) growth is the most common performance measure used by fourteen companies (46% of those with discretionary options). Total shareholder return (TSR) is used by six companies (19%), one company simply requires share price to exceed a certain level, and the rest use other criteria, or information is not available.

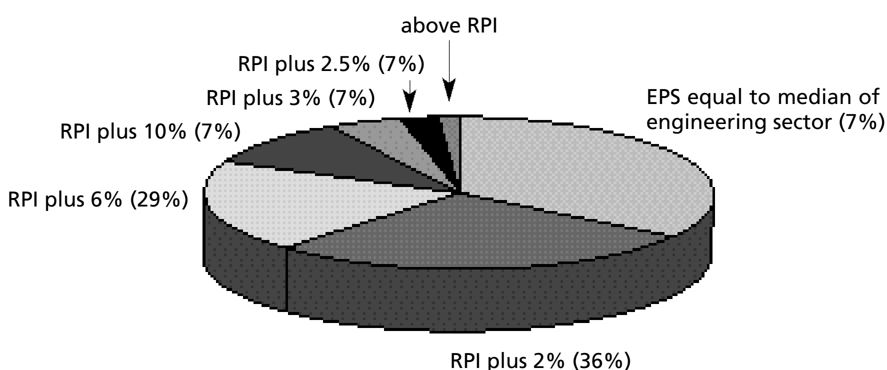
Share option performance targets



For performance targets based on EPS, the ABI calls for EPS growth of at least 2% per annum over the growth in the Retail Price Index, and this is the most popular measure. However, only a slightly smaller number of companies set a substantially more ambitious target of RPI plus 6%.

At the extremes, one company set a target based only on EPS exceeding RPI, whereas another required EPS to beat RPI by 10% per annum. There is evidence that the setting of higher performance targets is often accompanied by grants of higher values of options, in one case of 9 times annual salary.

Share options using EPS growth as a performance target



Of the smaller number of companies (six) applying total shareholder return (TSR) as the performance measure, there is no approach that stands out as the most popular. TSR is principally compared with that of either the FTSE All Share, the engineering sector or the FTSE Small Companies Index. One company (Firth Rixson) effectively created two separate performance measures for two separate bands of share options, one comparing TSR with the engineering sector, the other comparing it with the FTSE Small Companies Index.

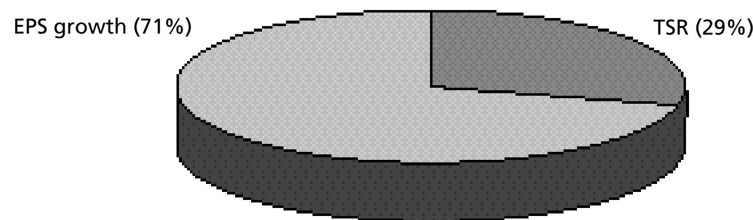
We identified one company with a performance target other than TSR or EPS. Ascot simply required share price to exceed certain specified levels in relation to different option grants (effectively requiring share price growth of between 15% and 120% depending on the time of grant).

Perhaps surprisingly, one company continues to grant options under a scheme carrying no performance criteria at all.

3.4.2. LTIPs

Of the eight companies identified as having an LTIP, seven have disclosed performance targets. Of these seven, five (71%) require some form of EPS growth and two (29%) comparative growth in TSR.

LTIPs: Comparative use of EPS and TSR



Just as with share options, there is no particular trend in the kind of EPS or TSR target.

EPS targets range from 3% growth over previous year's earnings (with no RPI element) to earnings beating RPI by 10%. One company (Ultra Electronics) requires growth in EPS to match EPS growth in the engineering sector.

In relation to TSR, comparator companies are, in one case, the FTSE 100 and in the other, those in the engineering sector. One company was criticised by institutional shareholders for not setting a performance underpin requiring real and sustainable improvement in performance.

LTIP Case Study: Fenner Plc

Fenner Plc established an LTIP in 1997, with the first round of awards covering a three year performance period (plan cycle) beginning in November 1997.

In the first plan cycle, two executive directors were provisionally allocated shares equal to their base annual salary, with final vesting at the end of the plan cycle dependent on achievement of a performance target. A small number of senior managers are also understood to have been made awards.

The performance measure for the first plan cycle is TSR compared with that of all companies in the FTSE engineering sector (peer group).

