The Deal Room Podcast

Episode 177 – Using Shares as a Talent Retention Strategy, and Their Impact to the Business at Exit

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Transcript

Joanna: Hi, it's Joana Oakey here and welcome back to the deal room podcast, a podcast proudly brought to you by our commercial legal practice Aspect Legal. Now today we have on the show the fabulous Rod Hore from HHMC global talking with me all about how using shares as a talent retention strategy can impact you when going to market. Now, this is the second part of a series in this discussion between Rod and I. If you're interested in hearing more of an in-depth discussion about the background of why you might use shares as a retention strategy for staff, what alternatives there are to shares, shareholders and discussing the concept of being more corporate then head over to our talking law episode where we talk all about the background of using shares as a talent retention strategy with a particular focus on professional service businesses. But of course, this can be just as relevant to almost any business. So you'll find a link in our show notes back to that episode in talking law, which is a podcast that is a sister podcast of the deal room where Rod and I talk all about the background details of using shares as a talent retention strategy that in today's podcast, Rod and I are specifically focusing on how shares within a business being held by your employees might impact you going to market so we talk about what a company might do to prepare for this as a strategy important to be prepared. But we also really talk about valuation in a business, how using share schemes for employees can really impact your value at exit both in a positive and sometimes also in a negative way. So without further ado, here we go with our discussion with Rod Hore. Well, thank you, Rod, for coming back to the deal room podcast. Of course, you're a serial guest, I absolutely love having you on our shows. And this being a follow up to a discussion that we had in our sister podcast talking law, I'm really excited to drive into how this subject really impacts a business at scale. So Rod, thank you once again, for coming back to the show.

Rod: It's a pleasure, and always good to talk to my favourite lawyer.

Joanna: I did not pay you to say that, by the way.

Rod: Catch you off guard.

Joanna: You did that, you did that. Okay. So and obviously, just before we get into this, can we step back a moment because in our previous discussions, if our listeners have heard those on talking law, where we talk really about the How to of organizing employees to hold shares, and why that works for it as an employee retention strategy, what we didn't really talk about was how it relates to exit, maybe if you can give our listeners a quick background on you and your background because I think that will really help to inform where we going today in talking about exit because of course, this is your area of specialization. So maybe just give us a quick background, Rod.

Rod: Sure. So for about 20 years, HHMC has been we're providing merger and acquisition services within the services industry, but we have a very strong focus on the recruitment industry. Also some work in the IT services industry. And in doing that we're talking to a lot of small to medium organizations as they go through their life. And, and we see and, and work with the owners of those organizations on the influences that have given them value or not given them value, and certainly retention of staff and how you motivate staff and keep the staff going and the corporate nature of your organization when you come to present it to a seller to a purchaser is is really, really important. And, and a lot of it comes down to the things we're talking about today. And making sure that you strategically get yourself organized.

Joanna: Yeah, well, let's drill into that a little bit more because it's it really is such an important point for what we're talking about today. But why is it that a business is more valuable the more corporate it is, the more corporate it's run? Can we talk about that for a moment?

Rod: Yeah, look, it's very hard to actually put into dollars and cents. But there is no doubt that the more attractive you are to a purchaser, the more that they will stop and pause and actually investigate you as an organization as opposed to go into someone down the street. So you want to be attractive to an organization. And if you're a pure lifestyle business where there are just the original founders, and they've been doing this stuff for a period of time, and they don't look like, and they don't look like the purchasing organization in any shape, or form, the way they do their accounts, the way they organize themselves, the way they set their strategy, the way they run their business doesn't look like the purchaser. But the more you become corporate, the more you move towards having all of the disciplines, I suppose of a slightly larger organization, a more corporate organization that actually assists in getting attention to your organization. Now, I'd also argue that in doing that, you will be a better organization, you will make better decisions, you will earn better revenue, and you will make more profit as well. And that's what generates the value. So there's that attractiveness, as well as the actual value of the organization comes along.

