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How To Sell Your Company Without An Outside Buyer

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OVERVIEW

There once was a time long ago and far away when one was secure in the knowledge that if they created a good staffing company they could sell it at a fair price to one of many buyers. This being similar to having built a sound house in a decent market one could sell it and make a reasonable profit. Unlike selling a house, which once again has become a good investment; being able to sell a staffing company via an acquisition now often belongs in the fiction section of the book store.

In 2012, there were 74 U.S. staffing M&A deals closed, up from the prior year but the same as in 2010. During the last five years, we are up modestly from 67 per year. Compare this to the peak year 1998 when 495 deals closed and one can see that we are off a staggering 85% and are unlikely to see anything close to that again. This not only affected the likelihood of doing a deal, but the high multiples which were common in peak years. At that time, almost 10 deals per week were closing vs. 1.4 per week now nationwide.

An attendant problem by going the M&A route is trying to keep the fact that the company is for sale a secret. You certainly don't want to advertise that the company is up for sale as all sorts of problems can result. Employees of course know that acquisitions inevitably lead to cost savings and synergy which usually results in terminations. And no matter how hard one tries to keep things under wraps with confidentiality clauses, rumors have a way of getting out, particularly the longer a deal takes to consummate. The result is that the company often loses the people it most wants to retain due to the fear of the unknown, regardless of what assurances they may tell the staff. This, as the staff knows a new owner will make decisions to cut economic costs and that they may be on the wrong end of that decision.

Secrecy involves your clients as well. We have seen a sales rep privy to ongoing negotiations involving buying a vendor to the client he was trying to win over and informed the client of this. Since the M&A contract did not specify this type of breach of confidence, there was nothing the vendor could do about this and he lost the business as the client in question sought out alternative suppliers. The more people involved in a deal, the greater the chance of a leak. This includes not only the buyer and seller, but the M&A specialist, accountants, attorneys, document printers, interviewees, friends, family members and even casual bystanders.

Regardless of any secrecy or confidentiality agreements in place, word has a way of getting out, particularly the longer a process takes. Leaks at publicly traded companies exist, where stock prices are impacted long before a deal takes place. Sometimes this is based on rumors or that the company may need to be acquired just to survive. All one can do under these circumstances is try to deal with damage control which is difficult.

But wait, there's still hope, if not by the traditional M&A route, as there is another way to skin the cat. This is a twist on the old LBO, or leveraged buyout, where one would put down a small down payment and leverage the rest of the purchase price with a bank loan. Needless to say, those days are long gone due to banking gimmicks and abuses that almost wrecked our economy some four years ago.

What has taken its place is the MBO or management buyout, which is not dependant on bank financing but rather provides the new management team with the opportunity to pay off the exiting owners from the ongoing profits of the business.

This however requires two major conditions to be successful. The first is the ability to find quality employees and then retain them to run the

business, which they can then inherit from the exiting owners. This is far different than having good recruiters and sales reps that are not able to efficiently run the company. This is not meant to exclude enabling key members of the existing staff into managers, but management requires a different skill set than operations. The second obstacle is to avoid triggering onerous tax consequences to one or both of the old and the exiting owners. Both of these can and have been done with dedicated effort, proper structuring of the deal, monitoring progress and careful tax planning.

THE VISION

Let's first describe how one creates a capable management team. If this is structured and promoted properly, it becomes a remarkable gift that can attract the most talented and capable people. They will basically inherit a company as if they were the biological heir of the owner. That's a pretty attractive proposition for anyone with the experience and intelligence to grasp and appreciate it. Let's say we want to attract really talented people, some of whom have proven management experience in every sense of the word, but no staffing expertise. These are the kinds of individuals who either go to work for a Fortune 500 company or a dynamic industry such as high tech. We are looking for people with the vision of what they can achieve in a field they probably knew nothing about. Remember, no one ever took a course in staffing and they will need to be educated in the field. In so doing, we will provide them with an opportunity of a lifetime, with far less competition than they would face in those other organizations and as the best and brightest should stand out like a beacon.

Let's also say that they are earning \$200K/year and might be looking

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for a 10% raise. Assuming we had a company with sales of \$10 million and \$600K in profit and a market value of \$2 million today, if that person could grow our company to become \$20 million in five years, it would be worth \$5+ million. As soon as the company was paid off to the tune of the current market value, it would be theirs, along with the annual profits it would generate, plus the net current assets. One would think that a prospect would be just a bit more attractive than being an employee at \$220K/year with no ownership prospects.

So we need to create a multi-step process for this to happen. The first component of which is to see if we have any people in the company who have the management potential needed to do the job. This would happen through a combination of their accomplishments, innate skills, coaching/or and further education. The new owner could consist of one or more people. Cohesions and working together would be critical with multiple owners. Once this is ascertained, the table is set to go forward.

The Devil Is In The Details

The basic formula is for our new potential owners to prove themselves before they inherit the company. We would establish a training program and meeting performance goals before we would hand over the company. Let's assume we had two people we selected and had a two year transition process before initiation of the new ownership program. At the end of that time a strike price would be set as to the value of the company based on the market value in two years. During that period, the existing owners would receive the profits and the potential new owners would receive fair compensation from their work. Assuming whatever targets were set for the program were to be met, the new ownership transition program would then begin. After the full market value of the company is later paid out to the exiting owners, all of the conditions of the deal would be met and the deal would be consummated. If management performance parameters were not met or market conditions changed, the deal could be renegotiated as part of the contract to the satisfaction to all parties. In the worst case scenario, the full future payout would not be pos-

sible and the existing owner could terminate the management team with whatever severance agreement might have been agreed upon. This would not be in either party's interest, as the exiting owner would not want to start the process all over again, so every effort would be made to make this process work.

