BIS Department for Business Innovation & Skills

Cass Business School
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THE EMPLOYEE OWNERSHIP ADVANTAGE

Benefits and consequences

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Contents

Cover photographs

Top – John Lewis Partnership was founded in 1864 and is the UK's largest employee-owned business with 69,000 partners and annual sales in excess of £8 billion from 275 stores.

Bottom – Stewart Buchanan Gauges, a successful Scottish manufacturer, became employee owned in 2012 when the company was acquired on behalf of its 150 staff by an Employee Benefit Trust.

The Employee Ownership Advantage:

Benefits and Consequences

Professor Joseph Lampel [a]

Professor Ajay Bhalla [b]

Dr. Pushkar Jha [c]

[a, b] Cass Business School, City University, London

[c] Newcastle University Business School, Newcastle

Foreword by Norman Lamb, Minister for Employment Relations

The ongoing economic crisis has exposed deep seated problems with the UK's growth model. The Coalition Government aims to drive sustainable economic growth and to rebalance the economy so new economic opportunities are spread more fairly.

Employee ownership can play an important part in achieving these aims. Aligning the interests of companies and their employees can make companies focus more on the long term, securing more sustainable growth. These businesses have also been more resilient to recessions. Other evidence shows how employee ownership and engagement can increase workers' well-being and productivity. This is why I believe employee ownership has a part to play in building a stronger, more diverse and dynamic economy; an economy which makes better use of our human resources, where risk and reward are closer aligned and where profits are distributed more fairly.

This study is a valuable contribution to the evidence base. It finds numerous benefits from employee ownership. It builds on an earlier report from the same authors which found, amongst other things, that employee owned businesses' performance is more stable across business cycles and that their job growth exceeds non-employee owned counterparts, particularly during recessions. It is my hope that studies such as these will stimulate further research and help spread understanding of the advantages of employee ownership more widely.

Norman Lamb MP, Minister for Employment Relations, Consumer and Postal Affairs

Key Findings

This study is based on a survey of 41 employee-owned businesses (EOBs) and 22 non-employee owned businesses. Our study also draws upon the published financial data of 49 EOBs and 204 non-EOBs in the UK. The key findings of this study add to the evidence base on the effects of employee ownership on business performance. They are as follows:

- EOBs have a stronger long-term focus. Non-EOBs are more conservative when it comes to balancing short- against long-term response to changing demand conditions, and are more preoccupied with efficiency and costs. EOBs are more likely to favour activities that have a long term payback horizon and put greater emphasis on forward growth planning

- Increasing employee representation at board level can improve EOBs' performance. Increasing employee representation by less than 30 per cent had no impact on performance, but increasing employee representation by at least 30 per cent had a significant impact on performance. However, increasing representation by more than 60 per cent does not deliver additional benefits

- EOBs invest more in human capital than non-EOBs

- EOBs face greater problems when it comes to raising capital and dealing with regulatory requirements

- EOBs get more of their growth from adding new customers compared to non-EOBs, particularly in the professional services sectors

- EOBs show greater preference for internal growth over external growth, this is particularly true for manufacturing and processing firms

- EOBs have a more positive media image than non-EOBs, particularly in the manufacturing and processing sectors

- Employee commitment supports the strategic imperatives of EOBs according to which sector they operate in.

1. Introduction

Adverse economic environment is prompting a reappraisal of alternative ownership models to the dominant public and private shareholder models - one that is not only resilient in times of adversity but also promotes sustainable wealth creation and equitable distribution. In the UK, in particular, the case of employee-ownership has recently gained attention - in part because of the recognition of the need for fairer society, but also because adverse economic conditions point to business resilience as an important part of sustaining employment and long-term growth. The UK has a healthy but small employee-owned sector. The sector is estimated to be worth £25 billion annually - equivalent to 2 per cent of UK GDP. It comprises firms that operate in a wide range of sectors, from retail, to manufacturing and engineering, to financial services. Employee-owned organisations can also be found in the public sector, where they deliver services such as health and community care.

