

Our mission is to shepherd as many business owners as possible to fulfillment of their goals and their ideal lifestyle.

.....



BUSINESS WEALTH SOLUTIONS, LLC

Joan M. Ridley
Pres., CFP™, CEPA, CBI

2911 Turtle Creek Blvd., Suite 300
Dallas, Texas 75219

E-MAIL: info@businesswealthsolutions.net

PHONE: 214.692.9192

FAX: 214.523.9001

Will Your Employees Buy Your Business and How Will They Do It

By

Joan M Ridley, CFP™, CEPA, CBI

Many business owners work day in and day out focusing on the issues at hand but not paying much attention to how they will eventually leave. If you have not given it much thought, or if you are **assuming** that someday you will sell it to some outside party, you might not be aware of how attractive or unattractive your business is from a buyer's viewpoint. It would be a mistake to think that because you are making a nice living, someone will want to buy it. However, your employees might be interested, and, if you have not properly prepared the business for a sale to an outside third party, they might be your only option. There are pros and cons to selling to employees. Here are a few:

Pros

- Reduced confidentiality concerns
- Employees understand your business and industry
- Employees know its strengths and weaknesses
- Continuity- your customers and vendors know your employees
- The satisfaction of knowing that your employees will still have a job

Cons

- Employees rarely can pay top dollar, or even a fair price
- Employees usually lack collateral to borrow from a bank
- Employees, or their spouses, have competing priorities for their liquid funds
- Their spouses don't want the risk of entrepreneurship
- You will probably have to finance the sale
- Your equity is at risk until they retire the note
- You might need to groom employees for ownership
- It usually takes longer to prepare to sell to employees
- You might have to foreclose on employees' collateralized assets
- Employees might not be credit worthy

Our mission is to shepherd as many business owners as possible to fulfillment of their goals and their ideal lifestyle.

How to sell to employees if you still want to move forward

Your goal is to develop a company that can run without you. If you were to take an extended holiday, say a year, with no contact whatsoever with the company, and return to a higher company value than when you left, there is a good chance the company can run without you. If you wince at the very thought of being away for an extended period of time, then you have work to do.

Here are some areas to focus on

- Customer diversification
- A well-functioning management team beyond technical knowledge employees already possess
- A well-designed and properly funded employee performance incentive plan
- A well-designed and properly funded key person post exit retention plan
- Impeccable financial record-keeping
- A well-documented work process
- A healthy and growing bottom line year in and year out
- A unique feature that or some other feature that your competitors want
- A competitive sales team
- A well-functioning sales management system
- A team of professional advisors for whom you are in their sweet spot
- A well-researched strategic plan supported with sound financial projections
- Non-compete and/or non-solicitation agreements signed by all employees
- A fail-safe hiring process - you could be hiring your future acquirer(s)
- A properly drafted and funded emergency operating plan
- A properly drafted and funded buy-sell or shareholder agreement
- Your mental preparedness and ability to give up control

Preparation is the key

Put together a plan of action that outlines what each employee needs to achieve with a specific date for achieving each goal, whether or not he will be acquiring any interest in the company. In many smaller companies, some employees will wear two hats. One might be involved in the

Our mission is to shepherd as many business owners as possible to fulfillment of their goals and their ideal lifestyle.

development of the service or product that the company provides for customers. The other has to do with the actual running of the company. However, those who will assume management or leadership responsibilities will need to understand at least the basics about running a business, depending on their new roles after you pass ownership to them. Those at the top will need to understand the basics of sales and marketing how to read financial statements and other performance measurement tools, and, they will need to know how to manage people and be able to hire and fire. The most important decision is who will replace the current owners who often perform multiple tasks. You will need to decide functions to outsource and where to find the talent. Be honest with yourself. If you even question your own ability to effectively run a business, for whatever reason, or, if you lack the time to train employees, retain an outside expert to help prepare them to be business owners.