Joanna: Love it. And of course, that's the theme of what we're talking about all the time on the deal room podcast, which is, you know, running your business in and sell ready state is a better business in any event. And let's just drill into as well what we mean by becoming more corporate. So we've, we've used that as a differentiation between the lifestyle business where it's, you know, where we generally have one or two, maybe three owners founders quite often who, who the business runs around, but who are also critical to the ongoing running and value of the business and from, from a corporate to look more corporate, what are some of the things we need to put in place? So what does that mean practically?

Rod: And we tend to look at organizations and reasonably crudely, I suppose, put them in one of three buckets. And you mentioned lifestyle there. And so that's one end where to, without, you know, without denigrating the business because there can be great profitable businesses in this category. But the business is run for the benefit of the shareholders. And they'll make decisions for the benefit of the shareholders not necessarily to make the business the best it could be or the most strategically strong it can be. At the other end of the scale, are the very corporate business, it's in the easy ones to look at. They're the ones that are listed because there are so many rules and regulations and obligations on those sorts of organizations. Now, you could be a large organization and not listed and still have those characteristics. In the middle is what we call sort of the owner dominant business or the owner-operated business. And we differentiate those from the lifestyle businesses because they have intent, they have the strategic intent to be a better business. And they will, they will constantly grow and push themselves and challenge themselves to be a better business. Lifestyle businesses don't really have that intent. So that's a very, in some ways, a wishy-washy solution, but you can see it in terms of how strategically organized they are, how they run themselves internally, how they pay people, how disciplined they are with their financial accounts, all of those sorts of components, you know, the process and procedure within the organization, both at the business end, as well as in terms of the operational end, you know, they're constantly striving to be better.

Joanna: Okay, and then let's talk about value as well. And of course, you deal primarily with lots of businesses in the recruitment sector. So when we're talking about valuation of businesses here, you know, bear in mind, for our listeners, we're talking also about the sector itself. But what is your experience might be the types of multiples the difference in the multiples that we'll see between the lifestyle between the owner dominant, and between the corporate? I mean, I've heard many times the lifestyle business is referred to almost as acqui-hires, you know, the hiring of talent through acquisition, but there being issues with any sort of value over and above that, but what does this look like, you know, just a crude.

Rod: Let's ignore structure at the moment. And let's ignore working capital. So let's just take those things off the table and just talk about a multiple of profit at the moment, because that's sort of the pub talk way of discussing value. And so a lifestyle business usually is somewhere between not much like close to zero, and maybe up two or three times multiple within the recruitment industry, but it has to be a larger business that had other sustainability factors about it to allow to get up to that sort of two to three times multiple of profit and owner dominant business that has got all of those characteristics of striving to be a better business. will usually have addressed a whole range of sustainability issues, it will usually balance its business better, it will run a cleaner set of books, so it's easier to assess. And they can be in that sort of, you know, three to maybe even up to five times multiple, and business that is truly corporate, there's actually not many of them in Australia, you know, they're at the top of the pyramid, they can be, you know, four or 5 6 7 8 times multiple, depending on where they sit in size and a few other characteristics. So, so there's definitely a valuation change as they go through those, those positions.

Joanna: An evaluation driver for what we're about to talk about now. But I think this is really good background, because some of these, some of these background concepts, because we work in the industry all the time, you know, it's, it's, it's obvious to us, but I think many of our listeners will find it really useful to understand, you know, here's the, here's the real drivers for moving towards being more corporate in your disciplines in the business and how you're approaching some of these issues that we're going to talk about

Rod: And look, and we want the owners to be self-assessed in this area so that they clearly understand where they are, there's nothing wrong with being in any category. It's, it's a choice, you know, it's just that we don't want people to end up there without having made conscious decisions. And we don't want people to not understand the implications of the decisions they've made. So they're evaluation and considerations, so so do whatever you want to but understand what what what it is that you've made the decision on.

