The Exit Strategies Newsletter

NO EXIT IS A PANACEA: THE PROS AND CONS OF INTERNAL TRANSFERS

Many owners know in their hearts that they built their businesses to create a legacy. Their companies do important work in a unique way with a team that they hand-picked and groomed over many years. These business owners take a parental view of the business, caring for it and the employees, always building upon the strengths and core values of the company. The business provides a nice lifestyle for these owners as well as a strong identity in their community. To say that the business provides much more than simply surplus cash flow would be an understatement.

For these owners it is somewhat inconceivable that an outsider would own their business. Therefore, these owners spend time giving careful consideration to the internal transfers that are available to them and how to empower their managers with future ownership.

There are three (3) primary methods of transferring a business internally. First is a management buyout, next is an employee stock ownership plan (ESOP). And finally, there is the option of gifting ownership to family and others, which this newsletter will not cover as gifting strategies do not generate a 'buyer' for company shares.

This newsletter reviews the pros and cons of each of these internal transfers, providing insights into what details owners should focus on when considering a transfer to their current employees (and/or family).

Let's begin with the idea that your managers will buy the business from you.

Management Buyout

So you look to your management team and think that your transition out of the business may best be handled internally and privately by selling to your managers. You are willing to give the managers a fair shake so long as they can behave like owners and make their payments to you. After all, you got these employees to help you grow the business successfully, why not just reshape your coaching and get them excited about buying you out?

Three (3) Big Benefits to Internal Transfers

There are three (3) major benefits.

First, you provide an opportunity to the people closest to you to own and run your business into the future.

Second, by transferring internally to your managers, you get to avoid the incredible disruption that often accompanies a sale to an outsider.

And, third, you get the flexibility to structure a transaction that is tailored to your personal timing, needs and, perhaps, has a high degree of tax efficiency.

All of these benefits sound wonderful but they come with a very large assumption – namely, the fact that the business will continue profitably without you.

The Cons of an Internal Transfer

What price might you pay for this internal transfer? Well, it all depends upon whether your managers will step into their role as leaders for your organization.

In order to navigate today's complex business world, your managers need to switch from a manager's mindset to an entrepreneur's mindset. This is of paramount importance because you need to have a high degree of confidence they will continue to run a successful company (here we are assuming that the managers don't have a financial sponsor and that your financial readiness is such that you are depending upon the proceeds of this exit for your post-exit lifestyle).

The Hidden Dangers

If you make it past the idea that your managers will act responsibly as owners, you then need to ask another series of questions that could be potential negatives to this transaction:

- Will you be able to come to a price and terms agreement for the sale?
- Will the managers want to sign personally for credit lines and take other risks like you did?
    - A subset of this question is whether the manager's spouses' will be comfortable with taking these risks.
- Will the managers see this sale objectively or will they think that you overcharged them for the business?

If you have difficulty answering these questions, a large negative to this transaction includes the fact that a failed transaction may cause irreparable damage to the relationship with your managers.

So, many owners will consider these issues and then take a first step towards a future management buyout by initially selling some stock to an employee stock ownership plan, or ESOP.

Employee Stock Ownership Plans (ESOP)

An employee stock ownership plan or ESOP is best seen – at least in the context of this newsletter - as a first step towards an internal transfer. An ESOP [trust] can be created to purchase shares from an exiting owner and, like the management buyout, the cash flows of the business will make the payments to fund the purchase. Like a management buyout, the ESOP is an 'internal' transaction. However, unlike a management buyout there are potentially great tax benefits to an ESOP.

<u>The Pros</u>
ESOPs are far too complex and applicable to too many situations to completely list the benefits here. However, some of the key features are:

- The creation of a buyer for shares of stock,
- An internal transaction – privacy is maintained,
- Tax deductions are available (which can be very meaningful),
- It can be a first step towards liquidity and future ownership of the business by the manager.

An ESOP can serve as a great tool to begin your succession and exit planning . . . but there are pitfalls to watch out for.

Like all transactions the ESOP is not without its limits and downsides. Some of the key areas to watch out for include:

- A leveraged ESOP puts non-productive debt on the company,
- A liability is created for the future purchase of shares from retiring employees (this needs to be accounted for over many years by the company),
- There are annual costs and maintenance costs to having an ESOP, and
- The initial fees for setting up the plan can be a bit costly.

So, if you can get comfortable with the pros and cons of an ESOP, it is likely that you will find it a valuable tool for the start of your internal transfer of your business.

Concluding Thoughts

Remember that all exits are challenging and you are not alone with making these tough choices. The best place to turn for advice in this area is to a trained, experienced and trusted advisor. In doing so, you can engage in the detailed conversation regarding the best exit option for your situation. Remember that there is no panacea when it comes to an exit, only choices that are the best fit for your situation.

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