The maximum number of shares will vest only if the Company's performance places it in the top 16% of the peer group. If the Company's TSR is below the median of the peer group, no shares vest at all.

Comment on LTIPs

Where TSR is set as a performance measure, the ABI takes the view that, as this relies substantially on share price, there should be a secondary criterion validating sustained and significant improvement in underlying financial performance. Some companies consider a secondary measure of this nature to be inappropriate, for example because difficult trading conditions caused by external economic factors may make significant improvement in financial performance impossible, whereas the company may have outperformed its peer group. Investors are unwilling to devote time to analysing non-compliant schemes, but where commercial factors justify a more flexible approach, companies should consider how to gain shareholder support, including through consultation with the ABI.

For any company granting share awards with a performance criterion based on TSR compared with companies outside the engineering sector, this can be a hazardous process. Share price under-performance, compared for example with the FTSE All Share Index, would prevent awards from vesting, whereas actual earnings may have increased substantially. The difficulties encountered by some engineering companies in seeing strong financial performance reflected in improved share price may therefore make TSR an unsuitable performance measure, and they should arguably concentrate on a measure such as EPS, which focuses on absolute, rather than comparative, performance. Additionally, TSR is far more difficult than EPS for individual participants to measure on a regular basis, which can potentially detract from its incentive effect.

3.5. Directors' confidence

If willingness of directors to invest in direct share purchases is an indicator of confidence in the fortunes of the smaller engineering companies and a belief that shares are undervalued, then confidence appears high. In the six months to the end of November 1998, directors of 55% of the companies surveyed bought shares in their companies.

Comment

Whilst many directors may be accustomed to share dealing, and are able, through simply buying shares on the market, to establish their own equity incentive in substitution for underwater options or other remote equity incentives, this may be less feasible for middle managers. Companies might therefore wish to consider ways of facilitating share purchases by selected staff, including preferential and dedicated dealing costs and arrangements, and bespoke loan packages.

Where applicable, companies might also consider taking advantage of current low valuations to establish an ESOP trust to acquire shares on the market, financed by the company or by a bank, for onward sale to selected employees, perhaps allowing payment in instalments. For quoted companies this would additionally cut down on brokers' dealing costs.

3.6. The way forward?

Many companies are frustrated by their inability to see strong performance reflected in enhanced share price. Over 25% of engineering companies have either been taken over or reclassified in the two years up to December 1998. Takeovers haven't just been acquisitions by bigger players; seven companies have been acquired by private equity institutions, often as management buyouts or buy-ins.

Section 5 of this Report considers some key issues concerned with taking a company private.

One factor is that, although many companies' directors wish to lead a buyout, financing is not always possible. Investors may require a substantial premium over market value to allow them to exit without crystallising a loss, and this will often not be fundable.

We believe it will be possible for some companies to establish a new ownership plan that brings similar benefits for shareholders, management and employees as a buyout, but that does not require the company to leave the market. We explore this further in Section 6.

4. All-employee incentives

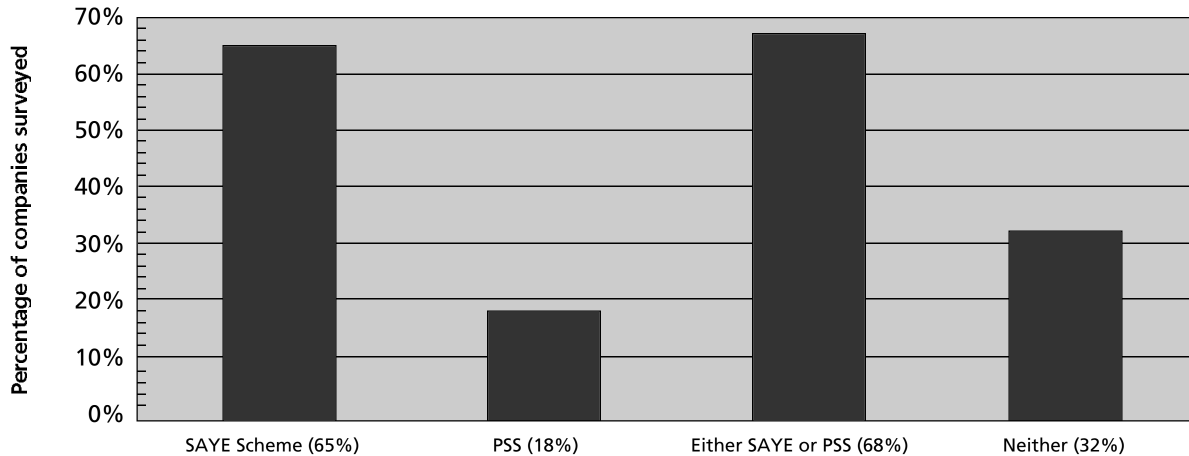
4.1. SAYE share options and profit sharing schemes