Joanna:
And we're trying to ward off that, that beast, that is disappointment at the point of exit, you know, be armed, understand, understand, you know, how you're running your business and where that puts you at the moment.

Rod: But the most disappointing conversation we can have, and I'll generic it, but if somebody who reaches an age where they say it's time for me to retire, and they come to us and say, please sell my business, you are going to provide me with my superannuation fund, you have to turn around and say, but you're not worth anything, or you're worth very little. I mean, we don't want that. So you know, we've even written an Ebook to help people self assess this service that's on our web page. And so you know, we want people to be able to understand the implications of the decisions they make. And today we're going to talk about, you know, staff and shareholders and things like that. And that's just one component of it, one characteristic of it. But it's very important for the education of the business owners.

Joanna: And we may as well give a link to that website right now. Where do we find that our listeners? How do they find that Ebook

Rod: Yes, there's an Ebook for download. It's on the front page of our website, which is hhmc.com.au

Joanna: Fabulous. Okay. All right. So then let's really drill into this topic that we're getting in to do today, there was a bit of background, but I think it's all really important to set up why we're talking about using shares as a talent retention strategy? One of the reasons is because talent retention can have a really big impact in your on your value at exit.

Rod: Yes. And right now, there's a chronic shortage of, of people to hire, not only in the recruitment industry in other sectors as well. And so trying to grow, by hiring more people is actually a really complicated thing. You don't want to make that worse by losing the top talent you've got.

Joanna: Absolutely. Okay. All right. So, so why it's so firstly, how is it that we can use shares as a talent retention strategy? How can that work? And we've got a brief overview of these just once again, in the talking law episode, where we talk about some of the options. But Rod, how have you seen this best applied?

Rod: So as an organization matures, there is usually some staff who show great capacity and capability. And it's up to the founders to recognize that and to work out an appropriate way of being able to reward those people or give those people the opportunity for reward, it's probably a different way of saying it. And, and allowing them to become part of the shareholding group is one of the options that are always on the table. There are other options. But one of the options that are on the table is saying can these people become shareholders in our business. And that's to not only, you know, on the one hand, you could say, well, we tried to lock them in, but it's also to reward them over time with, you know, dividends and so on. But it's also potentially those people could become the next generation that take over the business. So So there are all sorts of benefits over time of bringing your best people into the shareholding.

Joanna: Absolutely. And I guess in doing that, in some of the things that we'll talk about today is the positives and the potential negatives that this can relate to at exit but, but stepping back, of course, implicit on what you're saying right now is that this can provide the plan for exit potential you know that success plan because you might be building your future buyers of the rest of the shares in any event.

Rod: Yes, that's right. I mean, you can't make assumptions. I mean, shares aren't for everybody. And so it can't be the only card you put on the table in terms of, of looking after your best staff, but it can be a great one. And when you when it works, when it's appropriate for all the parties, it's a very strong outcome.

Joanna: Okay, wonderful. Let's maybe dig a little bit into then those positives, sorry, hold on to those positives, but then also potentially those, you know, downsides to be aware of at exit. So one of the positives is we're potentially building a succession path. And by the mere establishment of having our employees coming into holding equity, and other positives I absolutely have seen is the locking or the longevity of the staff in buyers' eyes as well, you know, coming in and saying that there there is a, you know, there's an established method of retention for key personnel. What's your comment on that?

Rod: Yeah, look at it, if an organization does all of the things that are appropriate in terms of also having the mechanisms for those shareholders to leave if that's appropriate. So in other words, the whole cycle of in and out, then for a purchaser, it shows that the organization is capable of regeneration, it shows that it's capable of bringing strong people in growing those people, giving them the rewards holding them into the organization, but also, if appropriate, having the mechanisms to let them leave the organization and the next group come through. So So that sort of regeneration is something that people are looking for, they're looking for an engine that's going to continue to work.

