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Funding a Sale to “Insiders”

When imagining the future of their businesses, and possibly a future that involves different ownership at some point, owners may wonder if it’s really possible to consider “insiders” (employees, children, or co-owner) as viable successor owners. Insiders are often a great match for company culture, leadership style, and vision. But they may lack one very important element – money to buy the business. Is this a fatal flaw in planning for the transition of future ownership? Maybe, but maybe not.

First Things First

Before we dig deep into an insider’s ability to pay for ownership, it may be a good idea to take a step back and see whether that line of investigation is even worth pursuing. Start by laying out your goals and objectives for the future of the business in writing. You should be able to clearly define:

- How much longer do you want to own your business?
- What do you want your relationship with the business to be before, during, and after an ownership transition?
- What do you want your business to look like after you no longer own it?

- What must the business provide, on an after-tax basis, to complete your plan for financial security and independence?

Once you know the answers to these questions, you can start to evaluate possible outcomes for the future of your ownership interest by holding each scenario up against your goals to see how well they fit together.

Insiders Don’t Have Money

It is often the case that an insider, who would otherwise be an excellent successor owner, does not have enough money (or access to money) to support a purchase of the business. But this does not mean that a transfer of ownership to them should be off the table. The secret to success for an insider who is otherwise a strong owner candidate is cash flow. Cash flow can bring everything together.

The Definition of Cash Flow

What is “cash flow?” You've probably heard others say that your sale price might be a “multiple of cash flow”. Well, that all depends on the definition of “cash flow.” There are several definitions or measures of cash flow, each with a potentially significant and substantive difference. Typical measures of cash flow include:

- **EBIT:** Earnings Before Interest and Taxes.
- **EBITDA:** Earnings Before Interest, Taxes, Depreciation and Amortization.
- **True Cash Flow:** The amount of pre-tax money directed to owners via salary (above the value of their services), bonuses, distributions or dividends, and rental payments in excess of fair market rates for equipment or buildings.

Each of these measures of cash flow can produce a different cash flow amount. Which one makes sense for you may depend on the unique nature of your business.

How Cash Flow Supports the Sale Price to

Insiders

Shaila Drexl, owner and manager of three commercial buildings, desired to sell each of her three property management operations to each of the three on-site building managers. She thought she'd retain ownership of the buildings themselves and separated her building ownership from the management businesses. She had heard that "six times cash flow" was a fair way to value her type of business and this method matched nicely with her idea of what she needed to meet her financial objectives.

Let's assume that Shaila's employees want to buy her business. Let's also assume that these employees share a trait common to many employees: *They don't have any money*. Since Shaila's employees don't have money of their own, and they have limited borrowing potential, the payments they make must come from business operations. Every dollar of cash flow that is created through operations will be taxed at ordinary income tax rates, because it will either get reported as company income or it will be paid or passed through to the employee, who will then report it as income. Each employee will only have an after-tax amount left to pay Shaila, who will then most likely owe capital gains tax because she is being paid for her ownership interest. That's two bites at the apple for the IRS before each dollar makes its way to Shaila's savings account. So, it may take some time for Shaila to reach her after-tax financial goals if her only plan is to sell ownership to employees, because company cash flow is eroding on its way to Shaila's pocket. Is there a faster way to help Shaila reach her financial targets?

Shaila did the math and decided that it would take too long for each employee to pay for their part of the business if they just used cash flow to pay for Shaila's ownership using a generous multiple of cash flow as the company value. She called a meeting of her most trusted advisors and began to look at planning strategies that might work better. Her advisors were able to identify a variety of potential improvements to her plan, including revisiting company value, adding different types of payments to Shaila, and transitioning ownership over time rather than all at once. Through analysis and creative thinking, they were able to come up with several ways to use company cash flow more efficiently, all the while keeping an eye on Shaila's stated goals. In *the end, Shaila was pleased with her more comprehensive plan.*

The Bottom Line

A sale of ownership to insiders can be fraught with danger if the overall picture, from company performance to individual tax consequences, is not taken into account. Comprehensive planning can take time or may require several perspectives, but the benefits can outweigh the costs for many owners.

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