We looked at the prevalence of the following Inland Revenue approved all-employee share schemes in the companies surveyed:

- Save As You Earn (SAYE) share options, commonly known as Sharesave schemes; and

- Profit sharing schemes.

Prevalence of all employee schemes



PSS: Profit sharing scheme

32% of the companies surveyed had neither scheme.

The average percentage of equity dedicated to these all employee schemes is 1.2% compared with 1% currently subject to discretionary share options and, for those companies with LTIPs only, an estimated 0.5%. It is therefore likely that many of the surveyed companies are operating substantially within the ABI guidelines, and so may enjoy significant potential scope for allocating undervalued equity for employee participation.

Our main finding is that, as with discretionary options, a substantial proportion of SAYE options are currently underwater. The average percentage of SAYE options currently underwater in the surveyed companies is 43%, and eight companies (36% of those with SAYE options) have all their SAYE options underwater.

Comment

Although SAYE participants suffer no direct disadvantage as a result of their options going underwater, but will simply retain the proceeds of savings contracts on maturity instead of applying them to option exercises, the role of the SAYE scheme as a performance incentive will be minimal in those companies.

4.2. Comparisons

We have undertaken two illustrative comparisons:

4.2.1. Degree of employee share ownership

There is no company among those surveyed that has a substantial proportion (10% or greater) of its shares held by employees (not including directors). We estimate the highest percentage of equity held by employees in any one company, including shares held under profit sharing schemes, shares potentially held under SAYE share options and shares held directly, is between 4% and 5%. Only one company has employee shareholding of this level, and we believe the average level of employee shareholding to be less than 3%.

We have compared the degree of all-employee share provision in the surveyed companies with that in companies comprising the UK Employee Ownership Index™ (EOI), which compares the share price performance of the FTSE All Share Index since 1992 with that of a basket of 36 companies known to have at least 10% of their equity owned by (non-director) employees. In the five years up to December 1998, the EOI rose by 151%, compared with a 59% rise in the FTSE All Share Index and a 72% rise in the FTSE 100 Index (see Appendix 2). Whilst we do not claim any direct relationship of cause and effect between employee share ownership and share price growth, our experience of companies with a commitment to employee ownership is that this frequently connects to:

- a culture that thrives on initiative;
- a more open and informative culture;
- more employees being educated to a higher level of financial and business literacy;
- managers being exposed to greater accountability.

We would encourage companies to reflect carefully on the benefits that could flow from increased employee participation and the extent to which this has acted as a catalyst in many of the EOI companies for creating an initiative culture.

4.2.2.Illustrative comparison with information technology companies

The Employee Ownership Index companies include several whose principal business relates to information technology. Clearly, engineering is substantially more capital intensive, but it is likely to rely increasingly on so-called intellectual capital: innovation, creativity, design and marketing; and individual commitment to apply these skills to the production of world-class products. These human qualities are key drivers of success in many information technology companies, so a review of one such company's approach to equity incentives may give some ideas for the design by engineering companies of their own fresh incentive packages.

FI GROUP Plc

FI Group is a UK supplier of outsourcing and information technology services. After a buyout from the founding shareholder in 1991, the company floated in 1996. Since flotation, its share price has risen by over 700%, reflecting its perceived growth potential in a fashionable sector.

The company has 4,000 staff, an annual turnover of £161 million and a market capitalisation of £613 million.

Equity incentives in the company have these characteristics:

- 40% of the company is employee owned (of which approximately 7% is held in an Inland Revenue-approved ESOP trust and a further 13% in a case law ESOP).

- approximately 1.8% of the Company's equity is the subject of SAYE share options.

- the percentage of shares currently held under an Inland Revenue approved profit sharing scheme is estimated at 3%.