Research by Lampel, Bhalla and Jha[1] established that Employee-Owned Businesses (EOBs) – firms where employees own stake both individually and collectively through a trust- are more resilient, display less sales variability, and deliver more stable performance over business cycles. The report also showed that the profitability of EOBs correlates with giving employees greater autonomy in decision-making. EOBs that adapt their organisational structure and empower their front-end employees are more likely to sustain their performance as their size increases. It also provides evidence that EOBs create jobs faster than their Non-EOB counterparts and particularly so in times of economic downturn.

This study adds to this evidence base by examining the following:

I. Evidence that benefits of employee ownership vary across different business sectors

II. Evidence on whether employee ownership can create a longer-term focus in businesses

III. Evidence of the impact of the distribution and concentration of employee ownership on performance

IV. Evidence on whether higher employee ownership increases human capital investment

V. Evidence on institutional disadvantages faced by employee owned businesses.

[1] Joseph Lampel, Ajay Bhalla, Pushkar Jha (2010). Model Growth: Do employee-owned businesses deliver sustainable performance?

2. Data and Methodology

This study is based on data from a survey of 41 employee-owned businesses (EOBs) and 22 non-employee owned businesses (non-EOBs) in the United Kingdom. Our study also draws upon the published financial data of 49 EOBs and 204 non-EOBs in the UK. To construct our sample, we used the Employee Ownership Association's list of member companies that explicitly identify themselves as 'employee owned'. We then added a comparable group of non-EOBs. The analysis we present in this report is therefore conducted on two levels. First, we focus on the overall performance of EOBs as opposed to non-EOBs. Second, based on shared commonalities we disaggregate the total sample to examine the performance of EOBs vs. non-EOBs in the following three business areas: a) professional services; b) technical services; and c) manufacturing and processing operations.

The professional services sub-sample is made up of businesses that provide clients with customised services and solutions (9 non-EOBs, 18 EOBs). The technical services sub-sample comprises businesses that provide generic solutions and services to customers (7 non-EOBs, 11 EOBs). The manufacturing and processing sub-sample includes businesses that focus on production and assembly (6 non-EOB, 12 EOBs).

We used a variety of techniques to analyse the data, ranging from basic descriptive statistics, to unpaired t-tests.

3. Findings and Implications

3.1 Evidence of benefits of employee ownership across business sectors

Research shows that employee ownership fosters employees' commitment to their organisation. This in turn is expected to improve the ability of firms to carry out a variety of key strategic activities such as product development, market expansion, and sales that lead to better performance. In our study we sought a direct link between employee ownership and higher levels of employee commitment by asking firms to rate activities that generated the most growth for their business over 2004-2009. This list includes launching new products, gaining new customers, pursuing market expansion, revamping operations, and improving logistics, among others.

In what follows, we report our analysis of responses to these items for EOBs and non-EOBs sub-samples according to their business activities. We focus only on items where we find statistically significant differences. We report statistics relating to these in appendix A.

3.1.1. Employee ownership benefits: comparing EOBs to non-EOBs across business sectors

Customer-oriented growth

A key growth activity for most firms is adding new customers to its current customer base. During economic downturns adding new customers requires higher levels of employee commitment and initiative. Since our survey was conducted just as the recent economic recession was taking hold, we were able to take advantage of the downturn to compare customer-oriented growth in EOBs vs. non-EOBs. We further compared customer-oriented growth for EOBs and non-EOBs across the three business areas of manufacturing and processing sector, technical service sector and professional service sector.

Our results show that on the whole **EOBs get more of their growth from adding new customers than do non-EOBs**. However, the difference is particularly strong, and statistically significant in the professional service sectors where EOBs get more of their growth from new customers than do non-EOBs**.** This result speaks to the value of employee commitment in EOBs, especially during difficult economic conditions. (In passing, this result also points to the limits of traditional incentives such as bonuses that are tied to customer-facing employees, without necessarily motivating other parts of the organisation).

Internal vs. external growth

Researchers traditionally contrast two models of firm growth: Internal growth, often described as 'organic', involves firms developing their own new products, and extending

their current base of operations to new markets, and external growth involving the acquisition of new products and new lines of business from other firms.
External growth is often seen as more rapid but also more risky than internal growth because it depends on acquirers obtaining the cooperation of employees in the acquired business unit. Internal growth is usually more effective in terms of performance in the long run in part because managers have a better grasp of their internal capabilities, but also because they can rely on employee commitment to tackle the difficulties that often arise during new business initiatives.