Joanna: Yeah, yeah. But you rightly point to the need for planning the in and out. And I think, therein lies some of the issues that I've also seen with using this approach, which is when there is, you know, when when you've built this system, where an employee can now actually potentially hold you ransom, because, you know, potentially, a buyer may want to buy the entire share pool, the entire equity pool and not be sharing equity with employees in that instances, and I've seen, you know, staff hold out and demand higher payments, refused to sell at all, where there's been no mechanism set up what some of the experiences you've

Rod: The worst one has been exactly along those lines, basically, on the day of signing, somebody sitting there in the corner with their arms crossed, saying, I want more money, or I'm not gonna sell and, you know, just ransom is the right word. And, you know, you never, ever want to be in that position. So you've got to put mechanisms in place that, obviously, legally protect the minority shareholders. But at the same time, the business has to be able to run and be able to make decisions and execute those decisions. And so, you know, the shareholder's agreement, which gets talked about a lot, but executed poorly, and sometimes not at all. You know, the shareholder's agreement needs to cover all of those scenarios for life as it continues, because it's more than just the corporate mechanics, it's people die, people get sick people don't work out and have to be removed from the business, all of those circumstances need to be covered in a shareholders agreement so that the business can continue and continue to operate successfully.

Joanna: Yeah, I often find and we've had this discussion many times before that, that business partners, whatever path they're at when they looking at entering into a deal together. So in this sense, we're talking about bringing employees on board quite often, everyone is best friends. You know, and sometimes, I just wonder if businesses sometimes end up in this situation without clear delineation and shareholders agreements about how to deal with exit, because I the number one, they just don't think that they're going to fall out, you know, they just appreciate properly the high likelihood that people change over time and their motivations change and their experiences change. or number two, whether they're just concerned, you know, about being off-putting to an employee that they're looking at bringing on board, what do you think the reasons are Rod, what have you seen is the wrong

Rod: I think it's, I actually think it's really hard for super serious conversations to be held amongst people who work together and you know, without pushing ourselves, but we get into this situation a lot, I mean, as you do is that an external party can actually ask all the really dumb hard questions that need to be asked. And it's very, very hard for three or four or five people to sit around a table and to talk about all of these sorts of scenarios that you hope will never appear. But you've got a document in case they do. And, you know, people grow apart over time. I mean, you know, sometimes it's not catastrophic type events, like, you know, death and all those sorts of things that cause the problems, it's just people gradually grow apart over time, or their performance drops over time. And so you've actually got to sort that out and have that clear and honest discussion and then document it so that you've got mechanisms in place for the business to continue. So the business comes first, everybody else comes a little bit second, in terms of being able to operate. And look, if I can give just a longer answer on that in one area. Some of it starts when you have a group of founders for a business, and they've been operating the business for a period of time. And this is the first time that they're thinking of bringing somebody else into that shareholding, there's actually a whole range of things that those people need to do to unwind themselves from the very comfortable existence that they've got into. And one way to just talk about that is that they become the legal directors, and they become the shareholders and they become the executive team, all wrapped up together, and not ever separated out. And they operate the business in that manner. So if you're bringing somebody else into the executive team, or you're bringing somebody else in as a shareholder, you need to start to unbundle all of that, and operate in a different manner. And those sorts of conversations can actually be quite confronting for the original founders. But if they don't do that properly, then the chances of all of this succeeding is actually quite low.

Joanna: And I know you do a lot of facilitation in this area, Rod. And I just think that you know, one of the points that I want to make is that I think that that is really critical, because obviously, we ultimately need to reflect all of this in a legal agreement, which is usually a shareholders agreement. And you know, there may be option agreements as well sitting next to this if we're using options as a way of providing equity or the possibility of equity in the future.

Rod: But by the way, the other document that doesn't get talked about enough is actually an employment contract. Because quite often the founders don't have an employment contract. An employment contract is a really important tool for when things go wrong because that defines how you can remove somebody from an organization or not.