- approximately 1.9% of the Company's equity is the subject of a share option scheme widely extended amongst the Company's employees, involving the matching grant of an option over one share for every share pledged by an employee. Pledged shares must be retained for three years and exercise of options is dependent on achieving EPS growth over three years of greater than RPI plus 6%. This scheme allows for discretionary grants of options to key executives.

- Directors hold options (excluding SAYE options) over approximately 4% of issued share capital.

- Based on current share value, the average value of shares that are the subject of non-SAYE share options is, for executive directors, over 14 times base fees and salary.

Comment

FI Group came to the market with two ESOP trusts holding approximately 20% of its equity, which had been previously acquired from the Company's founder, Steve Shirley. The ESOPs were financed by bank loan.

We have deliberately chosen FI Group for its unusually high commitment to employee participation.

Clearly, this level of employee share ownership will be extremely difficult for any existing quoted company to emulate, but FI Group does demonstrate:

- *the importance of commitment to widespread employee share ownership in a business which acknowledges that its success relies on two partners: shareholders (as providers of capital) and the workforce (as providers of skills and energy).*

- *the benefits of an ESOP borrowing to capture equity when it is cheap, for subsequent use as an employee incentive. FI Group's ESOPs hold shares valued at approximately £120 million, but with bank borrowing of just £7.5 million.*

FI Group is certainly not unique in placing a high premium on employee participation, as the number of companies in the EOI demonstrates.

4.3.Conclusion

Although we believe there are arguments for extending employee share ownership, we recognise that for so long as share prices remain flat, its incentive value is extremely limited. A company expecting market indifference to earnings growth may wish to look at ways of revitalising the connection between performance and share value. The leveraged co-investment plan proposed in Section 6 can potentially act as a far more powerful equity incentive for employees.

5. Public-to-private transactions

5.1. Undervalued Companies

The sharp downturn in share prices over the last couple of years in the engineering sector, caused largely by the impact of the strong pound and fears of a recession, has led to a large scale consolidation and restructuring with more than 40 companies either being acquired by larger groups, going private through an MBO or seeking to broaden their range of activities to include sectors where valuations are higher or growth prospects more attractive, and therefore being re-classified.

The market is potentially undervaluing Small Cap public companies in the engineering sector by between 20% and 40%. UK Small Cap companies generally have suffered from low valuations, in part due to the relative illiquidity of their shares, which are traded infrequently and tend to be tightly held by a small number of investors, often the original family owners or founders of the business. This not only discourages predators but also makes it harder for other investors to influence management. As our own research underlines, low share prices can also de-motivate senior management by making their share based incentive schemes lose value and can also affect their willingness to take calculated risks for fear of further depressing the share price.

Yet the downturn in engineering companies' share prices may have been overdone, particularly for the larger players. Of our survey companies with a market capitalisation in excess of £100 million, brokers' expectations for earnings in 1998/99 have declined by just 3% over the last twelve months. However, these companies have under-performed the FTSE All-Share Index by 18.5% in the same period. For smaller companies in our survey, brokers have reduced their expectations for earnings in 1998/99 by 25% over the last twelve months and the shares have under-performed the market by 40%.

The companies in our survey with a market capitalisation of less than £100 million trade on a prospective P/E multiple of 7.4, a 50% discount to the market as a whole and a 36% discount to the weighted average exit P/E of recent public to private MBO transactions in the sector. Yet many of these companies have strong balance sheets and cashflows. The average interest cover for these companies is 19.1 and their total indebtedness to market capitalisation is only 12.7% (3% in larger engineering companies). Given the ability of many of these companies to increase borrowings further, more public to private transactions are likely and there is potential for other capital restructurings that emulate the benefits of a public-to-private without a company leaving the market.

	Prospective PER	Last PSR[1]
Survey companies:		
> £100m Market Cap	9.7	1.0
< £100m Market Cap	7.4	0.5
Engineering Public to Privates[2]	11.5	0.6
Market - weighted[3]	14.8	4.3
- median[4]	9.2	0.8

[1] Share price to sales per share

[2] Average market capitalisation on exit was £55m

[3] Source: Company Refs February 1999

[4] Average market capitalisation of £37.7m

5.2.Public to Private

One increasingly popular solution to this dilemma is to take the company private. Last year saw a dramatic increase in such deals with several smaller public companies being acquired by management buyouts (MBOs) backed by private equity funds. For managers, the benefits of de-listing are two fold: greater access to capital and a greater opportunity for managers to profit directly from their endeavours by taking a substantial equity stake in the business.