Structuring An Exit Plan

Now let's describe some of the tax strategies that minimize triggering prohibitive tax consequences. Although there are many ways to structure an exit plan, you will want to minimize the tax consequences to the management buyout team to make the process affordable. Here are some of the successful ones we have been involved with along with some of their pros and cons. In all cases, qualified tax and legal counsel would need to be brought in to structure the deal in accordance with state law and an S corporate status is critical to minimize tax consequences.

I. Dissolution and Transfer of Assets - This is the dissolution of the company and the transfer of assets to a new owner. We would start with an assessment of the value of the company based on an arm's length transaction. We would then determine how long a payout period the exiting owner would be willing to receive. The future profits would pay off the exiting owner. A note would be signed by the new buyer in full for there to be no recourse. Based on a forward-looking business plan one could estimate the approximate amount of time until the payoff would be completed.

Under one structure, the exiting owner would collect receivables as payments came in on old billings and the new owner's sales would take their place. A value for the fixed assets will be determined based on their fair market value. A bank should be able to qualify the new owner based on the receivables as collateral as they built sales, but a personal guarantee may still be required. An SBA loan and factoring could be used to make up for any shortfall. If there are no formal contracts between the staffing company and their clients, the business should proceed as usual. If contracts are in place, they need to be assigned. Clearly, where dissolution of the com-

pany would void an agreement, this process will not work unless a client consent were executed. Regular income taxes would be paid on normal profits.

Potential risks to the buyer would include: the loss of key staff as a result of being left out of an ownership position, promises made to the staff that would not be honored by the new owners, the inability for the buyer to pay off the exiting owner in full, the owner having to wait too long to receive full payment and the owner having to settle for less than the agreed upon amount. If payment in full were not made, the existing owner could recover the company, though this could be rather messy. Although nothing is foolproof, we have had good experiences with this process when the exiting seller is well acquainted with the new buyer and has done a good job in vetting all of the risk factors.

II. Par Value - Alternatively, one could have a company that had low profits and a par value could be set at a low to minimize taxes. Assuming the company had 100,000 shares at a par value of \$1/share and 49% were to be transferred to the new owner, the taxes due would be \$49,000, which depending on tax laws would be relatively modest. The exiting owner could provide a loan to the new buyer repayable at a future time.

Assume a company had an EBITDA of \$370,000 and a 3.5 P/E multiple, the market value would be \$1.3 million. Assuming a strike price was set when the EBITDA reached \$1 million, the company would be worth \$4.0 million. If this were to take four years, the cumulative profits during this interval period would be \$2.9 million divided between both parties. The exiting owner would then sell his 51% of the company for \$2 million.

The new owner, as a result of the profits he would receive would be able to cover any taxes upon sale and retire the original loan. Receivables are typically not part of the purchase price and assuming normal receivables, the exiting owner might get another \$1.3 million. The exiting buyer could gross \$4.8 million. The new buyer would have made \$3.3 million (excluding his compensation) but would need to refinance receivables. Assuming continued growth at the same rate, in another

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four years, the new owner could have a combination of profits and company value equal to \$20 million and net current assets of some \$3.8 million. We have structured deals like this with various configurations.

III. Creative Stock Redemption Program - This structure may be the most broadly workable of all of the alternatives where under (a) the exiting shareholder of an S Corporation receives after tax dollars on the sale of his interests in the business; (b) the buyer purchases as few as one share in the corporation and (c) there is no debt created as part of the transaction. Simply stated, the corporation becomes the purchaser of the exiting seller's shares in the corporation so, other than the initial purchase of one share of stock, there is no further appreciable out of pocket costs to the buyer.

Here is how this program works: Rather than having a new buyer pay the transaction price to the exiting owner either in the form of cash and/or a note in after tax dollars (i.e., dollars on which the new buyer has already paid income tax) and

rather than having the exiting owner pay income tax on the monies he receives from the transaction, the exiting owner has the new owner become the holder of the corporation's shares and then have the corporation redeem (repurchase) the exiting owner's shares over a period of time. Because of the peculiarities of subchapter S of the Internal Revenue Code (the section which governs the tax treatment of "S Corporations" and its shareholders), under a properly structured redemption program, the payments made to the exiting shareholder are treated as "return of basis" and thereby not subject to income taxation.

This program is part of a series of corporate succession plans that have been successfully implemented over the past ten years when properly structured, whereby (a) exiting owners, over time, dispose of their ownership interests and receive their sales price in after tax dollars; (b) there is no debt of any kind incurred in the transaction.

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ment Inc. Started in 1994, see www.optimal-mgt.com or call (650) 655-2190. Michael mentors staffing owners and managers to maximize sales, profits and company value. He was senior executive VP for two national staffing firms; CEO, CFO, director of planning/M&A and marketing director from start-ups to Fortune 500 corporations. He has an MBA and an engineering undergraduate.