Strategies for Ownership Transition

If your employees have sufficient cash for a down payment and are able to borrow the remainder of the sale price from a bank, or if they purchase your business with a private equity group (see below), you can expect to immediately transfer 100% ownership to the new owners. If the employees cannot secure outside financing, you will need to finance the sale. Understandably, you might not be comfortable turning over ownership of your business to your purchaser-employees until they have satisfied the note that you hold. Consider the following ways to address this situation:

Performance bonuses and non-qualified deferred compensation plans

Set up a short and long term performance incentive bonus program where the short term bonus rewards each employee when he achieves his individual performance benchmark. Establish a long term bonus plan that bonuses the employee when the company achieves increasing profitability benchmarks. The former can be paid currently and the long term bonus can be set aside in an account for him to use for a down payment or the entire purchase amount when he purchases the business from you. The purchase agreement needs to be carefully drafted and contingent on the employee(s) achieving the stated performance standards before you actually transfer ownership to him(them). All employees need not be included. Bonuses need to be self-funded which means that the employee does not earn a bonus unless the company earns far more than is being paid to them. The benefit to the company is that it is growing in value as a result of the employees' efforts. As company profitability increases, it is likely that the multiple of the bottom line will increase as well, resulting in increasing value.

Vesting and payment schedules, along with forfeiture provisions are needed to protect the company, long after the company changes hands. A forfeiture

Our mission is to shepherd as many business owners as possible to fulfillment of their goals and their ideal lifestyle.

clause along with other necessary documents, such as an employment agreement with a non-compete or non-solicitation clause, can deter an employee from leaving and setting up a competing business with his deferred compensation funds. The ideal funding account is life insurance with rapid first-year cash value build-up. This strategy is far more complicated and regulated than is represented here so be sure to engage an experienced corporate attorney, corporate tax advisor, and a business insurance advisor to help you plan, draft, and fund the necessary documents.

Employee Stock Ownership Plan

If your company qualifies, an ESOP might be a good strategy. Basically, the business owner borrows from a bank and loans the money to an employee stock ownership trust which purchases stock from your company and makes an annual contribution of shares to the employees' retirement plans. You pay no tax on the sale of the stock in your company when you sell the shares (if you comply with all the rules). There are other tax benefits available only to ESOP transactions. The catch is that you and your company need to be well-qualified: at least 20-25 full time employees; at least \$20MM in annual revenues with a sound plan for increasing sustainable cash flow (less if revenues and profitability are growing rapidly); a strong management team that can run the company without you; and you must have the demeanor to handle a complicated transaction and process, including complying with numerous, unbending laws, rules, and regulations. Many companies might not qualify because they are in cyclical industries. You can start by selling only 30% of your company.

Be prepared to invest in a quality feasibility study before establishing an ESOP. If that makes you uncomfortable, stop right there. It's just the beginning of expenses you will encounter, many on an annual basis. Be aware that selling to a third party after a portion or all of your company is owned by an ESOP can be done, but is far more complicated than selling to a third party before you establish an the ESOP. While you can have significant influence over the trustees, ultimately they have a fiduciary responsibility. Their decisions must protect the financial health of the company and the employees who are the beneficiaries of the trust. Self-dealing, such as excessive salary and perks for you, are out of the question.

Management Buy-Out funded by private equity group

If you meet the criteria of a private equity group (PEG), this could be an excellent way to include your key people in the new ownership scheme. The PEG would acquire controlling interest in your company. Management could acquire an interest, but usually no more than 25%. Usually management has a smaller ownership interest with an opportunity to increase its share in the future, but rarely beyond 25%. Every PEG specializes in specific industries and has specific criteria in terms of what

Our mission is to shepherd as many business owners as possible to fulfillment of their goals and their ideal lifestyle.

it is looking for. A healthy bottom line, a unique product or service that it manufactures, or, a specific industry sector are a few examples. A minimum EBITDA of \$2MM is a common requirement. Service type businesses, except for some in the health care or oil and gas industries, would not be attractive acquisitions, especially if they cannot function without the owner(s). PEGs tend to favor manufacturing. They usually keep their acquisitions in their portfolios for a planned number of years, doing what they need to do to maximize value, and then sell them off. Besides having cash to make acquisitions, they contribute additional funds and expertise to grow them. Management, your former employees, could make more money in the long run if they meet performance benchmarks, but could be penalized or booted out if they don't.

Control your future by maximizing your options

Selling to your employees can be a good strategy for many reasons, but the best reason is when you have several options, and, if this truly is your strategy of choice.

Joan M. Ridley is president of Business Wealth Solutions, a Dallas-based advisory firm that consults with business owners about how to successfully leave their business. Visit our website at www.businesswealthsolutions.net. Call us today at 214.692.9192 for a complimentary meeting to learn how we can help you get where you want to go. Ask for our complimentary brochure.

Copyright 2011 Joan M. Ridley