25 quoted companies with a total value of £2.75 billion were taken private in 1998, compared with 8 in 1997 and just 2 in 1996. Of the 25 public to private deals in 1998, 18 were valued at less than £50 million and 4 were in the engineering sector. Significant premiums were a characteristic of all the public to private deals completed in the last 12 months and have typically ranged from 40% to 75%.

5.3.Practical hurdles

Regulatory and corporate governance restraints can make taking a company private a very involved process. There is also no guarantee that, having made an offer, the bid will be successful, in which case the costs of launching the bid are irrecoverable. These costs can be substantial although some advisers will work largely on a contingent basis, keeping their share of the costs down.

Winning the early support of key shareholders is vital, so institutional shareholders with large shareholdings are often very much in the driving seat. Shareholders, in particular larger shareholders, looking to realise an investment recognise that taking a company private can be an attractive way to achieve this.

5.4.A recent transaction

Clyde Blowers, a Glasgow engineering group which had seen its share price fall sharply, mainly as a result of a series of profit warnings, has recently been taken private. The transaction valued the company at £24.5 million, 175% above its market value before the bid was announced, in a purchase funded by 3i and the Bank of Scotland. Before the bid approach, the average daily turnover of shares was only 46,000 shares, 0.3% of its issued capital. Institutional shareholders exiting via the market would almost certainly have had to sell at a deep discount to the market price because of the amount of stock being placed on the market at one time. Instead, they were able to achieve a 175% premium to the market price by selling to management.

5.5. Is it feasible?

Not all companies are suitable to be taken private and some of the pre-requisites that both debt and equity finance providers look for are:

- coherent reasons for wanting to go private, such as to allow management to realise opportunities to add value to the company through acquisitions or disposals. If listed, a low share price increases the cost of capital, restricting a company's ability to make rights issues and earnings enhancing acquisitions;

- strong and credible management;

- the ability to get 90% acceptances from shareholders. This is the level at which a compulsory purchase of minority shareholders can take place. An analysis of the target company's share register is key in highlighting large shareholders who could be potential deal breakers;

- strong cashflow or opportunities for early asset disposals to repay buyout debt;

- the ability to undertake due diligence, albeit limited in scope compared to a wholly private deal.

5.6.Summary of engineering sector transactions

The table below shows the public to private transactions in the engineering sector over the last two years. Although large premiums have been paid on some transactions, the exit P/Es have been fairly conservative. An average exit P/E of 11.5 compares to an average P/E ratio on larger MBOs (i.e.>£10 million) in the UK last year of 13.4. The P/E ratios are also fairly uniform, ranging between 9.5 to 13.5, even though premiums have varied widely.

Public to Private transactions in the Engineering sector

Company	Date	Value (£ million)	Equity Providers	Debt Providers	Premium paid[1]	P/E multiple[2]
Clyde Blowers	11/98	25.4	3i	Bank of Scotland	175%	11.9
UPF	10/98	42.8	Phildrew Ventures	Bank of Scotland	41%	9.5
Concentric	8/98	87.0	Natwest Equity Partners	ICG	49%	11.5
B Elliott	2/98	43.5	Deutsche Morgan Grenfell	Royal Bank of Scotland	50%	12.4
Wellman	12/97	73.0	Alchemy Partners	Bank of Scotland	77%	12.3
IPECO	7/97	25.0	Close Brothers	Natwest Bank	16%	13.5
William Cook	1/97	80.0	Electra Fleming	Bank of Scotland	77%	10.4

Note:

1. P/E multiple calculated by reference to earnings for any 12 month period up to 4 months before the bid was announced. Otherwise earnings are based on consensus brokers' forecasts at the time of the bid for the accounting period in which the bid was made
2. Bid premium calculated by reference to the mid-market price before the announcement was made.

5.7.Other practical issues

Some other features of public to private transactions are:

Bank debt. Banks providing debt typically have to wait at least three months after a bid is accepted by the shareholders for all the legal processes to be completed and for the company to be re-registered as a private company, before they can obtain security over the company's assets.

