PRIVATE EQUITY transitions

When Will I Get Paid the Value for Exiting My Business?

Dear [member_name_first],

It is the American dream to build and sell a business. When owners stop to think about this glorious future day, they often envision a closing table with lots of attorneys and paperwork which ends with a check or wire transfer of an ungodly sum of money transferred to their personal bank accounts. This vision is often accompanied by pictures of leisure activity enjoyed in a comfortable bed of financial security. The worries of the world are left behind and the only thing remaining is to live out your future days in a blissful state. Unfortunately, the reality of many exit transactions is far from this vision. In fact, in a large number of cases, an exiting owner will be compelled to stay on-board with the business, working with the new owner(s) in continuing to grow the value. And, along with this continued employment, there is also the reality of not receiving all of your money at the time of closing. Rather, deferred and contingent payments are likely to be a part of most deal structures for exit transactions today.

Why Don’t Buyers Simply Pay Cash?

Since this newsletter is demystifying the dream of many would-be selling owners, it is at the very least our responsibility to explain why business sales are not paid 100% cash at the closing. Let’s start with the most simple – you buyer may not have the cash.

You see, the success rate of selling a business to an outside party is in the single digit percentages. Roughly 5% of privately-held businesses will successfully sell to an outside, third party. Therefore, one of the primary reasons that you may not get 100% cash at the closing for the sale of your business is that you are considering an internal transfer of the business to your managers, your family members, and/or perhaps to an Employee Stock Ownership Plan (ESOP). If this is the case, it is unlikely that any of these folks are going to achieve the level of financing (if they get any at all) to pay you for the entire ownership of the business at the time of transfer.

Moreover, these internal buyers are almost certainly going to be in a position where they will need continued oversight and support from you, the [former] owner, as the business transition occurs. Therefore, it is unrealistic to think that you will get paid for the business and stop working under this scenario.

Outside Buyers Who Structure Payments

Now, let's take a look at an outsider buyer for your business who likely does have the cash to pay you for complete control. Even if your future buyer has the money to pay you, it is likely that they will only want to pay you a certain amount as a down-payment while structuring the future proceeds over future years.

You see, as the American landscape of businesses have moved from a manufacturing to a service-based economy, more and more of the 'assets' of a business are tied to human capital. These include intangible capital, business intelligence, as well as intellectual property. In fact, one of the largest assets in many transactions with service-based businesses is the people who work the business – including you, the owner. And, because there is no assurance that these people / assets are going to report to work once the new owner has taken over, the new owner will often want to reduce their 'transition risk' by asking you to take an active role in the transition of the business. And, not only will they want you to assist with the transition, they are likely to also make a portion of your selling price <u>contingent</u> on certain goals being hit during the transition.

Notes Versus Earn-Outs

Once payments of business sale proceeds are pushed into future years, they generally fall into one of two categories – they are either 'contingent' payments, which only get paid upon the occurrence of certain events, or they are 'note' payments, which are simply I.O.U.s which are paid over time (in effect making you, the exiting owner, the bank for the transaction).

Whether your future payments are contingent or 'guaranteed', it is important to recognize that they will be paid to you sometime after the closing, which no matter what is promised, also puts those payments at risk of not being received at all.

Recognition of Income for Tax Purposes

It is also important to note that sale proceeds that you receive in future years will also be subject to the tax rates in place at that time (without some exception). Therefore, not only do owners need to estimate <u>when</u>, <u>how much</u>, and <u>if</u> they will receive their payments, they also need to estimate what the likely tax rates will be and, concurrently, how much they will 'net' from the exit transaction.

Concluding Thoughts - A Long Way From Paradise Leads to a Call for Planning

Having provided all of this analysis on how, if, and when you may or may not get paid for the sale of your business, it appears that we are a long way from the dream that rolls around in so many owner's minds about the day that they sell their business. Having demystified the idea that you'll get all of your exit proceeds at closing, we want to leave you with a positive thought – that it is never too early to begin to plan for this once-in-a-lifetime event.

If you are interested in better understanding how, when and if you are going to get paid the value for your exit transaction, we have a short assessment that can be completed in a few hours of your time to address all of the issues above. Feel free to call our office to get this process started so that we can assist you with answering the question ‘when will I get paid the value for exiting my business?’

Regards,

Joe Bazzano