Joanna: Yeah, brilliant. Exactly. And so then we have each of these legal agreements. And I and you know, of course, I'm a lawyer, I think these legal agreements are fabulous and critical. But the point is, they're, I see them as a checklist, they're a checklist, they're forcing you to ask the questions that are important. And, and sometimes, unfortunately, the checklist perhaps has been inappropriately prepared if you haven't got clarity on exit, if you haven't got clear drag on clauses, if you haven't, you know, reserved the rights for the founders to have some sort of control at the exit. But winding back then to the concept of facilitation, whilst you have the legal agreements as a checklist, there's a lot of thinking that goes behind arriving at the right outcome. And it's not that there is a one size fits all, there's no one answered that applies to every organization. And that's why I think having facilitation will help you come to a much better outcome. And, and ensure that there's this proper meeting of the minds, which is what it should be, it shouldn't be at the end of the day that people are surprised about what the agreements reflect. That's my perspective.

Rod: Everybody's drivers for life are different. The way the business is set up is different from one organization to another, set up and in terms of its goals, and objectives and strategy, and so on. And if you're going to change that, then you really need to go back to the first principles a little bit and say, you know, why are we here? What are we trying to achieve, and how we're going to take this forward. And you can't just lay it on people, it actually takes time for everybody to get their head around the changes that are coming up, because most of the time, they've been in quite a happy place and just operating gently, for a period of time, years, sometimes 20 years sometimes. And so and so to turn that around and say we're going to do things differently. You can't just rush that in, you've actually got to give everybody the founders as well as the people who are potentially gonna come in as shareholders time to, you know, go through the journey. I hate that sentence, but there's no other way of describing it. Go along the journey. You've got to everybody has to have time. They've got to go home and talk to their partner, they've got all of those things have to have to happen and have to happen at an appropriate pace to make this successful.

Joanna: And of course, we have a webinar coming up Rod, where we're going to really be driving into how to add value to your business through employee share schemes. And then we're going to talk about matching share plans with strategic objectives. And we're going to talk about some of the tips and tricks and how you set this up, you know, correctly, right from the beginning, and the sorts of questions you should be asking in the beginning, but maybe if you can just run us through, you know, one of the things that you talk about with your clients when you're helping them navigate this area, and what are some, you know, maybe some examples of some great outcomes that you've seen when businesses have really tackled this in the right way?

Rod: I think the catalyst for these sorts of discussions should be based on the organization maturing and developing and becoming more corporate, as we've talked about, there's usually a larger, more defined, strategic objective that's trying to be met. And then out of that comes all of these potential changes. And one of the things that we've worked with organizations is that they don't understand the value of the business, they don't understand the value of the shares that are in the business. And they haven't necessarily broached all of these subjects about what happens for entry exit challenges in the thing. And so bringing, bringing not only the founders along, but also, you know, working with the potential people who are going to come in, and helping them really understand what it means and Is it right for them? And does it fit their risk profile? And what does their partner think of attained? Are they prepared to purchase the shares? And how are they going to do that? And do they understand the implications of that, and do they understand what's not going to happen as well as what's going to happen? You know, I think it's quite a successful outcome. Sometimes when those potential shareholders turn around and say, This is not for me, I'm still loving the organization, I still want to work in the organization, I want to be part of the executive team. But I don't want to be a shareholder. And because that means that they've got enough information and been through a process to actually have some clarity around that.

Joanna: Yeah. Love it. And do you have any examples where you've seen this work really well?

Rod: Well, there are people involved. So it's never smooth. But I love it when there is basically when we don't get called again, or when you don't get called again, because the shareholder's agreement does its job. People know how to go through the circumstances that are in front of them. And they just deal with it, because they've got a, they've got a roadmap of how to deal with it. And that's what I love. And you hear about it a month later. That's great.