Most companies engage in both internal and external growth. The question is whether they exhibit a clear preference for one over the other. Our analysis points to EOBs showing greater preference for internal growth than non-EOBs. The preference is particularly marked in manufacturing and processing firms where the preference for internal growth is strong and statistically significant. To some extent this result may be explained by the constraints that EOBs in this sector face when it comes to raising capital. However, at a time when raising capital is proving difficult for both EOBs and non-EOBs, the former's long-standing reliance on internal growth is a distinct advantage, not only because it is far less dependent on external capital sources, but also because EOBs are more adept at using internal resources to pursue growth.

Positive media image

At a time when business is under increasing scrutiny, a positive media image has a variety of benefits. Media image impacts relationship with customers: customers are more likely to trust companies that have a positive image, and avoid companies that have a negative media image. The same can be said for suppliers. Likewise, employee recruitment is easier for companies that have a positive media image as oppose to companies that have a negative media image.

Our analysis of the data shows that on the whole, EOBs have a more positive media image than non-EOBs. The difference is particularly striking when we compare EOBs and non-EOBs in the manufacturing and processing sector. Our reading of these results suggest that firms in this sector attract considerable media attention because they are often located in areas where their operations are vital to the local economies, and because management/labour relations in this sector has traditionally been marked by conflict.

3.1.2. EO benefits: variation within EOBs classified by business sectors

In general our EOB respondents strongly endorse the view that employee ownership increases employee commitment to the enterprise. We further disaggregated these benefits across different sectors by analysing how EOBs saw the benefits that flow from employee commitment. Our results show that EOBs in professional services have stronger customer orientation than other sectors. We also find that EOBs in the technical services sector are better at drawing upon process improvements than EOBs in other sectors.

Both results are consistent with the strategy that firms pursue in each of the reported sectors. The performance of firms in professional services is based on gaining new customers, whereas strategic advantage of firms in technical services depends on delivering on improving quality and delivery. In both instances employee commitment supports these strategic imperatives. But in each instance the organisation makes different use of employee commitment depending on sector requirements.

3.2. Evidence on whether employee ownership can create a longer-term focus in businesses

Managers in publicly traded companies often cite pressure to increase share value as an important factor in decision-making. Faced with this pressure, publicly traded companies focus on actions that have a direct and immediate impact on their share value, often at the expense of activities that have a longer time horizon.

Employee owned businesses are in principle insulated from this pressure, and thus would be expected to be less susceptible to this kind of trade-off. With this prediction in mind, we tested for short- vs. long-term focus by asking companies how they would respond to increasing demand for their goods and services. Respondents had to select from one of the four choices:

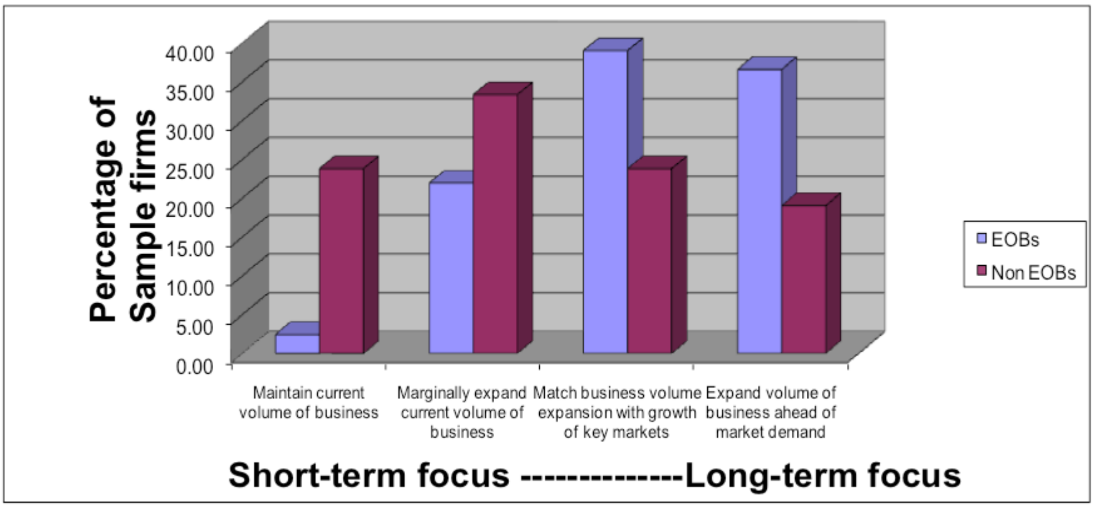
a) We will maintain our current volume of business.

