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No Transition 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 will be covered in a future newsletter, as gifting strategies do not generate a 'buyer' for company shares.

This newsletter reviews the pros and cons of the two internal non-gifting options, providing insights into what details owners should focus on when considering a transfer to their current employees and/or family.

Option 1: 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 Management Buyouts

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 – the business will continue profitably without you.

The Cons of Management Buyouts

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.

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?
 - o 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.

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.

Option 2: 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 a transitioning owner and like the management buyout; the cash flows of the business will make the payments to fund the purchase. However, unlike a management buyout there are potentially great tax benefits to an ESOP.

The Pros of ESOPs

ESOPs are far too complex and applicable to too many situations to completely list the benefits here. We will continue the ESOP discussion in our August newsletter.

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 transition planning . . . but there are pitfalls to watch out for.

The Cons of ESOPs

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.

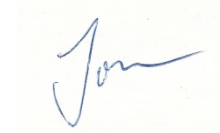
Concluding Thoughts

Remember that all transitions 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 like Owner's Edge. In doing so, you can engage in the detailed conversation regarding the best transition option for your situation.

We encourage you to come to our next Executive Briefing on September 11 to learn more about all of the transition options available to you (see the announcement on the back of this page). Remember that there is no panacea when it comes to a transition, only choices that are the best fit for your personal situation.

Regards,



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Our Commitment to our Customers

We help our owner/clients articulate and execute the strategies needed to make their profits sustainable and their business transferable. This creates true and meaningful value.

About Owner's Edge

Owner's Edge is a business advisory and consulting firm specializing in helping business owners work *on* their businesses by devising and implementing strategies to drive operational excellence every day. We are one of the few advisor firms that can provide a formal and comprehensive Transition Planning service for business owners. Call us for a no-obligation consultation today.

Executive Briefing: *Business Transition Strategy Planning*

Monday September 12 at South Kingstown Chamber of Commerce; 8:00AM – 10:00AM

This free educational breakfast briefing is tailored especially for business owners and their key advisors. Learn why it is important to plan your transition, where you should start, what your transition options are, who is involved in the process and when they need to enter into the process. A continental breakfast will be served. Reserve your seat today and feel free to invite members of your advisory team.

Co-Host: Michael C. Paolino, Financial Advisor, Edward Jones

Kindly RSVP by September 9, 2011
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