Swapping Debt-for-Equity

Transforming ownership to ease the Covid SME debt burden, protect jobs and create an inclusive economy.

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Social Investment Business

Executive Summary

Social Investment Business has been running a campaign to explore ambitious solutions to the unmanageable levels of debt facing SMEs as a result of Covid-19. Businesses have taken on a huge amount of debt since the onset of the pandemic, much of it through government-backed loans such as the Coronavirus Business Interruption Loan Scheme (CBILS) or Bounce Back Loan Scheme (BBLS).

Unsustainable debt is set to reach up to £70bn in 2021 and small businesses are estimated to incur half of this debt. We are concerned that as many as 250,000 businesses are in danger of folding over the next year. One third of SMEs have increased their levels of debt and are carrying an average of £173,000 additional debt to service annually – of these businesses, four in ten owners say that this debt is unmanageable.

The need for debt relief:

We are most concerned about areas that are facing a 'perfect storm' of (i) poor or sluggish recovery in economic activity (ii) high proportion of staff on furlough and (iii) high levels of government-backed debt through CIBLS or BBLS. As the various business support schemes have tapered or closed at the end of the year and the scale of the business debt burden becomes clearer, these areas could see a marked increase in unemployment and business insolvency. This could create long-term scarring in the places and communities that were already struggling before the pandemic and present a serious challenge to plans for levelling up the country.

Our analysis of the data shows:

- **There are significant geographic disparities in the economic impact of Covid**: The constituencies that have experienced the greatest economic damage over 12 months are generally concentrated in London, the South East and East of England – although there are also deep recessions around other urban centres across the rest of the country.

- **Some sectors have been hit significantly harder than others:** Businesses that relied on visitors or in-person services – hospitality, leisure, arts, recreation and other service activities – have suffered a sustained hit to their turnover, sales and employment. These businesses will be entering the Covid-19 recovery period in a substantially more precarious financial situation compared to other sectors.

- **The concentration of debt is evenly spread across the country**: there is relative heterogeneity in the regional distribution of CBILS/BBLS loans. While the highest levels of debt are in London and the North West, and there are certain hotspots of high indebtedness around other urban areas, there is no clear regional distribution to the levels of government-backed debt.

- **However, the most at-risk constituencies are heavily concentrated in the North West, London and West Midlands:** when debt is combined with additional compounding economic pressures – including the local recession, cumulative furlough uptake and deprivation – it reveals a set of places that are at serious risk of long-term scarring. Constituencies in the North West, London and the West Midlands account for almost two thirds of the 20% most at-risk constituencies.

- **Urban areas – particularly those in core cities[1] – are at significantly higher risk than rural areas**: based on our analysis 9 in 10 of the 20% most at risk constituencies are in either a city or large town – with constituencies in the core cities and London alone accounting for 4 in 10 of the 20% most at-risk constituencies

The opportunity:

We are interested in interventions that can reduce the debt burden while also driving improvements in the economy and society. The scale of Government backed lending presents a rare opportunity to think about ways of providing debt relief, while also encouraging alternative ownership models like employee, worker or community ownership. This has the potential to ease pressure on SMEs, protect jobs and create a more inclusive and social economy. We also hope to build mainstream recognition that investment in alternative ownership models is an effective pathway for levelling up the country, and through that start to mobilise greater levels of capital to support the growth of these high impact businesses.

There have been calls for wholesale debt write off from various parts of the business community. Whilst this might be a preferable option for business owners, it would also see vast amounts of public money lost without any widespread improvements to business governance or employment terms and conditions. The real opportunity is to find a solution that can both provide urgent debt relief and simultaneously create a more democratic and social economic system, either through wholesale alternative ownership transition or through a partial conversion / hybrid model.

Why alternative ownership?

There are several alternative ownership options – each of which can be adapted to suit the most appropriate legal and governance structures for businesses, employees and their wider stakeholders

- **Direct, indirect or hybrid employee ownership** – through an Employee Ownership Trust model and/or hybrid employee shareholding schemes.
- **Worker cooperative** – workers own and control the business, participating in decision making and benefiting from its financial success.
- **Community business** – a locally rooted enterprise that is accountable to the community (via direct ownership or through its governance) and generates profits that deliver positive community impact.

[1] Core cities: London, Birmingham, Glasgow, Liverpool, Bristol, Manchester, Sheffield, Leeds, Edinburgh, Cardiff, Nottingham, and Newcastle-upon-Tyne – based on the House of Commons Library's [City & Town classification of parliamentary constituencies].