b) We will marginally expand volume of business to take advantage of market growth.

c) We will match our volume of business with the growth of our key markets on a year-by-year basis.

d) We will expand our volume of business ahead of market demand to take advantage of growth opportunities.

FIGURE 1: How companies would respond to increasing demand



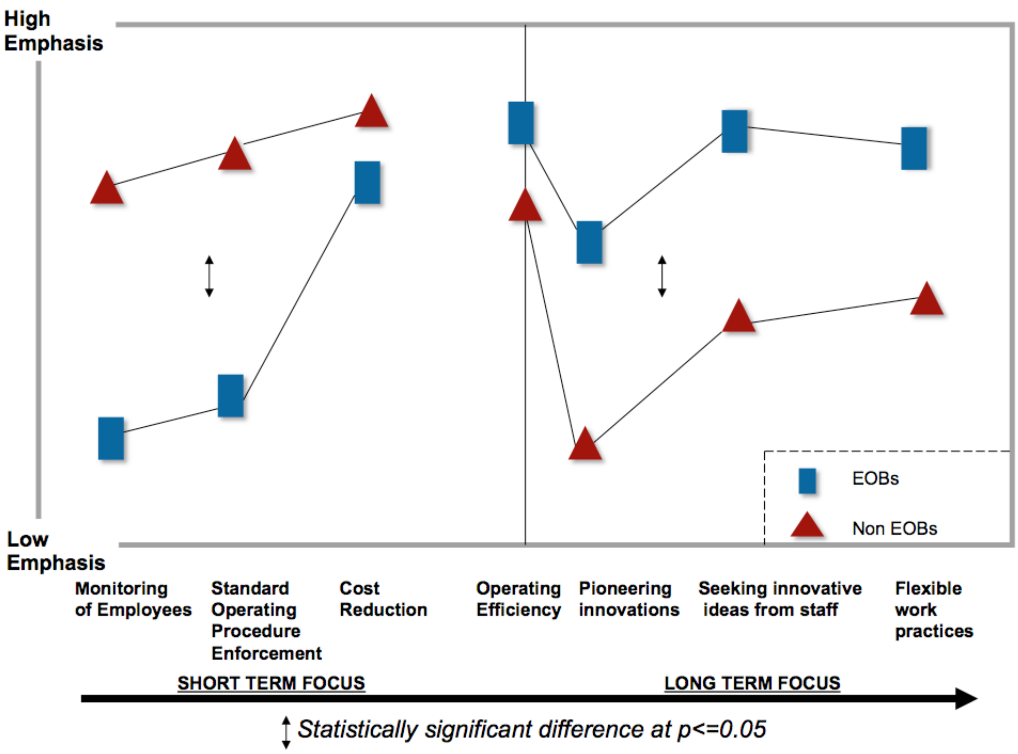
Our analysis of EOBs vs. non-EOBs responses support the view that non-EOBs are more conservative when it comes to balancing short- against long-term response to changing demand conditions (see figure 1). Non-EOBs were far more likely than EOBs to retain current volume of business as demand improved. By contrast, EOBs displayed a marked preference to increase volume of business ahead of improved demand for their products and services. Bearing in mind that this question was posed at the height of the economic crisis, it is significant that on the whole our analysis shows that EOBs are more willing to tackle the uncertainty associated with longer-time focus, whereas non-EOBs prefer actions that have clearly defined short-term risks.