Information disclosure. The City Code on Takeovers applies to these transactions. The making of an offer has to be announced publicly, as opposed to a wholly private deal where the proposed acquisition is more likely to be kept confidential until the deal has been completed. The fact that the company is effectively up for sale may attract other investors who wish to bid for the company in competition with the management's offer.

Costs. The costs of taking a listed company private can be as high as 10% of the financing raised, depending on the number of parties involved and the complexity of the deal.

Conflicts of interest. Where existing directors are involved in a bid, it is essential to demonstrate that an arm's length deal has been agreed with the Company's non-executive directors.

Despite these hurdles, we believe that public to private deals are very much here to stay, with the number of these transactions expected to double in 1999. An important catalyst for growth in public to private transactions will be fund managers increasingly eager to find exits from smaller company investments as the introduction of the Euro and a consolidating fund management industry deflects investors' attention away from Small Cap UK companies to larger UK and European companies.

6. Alternatives to a public to private

Some companies needing to change their capital structure to one more sharply focussed on connecting financial performance to reward will not be able to structure a public to private, or will not wish to. We propose two alternatives.

6.1.The leveraged co-investment plan

An alternative to an MBO and taking a company private, which avoids some of the risks and associated costs, is the leveraged co-investment plan. This involves the company gearing up its balance sheet by taking on senior debt and tendering for its own shares in the market. As Section 5.1 illustrates, many of the surveyed companies have substantial capacity to take on debt.

As with an MBO, ideal candidates would include companies with high interest cover, low gearing and where the business is not too exposed to an economic downturn or the strength of the pound. Restructuring the balance sheet in this way should lower the cost of finance for the business and improve returns to shareholders, albeit that the risk profile of the company will have changed.

The leverage effect could be magnified by arranging for additional debt to be lent to an ESOP trust, which would apply that funding to the purchase in the market of undervalued equity.

Management could be offered significant option grants by the ESOP in return for making a direct equity investment. By granting the options over shares acquired in the market, ABI guidelines would not place limits on the amount of equity to be used in this way. The arrangement could be extended to incentivise other employees too. Exercise of options would be dependent on achievement of stretching performance targets.

For companies able to do this, the benefits are:

- *partial realisation of value for current shareholders;*
- *significant increase of leverage, enabling the company to create opportunities for management and employees to make personal financial investment with a prospect of MBO-level returns if performance significantly improves.*
- *avoiding the cost, distraction and complexity of taking the company private; and*
- *retention of the benefit of a listing.*

6.2.Equity pay

For a UK company needing to reduce fixed overheads to restore profitability, the ability to offer equity in return for negotiated savings in employment costs is a potentially powerful, but relatively unused, bargaining tool. A number of major US corporates, including United Airlines and Weirton Steel, attribute their commercial success to the negotiation of reduced employment costs in return for employee equity, allowing employees to participate financially in any resulting shareholder gains. US unions have adopted a pragmatic approach, seeing this kind of agreement as preferable to job losses, and have hired investment banks to help them negotiate an acceptable deal.

Whilst this approach has to date been rare in the UK, there is evidence that, for those companies experiencing strong pressure on profit, it could be a highly effective route to restoring profitability. Small Cap companies have relatively high payroll costs; over 50% are currently valued at less than 5 times their annual payroll. This raises the prospect of establishing a significant equity stake for employees in return for a reduction in payroll costs.

For example, XYZ Plc has an annual payroll of £25 million, turnover of £100 million, pre-tax profits of £6 million and a market capitalisation of £32.5 million. It negotiates a payroll reduction of 5%, with an immediate annual value of £1.25 million. The net present value of the concession (after tax) is £3 million, financing a 9.2% equity stake for employees. Payroll reductions are immediately reflected in profit increase of 20%.

Although this is a simplified illustration, it shows how many Small Cap companies might achieve significant cost savings and create a new equity incentive for employees. This approach could be adopted as part of a public-to-private transaction, or it would be compatible with the company remaining quoted, or it could be applied in the leveraged co-investment plan described above.

