SELLING YOUR COMPANY TO YOUR EMPLOYEES

by David Ryan

For owners who want to sell their business, their first inclination is to reward their loyal employees. I frequently hear the statement, "I want to sell my company to my employees!" **If they want to buy the business and if they are capable of managing it, a business owner and their advisors can make the deal happen.** However, the fact is that if your employees were driven to own a business, they would probably not still be on your payroll. Think back to your previous employees. Have any of them left your company and become competition? While loyal employees are an asset to any business, they might not have the skill set or drive to move into the role of ownership.

Purchase price breakdown	Business valued at		
	Under $500K	$500k to $1M	$1M to $5M
Buyers Equity	67%	44%	40%
Senior Debt	16%	42%	40%
Seller Financing	14%	13%	14%
Earnout	1%	1%	4%
Other (Seller Retained Equity/Mezzanine Financing)	1%	0%	2%
Total purchase price	*100%*	*100%*	*100%*

TABLE 1: DEAL STRUCTURE

Another fact to consider is the financial aspect. Many employees simply do not have the capital necessary to purchase an existing business. So how are buyers and sellers structuring business purchases in today's market? The Market Pulse Survey's data compiled for 12 months ending June 30, 2015 shows how the purchase funds are obtained, based on the purchase price (Table 1, left).

When the purchase price is over $1 million, this data indicates that a typical buyer would borrow about 40% from their bank and put about 40% of their own cash down. In addition, the buyer would ask that the owner provide about 20% of the purchase price through seller financing. This would involve the seller carrying a note or agreeing to earn-out terms. An earn-out scenario would require payments to be made to the seller with the condition that specifically outlined events happen in the future. For example, the earn-out payments could be based on achieving a certain level of sales or maintaining a certain client relationship for a specific time period.

Imagine you were asking for $1.8 million or more for your company. According to recent data (table 1), the marketplace would require that your employees bring $720,000 dollars of their own capital (40% of $1.8 million) to complete the transaction. Does the employee or group of employees have that capital on hand? If they do, the next question is to find out if they are interested in investing in themselves by becoming business owners. Let's illustrate the potential purchase options by means of a business owner named Ken.

Ken's transaction illustrates several typical problems with selling a company to its employees. Ken offered his company to his employees for a purchase price of **$1 million**. However, the employees could not reach a consensus on a plan to obtain the necessary capital. They lacked a clear path to follow because none of the employees had ever purchased a company before. At the same time, Ken was a first time seller, so he had little guidance to offer. As a result, the process languished and frustration mounted on both sides.

Can you see yourself in this situation? When the buyer lacks a plan to obtain capital, as well as a clear plan for defining the purchase terms, the seller might find themselves in the position of holding onto the business longer than anticipated. Ken ultimately decided to hire a consultant to assist the process.

One of the first things I discovered is that no one had done a complete analysis or recasting of the company's financial statements. Ken was running his company as an entrepreneur. This meant he was minimizing his income and taxes as much as possible. This is a very common practice in small businesses and it can make good sense—until you try to sell your business!

I began recasting his financial history for the prior three years. The result was a presentation of what his company's finances would be if the company were operating in a public market versus private ownership. After showing Ken these details, he had a better understanding of the value of his asset. He also came to the realization that his employees did not have the leadership or financial means to purchase the company.

The final transaction benefited all the parties involved.

In the end, another buyer (a public company) stepped in and Ken's company sold for more than $12 million. Not only did we provide Ken's employees with some great opportunities, the public buyer was able to take its initial step of expanding to California where Ken's company was located. The final transaction benefited all the parties involved.

Though Ken's example ended with the employees not being the final buyer, in a different transaction we were able to structure a deal that worked for one of the company's employees. In this instance, the company's two shareholders had invested over two years in trying to sell the business to their key employees, but had little to show for it. The owners wanted to retire, but felt they would never get a transaction structured with the current employee as the buyer. Throughout the long negotiation process, the current owners had come to believe that the employee did not have the desire or drive to purchase the business. However, their attempts to sell the company to a competitor were also unsuccessful.

They then decided during our consulting process to take the company to the public market. In a short time, a number of interested buyers were found and several proposals were presented. The offers ranged from $1.5 to $1.8 million. Most of the potential buyers were individuals that wanted to buy a small manageable business. According to the Market Pulse Survey, the most likely buyer of a business under $1 million will be an individual looking to "buy a job" (Table 2, right).

	Under $500K	$500k to $1M	$1M to $5M	$5M+
Buying a job	51%	46%	22%	5%
Vertical add-on	10%	13%	16%	17%
Horizontal add-on	17%	18%	27%	49%
Better ROI than other investment	10%	11%	22%	12%
Other	12%	12%	13%	17%

TABLE 2: REASONS THAT BUYERS BUY A BUSINESS

If you follow the typical terms indicated in Table 1, however, the buyer pool is limited to those that have $720,000 in capital (for a company valued at $1.8 million). This amount was out of the employee's range, thus contributing to his reluctance to sign on the dotted line. Yet the owners knew that because of his long history with the company, he would care for the business, its employees and of course, their customer base. His abilities weren't in question, but the financial structure was proving to be the true hurdle.

This is the point when a buyer and seller have to be smart, but also creative. All the offers had the business owners providing a seller carryback note or an earn-out contingent payment covering a portion of the purchase price. Additionally, the buyers wanted to structure the sale in a way that would have ended up causing tax problems for the sellers.

So I presented to the owners with a transaction utilizing SBA financing, which requires only 25% down payment versus the typical 40% for traditional commercial lending. Additionally, with the proper structure, the carryback note could be a portion of the 25% down payment. After comparing this structure with the other offers, the owners saw they could get market value and have the structure be tax efficient, thus improving their net proceeds. At the same time, these terms made it possible for the employee to complete the purchase.

In the end, the transaction could be structured to reduce the sellers' income tax bill by an amount that was comparable to the seller note, reducing their overall risk. The structure also netted more cash at closing than would have been possible with one of their other offers.

Without the right financial structure, the business could be put at risk because of an unnecessary tight cash position.

The owners agreed to the plan. The final transaction was ultimately structured to allow the employee and a friendly competitor to combine forces to complete the purchase. The buyers brought in 10% of the down payment, with the sellers holding notes equal to the other 15% of the down payment. Additionally, by using an SBA lender, the amortization period was longer in comparison to a commercial bank. Thus, the company benefited from the added cash flow in the future.

This brings up another important point, which is the financial structure itself. Without the right financial structure, the business could be put at risk because of an unnecessary tight cash position. There are many unnecessary risks that can extend beyond the time frame most sellers envision when considering a potential sale.

In this particular example, the new owners were already familiar with the customers and the employees, making for an easier transition with minimal risk. The sellers knew they received a fair deal because of the offers received. At the same time, the buyers knew it was a fair price because of the other offers, as well as the SBA required outside valuation which confirmed the valuation.

In conclusion, an outside specialist who knows the "ins and outs" of the process and what resources are available to complete the transaction can assist in structuring a deal that both parties can get excited about.

If you are interested in selling your company, give us a call to discuss your circumstances and possible options. All communications will be kept strictly confidential and there is no charge for our initial meeting. The best way to reach me is either by phone at 707-523-9651 or by email at david@uptonco.com.

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