To probe these differences further, we asked respondents to rate the importance their organisations attached to activities that have shorter vs. longer payback horizon. The items we listed for short payback horizon were activities that promoted cost reduction, involved detailed monitoring of employees, and increased enforcement of standard operating procedures. The items that stood for long payback horizon were willingness to pioneer innovations, introducing flexible work practices, and actively seeking innovative ideas from employees. We also asked respondents to rate emphasis on operational efficiency which we see as a mid-way mark between the two orientations.

Our results show that EOBs have longer payback horizon when compared to non-EOBs across a number of activities (see figure 2). Specifically, our data shows that EOBs are more likely to support pioneering of innovations than non-EOBs. By contrast, non-EOBs are more preoccupied with efficiency and costs than EOBs who put greater emphasis on forward growth planning. EOBs delegate more initiative to first-line and middle management, and are less preoccupied with maintaining standard operating procedures.

Using unpaired t-tests we find statistical significance to validate the descriptive statistics we report above. This allows us to present the following diagram:

FIGURE 2: Importance of activities with varying payback periods



3.3 Evidence of impact of the distribution and concentration of employee ownership on performance

There are two dimensions to employee ownership. The first is the percentage of employees that own shares, and the second the distribution of shares across the organisation. The percentage of employees that own shares has an impact on whether a business regards itself as employee owned. Clearly, the higher the percentage the more likely is the business to see itself as employee owned. Some researchers have advocated using a 50 per cent threshold as a minimum requirement for such definition. In our sample we included firms that identified themselves as employee owned that were below this threshold. This is in line with conventional definitions of corporate control that see effective control as feasible with minority of the shares, as long as the rest are widely dispersed.

Reaping the advantages of employee commitment to the business does not only depend on percentage of shares owned by employees, but also on how many of the employees own shares. During interviews with EOBs that preceded the design of our survey it became clear that companies have different policies when it came to awarding shares to employees. Some sought to ensure that not only did every employee have the right to own shares, but that there should be relatively equal distribution of shares within the company. Other firms were more comfortable with some employees (mostly top managers) holding more shares than others. Since the policies tended to vary, and were often rather complex, we chose to capture this dimension by using percentage of employee representation on the board as a proxy for concentration of total shares owned by employees. From the point of governance, therefore, we would expect greater equality of share ownership to result in more employee representation on the board.

We used these two dimensions to analyse the relative performance of EOBs. Our performance variable was sales revenue per employee.

Analysis of our data did not show a consistent correlation between employee ownership levels and firm performance. In other words, increasing levels of employee ownership did not automatically translate into higher performance. However, interviews with EOB managers conducted prior to the survey suggest that employee ownership has limited influence on motivation, unless it is linked to employee representation, preferably at board level. In our survey we therefore included items that requested information on percentage of employees that serve on the board in 2004 and 2008/2009. We were interested in seeing whether increasing employee representation had an impact on EOB performance. Analysing this data we find that increasing employee representation by less than 30 per cent had no impact on performance, but that increasing employee representation beyond 30 per cent had significant impact on performance. This impact, however, declined if representation increased by more than 60 per cent. These percentage figures are with reference to the initial levels of employee representation. For instance, increasing employee representation from 5 to 8 members in a 10 member board amounts to 60 per cent increase in employee representation.

The 30 per cent/60 per cent thresholds suggest a relationship between percentage of employees that own shares and board dynamics. Although our data does not yield conclusive statistical evidence on this issue, we believe that as greater percentage of employees own shares, the benefits that the organisation can derive from wider share ownership are more likely to materialise if this has an impact on representation at the board level. At the same time, the impact is not linear. In other words, increasing representation beyond a certain point does not deliver additional benefits, and may in fact damage strategic decision making at the top.

3.4. Evidence on whether higher employee ownership increases human capital investment

Economists have long identified investment in human capital as an important contributor to firm performance. Although firm investment in employee human capital is normally undertaken with specific strategic objectives in mind, it is worth bearing in mind that it also contributes to the common stock of skills and knowledge that benefits the entire economy. Differential rates of human capital investments between EOBs and non-EOBs therefore impact not only firms in each of these categories, but also the economic environment in which they operate.

Our survey included questions that addressed the extent to which firms invested in employee training, and in programs that improved employee skills in areas such as quality control, product development, and business skills. Our analysis of the data shows that on the whole EOBs invest more in human capital than non-EOBs.

