Exiting Via A Sale to Your Managers
The Math You Need to Know to Think Through This Important Decision

Dear [member_name_first],

As the owner of a successful business, you may be looking ahead and wondering 'who is going to own my business after me?' In trying to answer this question, many owners will look to their management teams, the very people who helped them grow the business, as potential future purchasers. This is a natural progression in thinking for many owners because it provides a unique opportunity for managers to become owners. After all, where else are your managers going to get this opportunity . . . unless, of course, it is in competition with you. If you have been considering an internal transfer of ownership to your managers, one of the most important first steps that you need to take in answering this question is figuring out how the math of an internal transfer can possibly work for you.

How Can the Managers Afford to Pay You?

Most business owners begin the consideration of an internal sale to their managers with the idea that the managers do not have the money to purchase the business. After all, if they did have the money, they likely would not be working for you. Therefore, in order to fund the buyout, the managers will most likely need to pay you out of the future cash flows of the business. Well, here is where it gets tricky. For most owners, this cash flow represents the lifeblood of the business. It allows you to grow. It allows you to take excess salary. It allows you to pay down debt. Cash (and cash flow) truly are 'king' in a small business so if you are considering using this cash flow to make payments for future ownership of your business, to yourself, you need to make careful forecasts. The largest projection that you need to make in this analysis is what those future payments will be and what the risk of receiving them is for you as the exiting owner after you have sold your business to your management team.

Structuring Payments to You from Current Cash Flow

In order to examine this issue further, it is helpful to begin with some math. Let's assume that your business has annual cash flow (that is cash available after expenses are paid) of $1 million and you decide to sell the business to your managers for a price of $5 million. In order to make this transaction work, you realize that the managers cannot make much of a down payment to you for the business so you agree to take a note for the payments, i.e. have them pay you for the ownership, over time, out of future cash flow from the business.

In our example, the note has a ten (10) year time horizon and has a 6% rate of interest. Therefore, the managers' annual payment to you on that note is going to be $679,340. Assuming that after your exit the annual cash flow remains at $1 million, the managers should, it would appear, have enough money to make the note payments. But what is missing from this equation?

The 'Tax Trap' for Internal Transfers

The first consideration that you need to factor into your analysis of an internal transfer is the taxes that will be paid. It is important to realize that unlike the excess salary that you may have taken at the end of each year from surplus cash your managers cannot take a tax deduction for the payment of stock that they make to you each year. Therefore, each payment that the managers make to you will be with after-tax dollars.

So, if $679,340 is due each year in note payments and there is an additional $1 million in cash flow to fund those payments, it would appear that the managers would have just about enough after-tax cash flow to make your payments. However, we need to see if there is something else missing from this equation.

Prior Reinvestment in Business Growth

To complete the analysis of whether or not there is enough cash to make the payments, owners need to now ask the next important question which is 'what happened to that extra cash flow in prior years?' It is possible that the extra cash flow in prior years was reinvested in the business in order to grow the company. If that is the case, as the exiting owner you need to question whether or not the business will continue to earn $1 million in surplus cash each year if the managers are compelled to use the majority of those payments for their note to you.

Or, as mentioned above, you may have chosen to taken additional salary compensation with the extra cash flow in the past. In this case you need to ask whether or not it truly makes sense to reduce your own extra income in order to provide your managers with an opportunity to use that same cash flow to fund a buyout of your stock?

In summary, as an owner trying to do the math on an internal buyout, you essentially need to ask yourself if you really want to take the risk of receiving future payments or you want to sacrifice personal income in order to fund your own company buyout from the business.

Concluding Thoughts

When evaluating the opportunity to transfer your business to your managers, it is critical that you understand the math behind the potential transaction. This is the first step in a series of questions that ultimately helps owners understand whether or not they can afford an internal transfer.

If you are interested in having your business assessed for an internal buyout, we have a short assessment that can be completed in a few hours of your time to answer all of the issues above. An internal transfer is a tricky transaction to navigate. Feel free to call our

office to get this process started by first answering the question, ‘can I afford to exit my business today?’

Regards,

Joe Bazzano