Can You Afford To Sell To Your Employees?

Business owners often tell us that, in an ideal world, they would sell their businesses to their loyal, dedicated employees. However, they frequently dismiss this option because their employees typically don't have enough money to buy the business. They know that because business owners are the ones who set the salaries of their management teams. What most business owners don't know early enough is that there Is a way to put this options back on the table.

Let's take the example of Joe Williams, the fictional owner of fictional company, Williams Scientific, Inc., a 30-year old equipment distributor. Joe's management team was capable and interested in buying the company, but is often the case, did not have the capital to purchase it. The business had little debt and good cash flow.

When Joe confided in his advisors at an annual planning meeting that he had always hoped to sell his business to his employees but just did not see a way to make that happen, one of their first questions was, "When do you want to leave the business?" If Joe had answered, "Yesterday!" a sale to employees who lack cash would have been extremely risky. If Joe's answer was, "I'd like to be out —both financially and as a participant in management —in five to eight years," a well-designed plan would have made that happen.

The Elements of a Good Plan

A solid buy-out plan, regardless of the buyer, should accomplish three goals:

1. Minimize the risk for the owner, the business, and the employees by keeping the owner in control of the business throughout the multi-year sales process.
2. Ensure that the owner sells for the full value of his or her ownership interest.
3. Allow the owner to stay in full control until full value is actually received.

Unless a buy-out plan meets these goals, owners would be wise to reconsider selling their companies to their employees. If, on the other hand, owners plan and begin to execute a transfer plan well in advance of departures, they can achieve these three goals. Of course, special planning is required to meet income tax minimization.

The Secret? ...Time

A plan to execute an employee buy-out has two major steps.

Step 1: Sell incremental shares of ownership for a reasonable, or even conservative, price over several years, each for a promissory note at a reasonable interest rate. Employee purchasers pay down the note balances with some combination of earnings, bonuses, and ownership distributions or dividends from the ownership they've acquired thus far. After a few years (depending on the company's ability to produce cash flow), the employee purchaser will own a portion of the company free and clear. During this period the owner usually reduces involvement and delegates more responsibility to the successor owners.

Step 2: Assuming the business continues to be profitable, paid-up owners of 30-40% of a company can present themselves as strong, stable and wellprepared buyers to secure bank financing to purchase the remaining balance of the owner's stock.

Following this strategy, Joe's buy-out plan kept him in full control of his business until he received all of his money. Because he maintained control, he significantly reduced the risk of not receiving his full value. He successfully cashed out of his business because he did not wait to begin his transition planning until he was ready to leave. By starting before he was actually ready to leave, he was able to choose his successor, exit on his own timetable, and leave with the cash he wanted.

Caveats

1. This plan does not work for all businesses, but can work well for companies valued between $500,000 and $5 million and, in some cases, even more.
2. Executing the plan takes time, usually at least five years to allow the employees to purchase a significant share of the company.
3. This plan requires a cooperative bank aware of the owner's intentions well in advance of the transfer.
4. This plan requires a strong management team interested in owning a company financially fit enough to allow most of the available cash flow to be used to pay off the purchase debt.

This plan typically requires a company with earnings stability or predictable earnings. Companies on "boom or bust" or "feast or famine" industries present excessive risk for both the seller and buyers.

For more information or to learn how L. Harris Partners can help you plan your exit:

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