by Dyanne Ross-Hanson

Is selling to key employees a pipe dream or do-able?

BABY BOOMER business owners are transitioning ownership of their companies in record numbers over the next five to 10 years. And statistics state that 75 percent of them who sold their companies reported having post-exit remorse.

One reason may be that, given the choice, many owners would prefer to hand the baton off to their key management group. Why? There are several factors cited for this preference:

- They want to reward their employees for their loyalty and service.
- They want to protect and preserve company culture for benefit of their employees and customers.
- They want to sell "as is" with no pre-sale preparation, while retaining marketplace confidentiality.
- They want to remain an employee of the new owner, on their own terms.

This article will explore the greatest challenge faced by key management as buyers: lack of capital and access to it. It will include transition strategies that have proven successful and affordable. Of course, all of this is predicated on the presumption that key employees are both capable and willing to assume leadership of the business. And, that the owner is ready to transition ownership. And, that a purchase price has been agreed upon.

Short of a cash pile, equity in a residence or a rich relative interested in financing the sale, key management have several financing options available. Qualifications, cost, risk, terms and equity share are just a few of the considerations required.

Financing options

Bank loan – senior debt is the most flexible of debt-only financing options. It can provide short-mid-long term financing if cash flow of the business is sufficient to repay loan interest and principal over the loan period. The loan is secured by the assets and stock of the business and the personal guarantee and collateral (usually residences) of the buyers.

Small Business Administration (SBA) loans are an option for buyers that may have difficulty qualifying for a traditional bank loan. SBA loans are federally sponsored debt-financing programs, that can loosen the flow of credit by guaranteeing the lender against a portion of any loss incurred on the loan. As with any government-subsidized aid, expect regulations, restrictions and rules to apply.

Subordinated debt is debt that ranks

tips

1. Incentive bonus plans offer a mechanism to reward key performers, based upon the attainment of pre-determined financial metrics, with cash or stock.
2. If properly designed, the bonus is financed entirely from increased profits/value, generated by key managers' efforts.
3. Should either be absent, then too, is the award!
4. The annual award can be immediate or deferred for future payout, subject to a vesting schedule, if desired.
5. Deferral serves to retain key managers with the company, until the owner is willing to share equity, along with the nuances of a minority shareholder.

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after other debts, if a company falls into liquidation or bankruptcy. It relies on positive cash flow rather than a first position on hard collateral, and refers to the layer of financing between equity and bank debt. It is typically utilized by individuals and companies that require capital but lack the assets to secure financing from the bank. Subordinated loans are typically a higher cost of borrowing than senior debt and SBA loans.

Mezzanine financing is like subordinated debt; however, it adds an equity or quasi-equity bonus to the return requirement. It is a hybrid of debt and equity financing that gives the lender the rights to convert to an ownership or equity interest in case of default. Mezzanine is more expensive than traditional debt, but it is not as strict. It is also less expensive than issuing equity where private equity investors target an internal rate of return (IRR) of more than 25 percent.

Private equity (PE) firms are financial buyers that typically raise funds via general partnerships from institutional-type capital sources such as pension funds, endowment funds, family offices, and high-net-worth individuals. Their objective is to identify and invest in companies that they believe have room for growth via capital influx, strategic direction, industry experience and access to customers. They invest for up to 10 years, then divest, ideally with a handsome internal rate of return for their investors. Caveats include temporarily answering to a "new boss" and having to reach $10M+ in value before attracting this type of capital.

Should the idea of amassing significant debt and/or equity partners lack appeal with key managers and/or sellers, other financing arrangements exist. These may take the form of seller-financing. But be not afraid. (See www.upsizemag.com, 'Seller financing not to be feared when planning firm's sale.')

Alternative purchase strategies

Employee Stock Ownership Plans (ESOP) offer a viable solution to share equity with key managers, and the rest of your employees, while offering significant tax benefits to the seller upon sale. The strategy can be complex and requires a strong, sustainable cash flow to succeed. In addition to the tax benefits associated with sale proceeds, an owner gains immediate cash payment and possibility of departure.

Incentive bonus plans offer a mechanism to reward key performers, based upon the attainment of pre-determined financial metrics, with cash or stock. If properly designed, the bonus is financed entirely from increased profits/value, generated by key managers' efforts. Should either be absent, then too, is the award!

The annual award can be immediate or deferred for future payout, subject to a vesting schedule, if desired. Deferral serves to retain key managers with the company, until the owner is willing to share equity, along with the nuances of a minority shareholder. This strategy lends itself to a gradual sale/transition and continued owner involvement. It often forms the foundation for key employees to meet collateral and leadership requirements to qualify for bank financing, and with it, the ability to complete a stock purchase.

New entity formation is a strategy commonly used within the construction, architectural, engineering and manufacturing industry, but may be applicable to any. Benefits include a gradual transition of ownership without selling stock, staged tax obligations, minimal outside capital required, key employee retention and mentoring, operational risk transfer and finally, flexibility with regards to the owner's control, participation and profit split. Like an ESOP, this strategy can be complex, but may offer an ideal solution for transitioning ownership to key employees.

If handing the controls over to key employees is an objective, understand that it is absolutely "do-able" and indeed, profitable. Start planning early, five to seven years in advance, know your "number" required to attain financial freedom, mentor your successor's talent/risk tolerance, understand transition strategies and their implication for payment, taxes, control, continued involvement, etc.

And don't forget the importance of surrounding yourself with experienced, objective expertise.

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