Appendix 1: Surveyed companies

Company	Market Capital-isation £m	Prospective Price to Earnings Ratio	Price to Sales Ratio	Market Cap / Payroll	%Shares Held by Directors %	Share Price Against FTSE All Share Over 1 Year %	Change in brokers' expect-ations of EPS over last 12 months %
Ash & Lacy	38.6	5.0	0.26	1.08	0.19	-40.3	-11
Alvis	189.0	15.3	1.49	14.92	0.08	15.5	6
Alumasc Group	39.7	4.9	0.24	0.92	20.30	-59.1	-21
Ascot	177.0	7.0	0.81	3.76	0.58	-8.1	8
Babcock	121.0	7.7	0.21	0.64	0.05	0.8	15
Berisford	267.0	6.5	0.45	2.31	1.46	-15.0	21
Bullough	69.0	5.2	0.29	0.96	0.23	-41.6	-16
Carclo	67.3	8.4	0.4	1.22	0.76	-46.5	-45
Castings	78.1	10.5	1.16	2.89	5.55	-10.7	-2
Cirqual	36.6	4.5	0.75	4.11	31.40	-52.8	-20
Expamet	74.7	8.7	0.71	3.03	1.23	-17.2	14
Fenner	113.0	8.6	0.39	1.58	0.43	-45.1	-35
Firth Rixson	105.0	8.6	0.62	3.46	0.17	-49.2	-22
Haden Mclellan	58.8	6.6	0.13	0.50	0.50	-53.8	-36
Hall Engineering	65.4	8.4	0.31	1.70	0.76	-29.3	-36
Hampson Industries	58.5	6.9	0.39	1.23	0.67	-33.4	2
Manganese Bronze	32.1	8.4	0.28	1.29	4.30	-60.9	-56
McLeod Russell	53.6	7.2	0.49	1.73	0.38	-47.1	-21
Metalrax	105.0	9.7	1.05	4.32	4.22	-14.7	3
Molins	35.6	5.5	0.14	4.87	0.18	-66.1	-100
Powerscreen	111.0	7.2	0.35	3.00	0.45	-57.4	-60
Quadramatic	72.2	11.2	0.98	3.19	3.92	-25.4	-44
Renold	102.0	9.7	0.55	1.53	0.74	-42.4	-47
Severfield Reeve	53.8	8.6	0.44	3.29	5.85	-47.9	-5
Transtec	70.7	4.3	0.18	0.77	2.19	-47.9	-40
Ultra	228.0	14.3	1.59	5.44	4.38	-8.1	5
Vitec	260.0	9.7	1.79	7.94	5.22	-23.4	3
Vosper Thorneycroft	235.0	10.7	1.13	4.13	0.66	-14.2	3
Wagon Industrial	127.0	7.7	0.39	1.40	0.27	-27.1	-1
600 Group	41.2	6.5	0.31	1.72	0.16	-41.5	-33

Source: Company Refs, February 1999

Appendix 2: UK Employee Ownership Index™

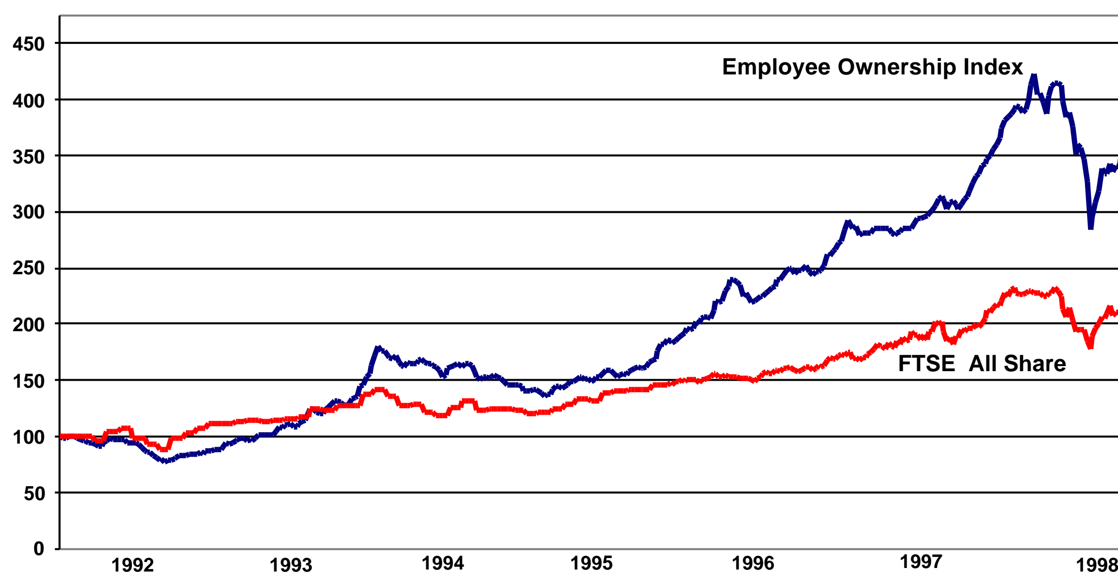
Summary
The UK Employee Ownership Index measures the relative share price performance of UK quoted companies with significant levels of employee share ownership.