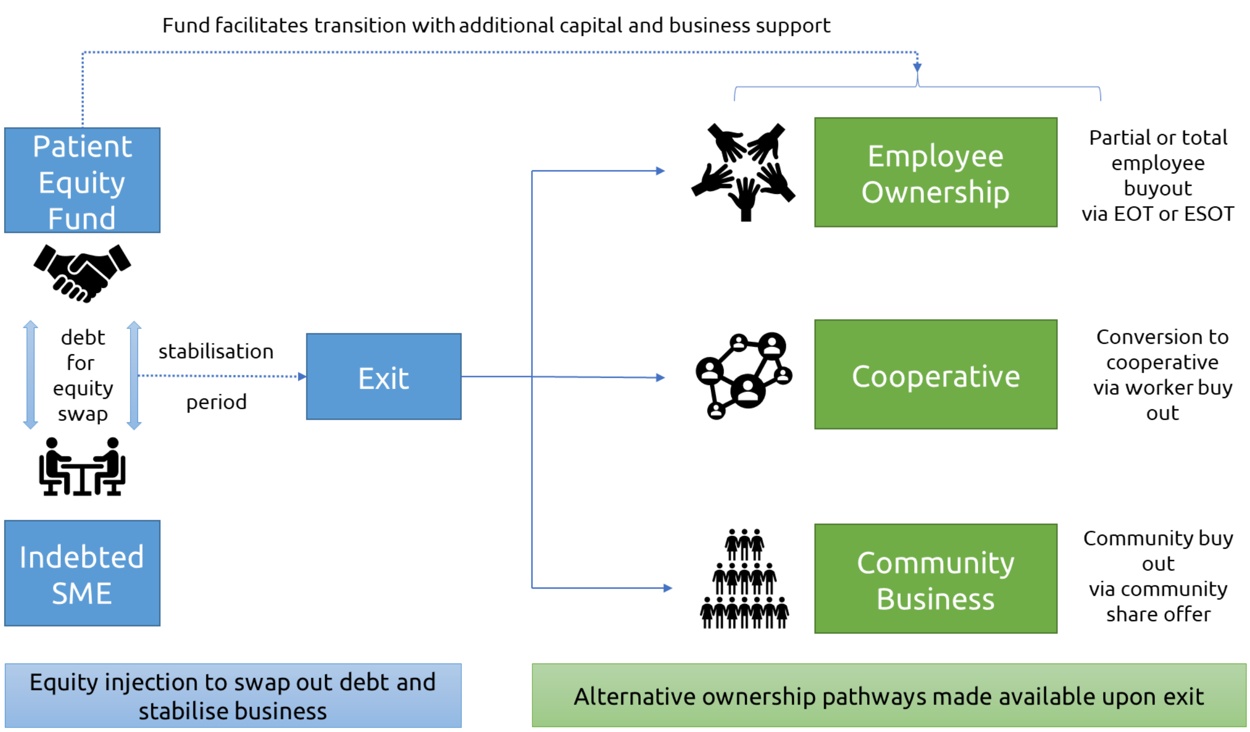
Expanding alternative ownership would have a demonstrably positive impact on businesses, employees and the wider economy. These models have been shown to improve firms' economic performance and resilience, enhance employee satisfaction and reduce inequalities, and strengthen communities in which they operate.[2]

Debt-for-Equity Mechanisms:

During the campaign, SIB hosted two roundtables to discuss the feasibility and design of this kind of debt-for-equity swap – these were (i) a 'patient equity' model bringing together a consortium of investors and (ii) establishing government-backed Employee Ownership Trusts as part of a comprehensive debt relief scheme.

Option 1: Patient Equity Model:

The Fund makes an equity injection into an ordinary company, followed by a transition period where alternative models can be explored. It provides flexibility and wide targeting remit for SMEs, without being too prescriptive on the transition pathways (e.g. employee ownership, worker cooperative, community business or other hybrid shared ownership model). A patient equity approach would allow for repayments to be made when possible, giving time to facilitate conversations with business owners on alternative models and their respective benefits. It could then provide different pathways for businesses that would like to convert straight away, and those that might come to appreciate the value of doing so over time.



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[2] The Employee Ownership Association, Cooperatives UK and Power to Change have published substantial amounts of data and evidence on the economic and social benefits of employee, worker and community ownership models respectively.

