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Case Study

Selling the Business to Key Employees

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Baltimore, MD | Fairfax, VA

When it comes to transferring a closely-held business – assuming you want to get something close to fair market value for it – there are basically only two options: (1) selling it to an outside third party or (2) selling it to a family member or key employee.

A third potential exists in creating an ESOP, but that often does not make sense for many small businesses due to the ongoing costs associated with ESOPs.

This real life case study focuses on the second scenario of a sale to a family member / key employee. In our experience, this occurs more frequently than a sale to an outside third party. While still explaining the essence of the actual transaction, I am changing various attributes of the transaction to protect the anonymity of the business.

Case Study: Frank, Up-front Discussions Helped Business Owner Establish Exit Planning Strategy

My client Roger and I had been together for many years. As Roger got into his mid-50s we began in earnest discussing his plans for retirement.

Around this time I prepared a valuation of the business on a going concern fair market value basis as the company was currently structured.

Over the years Roger received inquiries from competitors who wanted to buy the business. Their "loose offer" prices were a good bit higher than what I was coming up with. This led to a discussion between Roger and me; our conversation focused on the reality that internal sales are going to generally be at prices *below* what a "strategic" industry competitor might pay under their own management structure, which would probably involve a significant removal of Roger's current employees who are redundant to the purchaser.

We also discussed how internal sales are going to involve time and self-financing. He would have to come to accept that to some degree he would be BYOWYOM – "buying yourself out with your own money."

All these frank discussions helped Roger identify that his primary goals were (1) to see the business continue as a legacy and (2) for him to receive an annual income for some period that was equivalent to his current compensation, but also was representative of a fair price for the business.

Identifying Roger's Successors / Buyers

Since family members were involved in the business perhaps the biggest initial hurdle for Roger was deciding who the business could be transitioned to. This took some time but over a period of a few years it became apparent that two non-related key employees, *not* the family members, had the attributes to successfully continue the business. They also had the *desire* to continue. Often, these two qualities do not co-exist.

I admired Roger for this very difficult decision. In my experience, many business owners don't always make the best decisions in identifying their successors.

The Buyers Are In Place … Now What?

Having identified the potential buyers about the time Roger turned 60, we began the several-years long process of guiding and educating both sides on how the transition could be accomplished by the time Roger turned 65.

It was important that everyone was as comfortable as they could be about such a significant transaction. All parties needed to see it as a win-win.

How to Approach Key Employees About a Potential Business Purchase

I can remember the first meeting Roger and I had with the two employees. The biggest question running through their minds was, "How in the world can we afford to do this?" This is typical for someone in their early 40s who has worked hard, but hasn't acquired a significant personal net worth. They often assume that the transaction will involve a significant check up front.

At the first meeting, we talked in broad terms about the range of business value and how it was being determined, cash flow of the business, and how the purchase could be financed over time.

The goal of this first meeting was to give them a vision of themselves as owners of the business, without outright overwhelming them. Roger and I accomplished that goal. I can't overemphasize how important it is to handle the first meeting well.

I counseled Roger over the ensuing years on how to gradually increase the key employees' roles in the business, including the sharing of the company's finances.

How We Financed the Transaction – And Made It Work for All Parties

About two years out from the sale, based on the prior annual valuations prepared, Roger agreed to a price of $2,250,000 on a capital transaction basis. Without going into all the details, there was a $250,000 down payment financed by their current bank, with annual payments from the key employees totaling $200,000 for 10 years, which was equivalent to Roger's current annual base pay.

Working with this information I created a cash flow projection for both Roger and the key employees. The cash flow projection covered the entire purchase cycle.

We presented the analysis and had a very lengthy and detailed discussion about it. It was essential that the buyers see how, through annual bonuses, they would be able to afford the business. My role in this process was to advise both sides very clearly on the cash and tax ramifications of the purchase, and especially to educate the buyers on conservative finance principles.

After giving both sides a very clear roadmap of the transaction, and after some further discussion, both sides approved and we engaged an attorney to draft the appropriate legal documents. We also helped the key employees engage an attorney so they could get an independent opinion and confirmation on the fairness of the deal.

Reasons for This Transaction's Success

This particular transaction is now in its last year of the buy-out and has been successful.

Having taken several business through similar transactions, I've found the following to be essential for a successful transaction.

1. The deal is based on *reality* from a valuation and cash flow perspective.
2. It involves the right buyers who can accomplish the plan.
3. Both the seller and buyers are people of character who desired all-around success.
4. A very clear roadmap on how to get there, and steps for consistent and appropriate follow up, was provided to all parties.

Moving into retirement can be a very emotional time for entrepreneurs who have given their life to the business they nurtured and built. Selling to key employees can be a very rewarding way to accomplish your retirement financial goals while seeing your legacy maintained, and the lives of your employees thrive.

For Help or More Information

The insights, observations and guidance presented in this case study are based upon the experience of our firm in helping business owners sell their business at a maximum price with minimal tax obligations.

Gross Mendelsohn's exit planning, succession planning and business valuation specialists plan and "quarterback" exit strategies for small to medium size companies in Baltimore and throughout Maryland. Whether you are retiring, selling the business, closing its doors forever, or gifting it to a family member, we can help.

For more information on how we can help you with the sale of your business, visit www.gma-cpa.com/exit-succession-planning-baltimore-maryland, or email or call us today.

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