The index, which presently comprises thirty six quoted companies, is measured against the FTSE All Share index from January 1992. The index outperformed the main market index in all four quarters of 1998 and in six of the last eight quarters. The performance of the Employee Ownership Index compared to the FTSE 100, FTSE All Share and FTSE Small Cap indices over one, three and five years is shown below.

Performance Period	UK Employee Ownership Index	FTSE 100 Index	FTSE All Share Index	FTSE Small Cap Index
1 Year	12.7%	14.5%	11.1%	-10.4%
3 Years	98.4%	59.5%	48.3%	6.7%
5 Years	150.9%	72.1%	59.0%	N/A

An amount of £100 invested in the Employee Ownership Index and the FTSE All Share Index on 1 January 1992 would now be worth £368 and £218 in nominal terms.

UK Employee Ownership Index 1992-1998



Construction of the Index

To define eligibility for inclusion in the index, we select companies with more than 10% of their issued share capital held directly by, or indirectly for the benefit of, employees other than board directors (clearly, many more Stock Market companies are more than 10% owned by directors). We use a variety of information sources to identify candidate companies, including annual reports, share registers, prospectuses and listing particulars, press reports and analysts' reports. Some companies move in and out of the index as their level of employee ownership changes. Whilst all thirty six companies in the index have been verified as eligible for inclusion, it is possible that we are missing a number of candidate companies which satisfy the ownership test but whose ownership is fragmented and therefore not detectable from our information sources. We are surveying quoted companies continuously to attempt to identify these omissions, and to track changes to the status of our present sample. The index is updated weekly. No account is taken of dividend income.

Origins of the Index

For many years, academics, policy-makers and analysts have attempted to measure the impact of employee share ownership on company performance, but this has often proved to be an elusive goal. There are too many factors affecting a company's performance (whichever performance measure is chosen) to be able to isolate the single effect of employee ownership with any scientific or statistical rigour. Only in the United States, where the population of employee owned companies is sufficiently large, can analysts begin to draw reliable conclusions.

Two landmark studies in the 1980s concluded that sales growth and employment growth were slightly higher in companies with employee ownership, and this margin of superiority was greatest in companies which encouraged other (non-financial) forms of employee involvement and participation. In 1994, American Capital Strategies building on research by Professors Conte, Blasi and Kruse at Rutgers University, New Jersey, compiled an index of the stock prices of all US quoted companies that were more than 10% owned by their employees. Stock prices of employee owned companies significantly outpaced those of conventionally owned companies over a sustained period. The UK index is based on the same criteria and methodologies as its US antecedent.

Interpretation

Clearly, share price is only one crude measure of corporate performance and not one that always correlates closely with profitability or durability in the short term. But it is clear-cut, unambiguous and readily measurable. So what might explain these results from both the UK and US indices? It would be unwise to claim any direct relationship of cause and effect between employee ownership and share price growth. The UK index in particular contains a number of biases which may themselves result in superior performance and which may therefore distort the picture. For example, the index is biased towards smaller companies, towards the support services and transport sectors, and towards companies that have more recently listed.

However, it is clear from Capital Strategies' experience that employee-owned companies tend to feature progressive approaches to management and communication most often associated with best practice and top performing companies. For example:

- there is a more open and informative culture
- employees are educated to a higher level of financial and business literacy
- employees are more involved in the issues facing the company, at all levels of the business
- managers are exposed to a greater degree of scrutiny and accountability (not always welcomed!)

As a result, many companies report incremental improvements in productivity and efficiency and reduced wastage and absenteeism, which can add up to material improvements to "the bottom line".

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