More specifically, our data indicates the following:

- EOBs are more likely to invest in quality improvement training compared to non-EOBs

- Nearly half the EOBs in our sample strongly encouraged employees to build skills in new product development as opposed to only 5 per cent of the non-EOBs in our sample

- EOBs allow far greater employee involvement in operational and strategic decision making processes than non-EOBs. These higher levels of involvement allow employees to acquire managerial and business skills that would normally be out of reach for many employees in non-EOBs who are usually relegated to purely subordinate role.

3.5 Evidence on institutional disadvantages faced by employee owned businesses

All firms face institutional barriers when it comes to raising capital, and all must negotiate their regulatory environment. Anecdotal evidence suggests that EOBs confront greater difficulties in both areas than non-EOBs. Our survey shows that EOBs do face greater problems when it comes to raising capital and dealing with regulatory requirements.

Using unpaired t-test we find statistically significant results that show:

- EOBs experience greater difficulty in obtaining capital from banks than non-EOBs. This may be due to the fact that EOBs are more interested in expanding business, and hence have greater need of external capital to finance new operations

- EOB firms find handling government approved share plans more of a challenge than non-EOBs

- EOBs report having to deal with greater diversity of regulatory issues than non-EOBs, including handling of tax issues. They show significant differences from non-EOBs in the following areas: a) perceived lack of support from policy makers; b) perceived difficulty in addressing the requirements of HM Revenue and Customs; c) perceived lack of specialist support for firms seeking conversion to EOB status and; d) perceived difficulties in negotiating taxation issues.

APPENDIX

Appendix A: benefits of the EO model using a comparison with non-EOBs

Customer oriented growth

Growth from adding new customers	**EOBs in professional service sector**	**non-EOBs in professional service sector**
Mean*	4.5 [90% mean agreement[2]]	3.30 [66% mean agreement]
Median	5	3
* Unpaired *t-test for difference of means is statistically significant at p<0.05.*		

Internal vs. external growth

Internal growth preference

Growth from process improvements	**EOBs in technical service sector**	**non-EOBs in technical service sector**
Mean*	3.63 [73% mean agreement]	2.43 [49% mean agreement]
Median	4	2
* Unpaired *t-test for difference of means is statistically significant at p<0.05.*		

[2] Mean agreement implies the overall extent to which the respondent group agrees with the assertion under purview

External growth preference

Growth from acquisitions	EOBs in professional service sector	non-EOBs in professional service sector
Mean*	2.16 [43% mean agreement]	3.66 [73% mean agreement]
Median	1	3
* Unpaired *t-test for difference of means is statistically significant at p<0.05.*		

Positive media image

Positive media	EOBs in the manufacturing and processing sector	non-EOBs in the manufacturing and processing sector
Mean*	3.59 [71.8% mean agreement]	1.17 [23.4% mean agreement]
Median	4	1
* Unpaired *t-test for difference of means is statistically significant at p<0.05.*		

Appendix B: inter-sector comparisons of benefits of the EO model

Customer oriented growth

Growth from adding new customers	**EOBs in manufacturing and processing sector**	**EOBs in technical service sector**	**EOBs in professional service sector**
Mean*	4.2 [84% mean agreement]	4.8 [96% mean agreement]	4.45[90% mean agreement]
Median	4	5	5
* Unpaired *t-test for difference of means is statistically significant at p<0.05.*			

Drawing upon process improvements for internal growth

Growth from process improvements	**EOBs in manufacturing and processing sector**	**EOBs in technical service sector**	**EOBs in professional service sector**
Mean*	3.08 [61.6% mean agreement]	3.63 [72.6% mean agreement]	3.16[63.2% mean agreement]
Median	4	4	3
* Unpaired *t-test for difference of means is statistically significant at p<0.05.*			

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Any enquiries regarding this publication should be sent to:

Department for Business, Innovation and Skills
1 Victoria Street
London SW1H 0ET
Tel: 020 7215 5000

If you require this publication in an alternative format, email enquiries@bis.gsi.gov.uk, or call 020 7215 5000.

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