"Internal" Management Buy-IN's

Is this the first … or … last approach for an owner with a good management team?

Many business owners immediately think of selling their business to their management team. In some cases, this is the only plan that they have mentally explored. While it may be right to provide management an opportunity to own the business, there are a number of concerns that should be addressed long before any discussion or hints take place.

Typically, the management team does not have much available cash to fund a purchase. Consequently, the owner (seller) will have to facilitate the deal...meaning, let the management team take the funds required for the purchase from future operational cash flow. (The down payment will be small or non-existent and the owner will have to provide a significantly larger amount of seller financing then in other deal structures.)

Management also may have an entirely different view of how a deal and the transition will take place. Since the selling owner is financing the deal, he/she usually plans to "stick around" longer then in other transactions. In addition, the selling owner may determine that is only possible to do a deal in a staged manner which normally makes the transition picture a little fuzzy for all involved.

Competing Goals in a Sale to Management		
Why there are conflicts after the process starts!		
Areas of Concern	**Current Owner's Goals**	**New Owner's Competing Goals**
Financial Control	Retain completely	Immediately have input
Ownership Benefits	Retain all benefits	Immediately have owner's benefits
Management Control	Retain final decisions	Exercise significant authority
Defined Responsibility	Transfer responsibility without authority	Desire to have authority matched to responsibility
"Transfer" Price	Maximize value of equity	Pay minimum price for ownership
Deal Structure	Minimize taxes	Maximum deductible payments
Note Terms	Guaranteed payments	No risk to personal assets

The chart below outlines a few of the differences that normally occur when an owner attempts to sell the business to the existing management team.

There may be may ultruistic reasons for offering the business to management first...but, there are some good sound practical reasons not to do it.

First, the price that a management team can and will pay is almost alway lower than the price achieved with a marketing effort coupled with a modified auction process. In addition, the terms required in a management buy-in deal will require a significantly larger seller note than in a typical deal structure developed with an outside buyer. (Remember: The chance that the management team will have a lot of cash available to put into a purchase is very small.)

Second, the management team may not have the necessary risk-taking attributes required to help the business progress over the next cycle. If they are not prepared to make difficult decisions, the consequences will add up over time. If this occurrs, both you, the business owner (seller) and the management team (the buyers) will be in a very difficult position. Without business preformance, the chance that the notes will be paid in full are small...and with busines preformance, the new owners will not have the cash to reinvest in the business to meet competition in the market place.

Third, once you start even the smallest discussion with the management team about "buying" the business, you cannot take it back very easily. You will have instantly gone from the unspoken words "I should have been considered"...to "I was promised that I could buy the business"...even though that is not what was said. Before any discussion takes place, the problems address above must be reconciled.

<u>Simply state</u>:

- Are you willing to take a lower price and give more liberal terms to permit the management team to buy the business?
- Are you confident that the management team has all the skills necessary to continue operations in place and to improve business performance?
- Will the combination of past business results, current busines position, and the management team's ability and personal finances permit a reasonable measure of commercial financing?
- Do you know what a deal will look like when it is done so that you can immediately outline it for the team? (If not, each of them will have their own picture of the deal...which will probably be far from each other and far, far what you can reasonable consider.)

If you can answer yes to all of these question, you are in a position to contact your professional team to discuss this possibility. You must have your CPA, attorney, and business intermediary review the details of your "idea" to be sure you are solid ground...on expected valuation, expected financing amounts and terms, and on overall deal terms. This is a critical step. The reason it is a critical step is that in some ways you, the business owner, you are negotiating the deal for the management team. You are putting together the "letter of intent" for the management team...so that you can put them on the right page from the start. If there are problems with the plan, the professionals will pick it up, before you expose it to the team (buyer). This is the time to fix the problems; the time to step back and reassess it reasons to take this approach; the time for your trusted advisors to review the difficult steps required to complete a deal of this type; and the time for you to develop a clear picture of just what both they and you will have when the deal is done.

Once you know what is possible and what it will mean in the end, then and only then should you offer to help your management team buy your business. It may be the right alternative. If it is, the care taken before you engage in any discussion will help assure that you get the results you want.

If a deal cannot or does not get completed with a management team, the consequences are great. You now have the key people in your business unhappy with you, unhappy with the situation, and unhappy with the buyer who finally completes the deal. Not to mention the fact that the required confidentiallity concerning the deal will no doubt be long gone. Think first...plan...and you will have a much greater chance of completing a management buy-in.

A final note: If you are a buyer, you will always want to ask if the owner offered the business to management first...and learn exactly what happened. This knowledge may be critical to understanding what is happening in a transaction and in what to expect after the sale is completed. In some cases, it may give a buyer a reason to move on early and not persist in completing a sale.