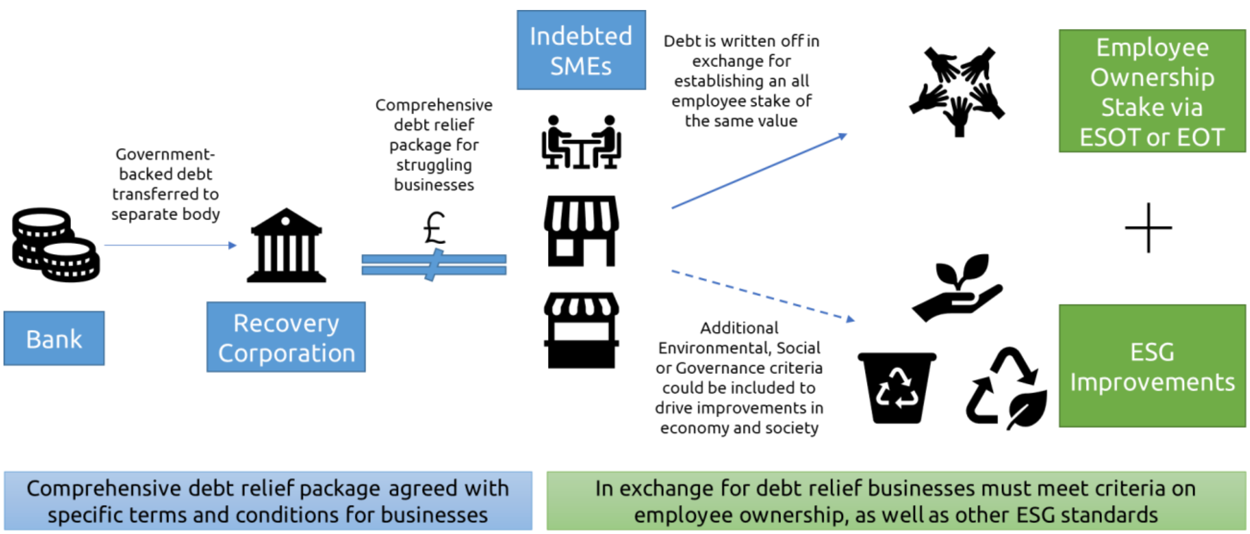
Option 2: Government-backed Employee Ownership Trust:

Employees take a stake that is equivalent to the value of the Government-backed debt. Through this mechanism, employee motivation is super-charged to ensure the business survives and succeeds. If that works, all stakeholders benefit:

- The business can repay the debt, taking it off Government's balance sheet
- The employees hold a stake in their business which enables them to benefit through sharing profits - ideally that stake is accompanied by the other benefits associated with employee ownership (sharing information and influence)
- The business owner has given up ownership of part of his business – but in return the business survives and grows (in part because of greater employee motivation) – and the new internal shareholder is patient (i.e. not driving an early exit)

On the other hand, if the business fails, government and business owners lose what they would have lost anyway, and employees are not out of pocket.

This could be implemented as part of a wider government-backed debt-relief scheme – perhaps as one pathway for business to choose. The debt relief scheme could also include additional conditions to drive improvements in the business' environmental, social and governance standards.



The two options both have potential – albeit with different sets of stakeholders involved – and could even run in tandem. The patient equity fund would bring in capital from a variety of different sources and offer flexible pathways to suit SMEs that are open to a more substantive alternative ownership transition (although this may not be appropriate or desirable for all businesses). On the other hand, the EOT option would require more significant government involvement, and could be offered as part of a wider debt relief scheme that aims to drive improvements in the economy and society.

The debt-for-equity proposal outlined in this paper has the potential to not only support a swift recovery from the pandemic by providing much needed debt relief to businesses, but also to turbocharge the Government's levelling up agenda by empowering the workforce, democratising corporate governance and including more people in the wealth creation process.

Key Recommendations:

Banks, funders and social impact investors:

1. Build the impact case for investing in private businesses to protect jobs and provide good employment in areas of deprivation and/or sectors with endemic job insecurity.

2. Establish impact funds that focus on supporting alternative ownership models, bringing together private equity and institutional investors who are seeking both social and financial return and social and philanthropic funders, particularly as part of a place-based programme to level up deprived areas.

3. Pilot a patient equity fund with a consortium of investors across the spectrum of capital that will support at-risk, yet viable, enterprises transition to alternative ownership models.

Government:

4. Establish an arm's length body to hold and manage bad government-backed debt and provide a comprehensive and conditional debt relief package for struggling businesses with a dedicated employee ownership pathway.

5. Establish a new Alternative Ownership Unit across BEIS and DCMS to support the growth of alternative ownership models – including funding to support technical and legal costs associated with transition.

6. Recognise through both economic policy and industrial strategy the value of alternative ownership models as an effective vehicle for turbocharging the Covid-19 recovery and supporting levelling up agenda.

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