Joanna: Yeah. Look, Rod, I just want to say a massive thank you for coming on to the show. Did you have any parting thoughts? And of course, we've got lots and lots of further thoughts in the webinar that we have coming up. So don't forget to check out our show notes to register yourself. And if you're hearing this too far in the future, and have missed the webinar, don't worry, we'll have a replay available for you. But Rod, in advance of the webinar. Do you have any parting thoughts? And I and I guess particularly because we talking about how this relates to exit, any parting thoughts on that whole, you know, a box of value that that really sits in this area?

Rod: I think that the reason that we go on about this as much as we do is that we want those owners to be probably more educated. And that sounds terrible, but you know, to get exposure to the risks and the rewards of all of these decisions, and to be able to make really conscious decisions about how they're going to grow their business and how they're going to bring people in. And, you know, hopefully, we can give enough information not only in these podcasts but also especially in the webinar so that people can say, okay, that's something I want to investigate further. It's not all about the legal it's actually some internal work I've got to do, I've got to get my head around what I want to achieve, and then they can take it forward with their organization,

Joanna: and Rod, if our listeners want to get in contact with you, how do they do that?

Rod: All my contact details are on our website, Hh mc.com.au. Look forward to talking to people

Joanna: Brilliant. And Rod, as always, it's been an absolute pleasure. You'll find in our show notes links to the registration for that webinar, as well as to the talking law episode where Rod and I really stepped through some of the preparation and the reasons behind using this sort of strategy in your business. Rod, thank you so much for coming on to the deal room podcast.

Rod: Absolute pleasure. Thanks, Joanna.

Joanna: Well, that's it for this episode of the deal room podcast, of course, where we're talking all about employee share schemes and how they can provide a valid retention strategy but also an important value driver at the exit. Now, of course, don't forget that we have another episode drilling into other areas on this topic. In our sister podcast talking law now, you'll find in the show notes or links straight through to that podcast episode in talking law where Rod and I dig further into some of the backgrounds as to why shares can be a useful retention strategy, what alternatives there might be to shares how to prepare the business for new shareholders and a little bit more about shareholders agreements and what you want out of those. And of course, if you found the topic extremely interesting, or something that you're considering for the future, or perhaps have even entered the into, but are not entirely sure whether you've set it up correctly, then make sure you tune in to the webinar with Rod and I discussing how to add value to your business through employee share schemes. And in that webinar, we're drilling into matching share plans, with the strategic objectives, understanding the pros and cons of share plans, how to get the structure, right critical background work, operational considerations going forward, and lots of implementation tips and tricks. Now if you want to register for that webinar, then simply check out the show notes where we have a link straight through to the webinar registration page. Of course, it's free, so why not? Why not register, and if the webinar time has passed, don't worry, we will have an on-demand version for you. So just check out the show notes for that. Now if you'd like more information generally about this topic, then head over to our website at www.thedealroompodcast.com where you'll also be able to download a transcript of this podcast episode and of course there you'll be able to find details of how to contact Rod Hore at HHMC global and you will also be able to find out how to contact our legal Eagles at Aspect Legal if you or your clients are interested in setting up an employee share scheme or indeed if you would like to have one that is set up reviewed, we've got a range of services to help guide businesses both large and small through this area. And of course, we also provide advice on how to make sure you're protecting yourself best at the exit when setting up these schemes. And finally, if you enjoyed what you heard today, then don't forget to pop over to your favourite podcast player, hit subscribe and maybe even consider leaving us a review. Well, thanks again. You have been listening to Joanna Oakey and the deal room podcast, a podcast proudly brought to you by our commercial legal practice Aspect Legal. See you next time.

Joanna: If you'd like to find out more about how to add value to your business through employee share schemes, then make sure you register for our upcoming webinar with Rod Hore and me to talk about employee shares. We talk about matching share plans with strategic objectives, understanding the pros and cons of getting the structure right critical background work and lots and lots of implementation tips and tricks. So please make sure you hit the registration link in our show notes or over at our website talking law.com.au and there if you have missed the webinar, you'll also find details of how you can catch up into the future and get a copy of the on-demand version.