

SUCCESSION OPTIONS FOR STAFFING FIRM OWNERS

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There are several strategies that can be used to create an effective exit strategy for an owner of a staffing business. Part of the exercise involves tax planning to maximize the shareholders net proceeds from their business, however it also involves questions such as "What do I want for myself, my family and for the future of my business"?

Exit Options

Hire a Manager to operate the business;

Sell your business to your employees (Management or Leveraged Buy-out);

- a) Bank or Lender Financing
- b) Seller Financing
- c) Installment Purchase of Stock
- d) ESOP's

Sell, gift or transfer the business to family members;

Liquidate the business;

Sell to a third party acquirer.

Let's explore each option in further depth.

Hire a Manager to operate the business.

Can be a viable alternative, as it should allow an owner relief from much of the day-to-day operational demands of running a staffing business however; it does not change the owner's risk level.

Often, much of the owner's personal wealth (including their retirement funds) may be tied to his/her business. With a Manager handling the operation, the owner still has his assets in play and at risk. In certain circumstances it can be a good solution for a period of time however; it is rarely an ultimate solution.

Comment: This can be an effective strategy if this is not a good time to sell your business, if the economy is poor, your market is down or if your firm is not in a good healthy growth cycle. It can be used while a firm waits for the next generation of management to mature and develop to the point they are ready to carry on. It can also be used if a sudden illness affects the owner.

Sell your business to your employees.

Sometimes referred to as a Management (MBO) or Leveraged Buy-Out (LBO). These types of buy-outs can be an excellent way to keep the business independent and insure that it will continue operating.

The challenge in this scenario involves that often the Management Group cannot afford the cost of acquiring the business. However, there are ways of financing the acquisition of the business, such as:

- a) *Bank or Lender Financing-Any Bank or Lender will require the prospective new owners to put up a portion of the purchase price with their own cash, savings, mortgages and/ or family loans.*

The reason these types of transactions are also referred to as Leveraged Buy-Outs is that they are often financed by loans secured by the assets of the acquired company as well as the assets of the acquiring company, therefore (they are highly leveraged) and risky for all parties.

- b) *Seller Financing-requires the owner to leave cash and other assets in the business (and at risk). It also tends to extend payments over a longer number of years.*

“Seller financing” may reduce costs and make the transaction easier but the payments are still in post-tax dollars and reasonable interest must be paid. Further, extending payment terms has a number of negative implications for the selling owner.

Comment: This can be a good strategy when the owner has great confidence in the management team’s abilities to run the business in the future. Inevitably, leveraged buy-outs, by management or anyone else, strap the business with substantial debt, which may get in the way of other business plans.

- c) *Installment Purchases of Stock are similar to seller financing and can be attractive, as the management team and company can purchase the stock over a number of years.*

Comment: IRS rules can sometimes make these deals difficult to implement. If the owner has not sold majority control, or substantially all of his or her stock the IRS may determine that the sale of stock did not substantially reduce the owner’s effective ownership, so they will tax the income as dividends, rather than capital gain. Fortunately, other tools, including trusts can be used to hold the stock until the company and/or management team can buy it.

- d) *Employee Stock Ownership Plans (ESOP’s) can be used to finance part of the stock purchase on more favorable terms, while retaining control among the chosen management team. A partial sale to an ESOP can make management buy-outs easier. The ESOP can purchase any amount of company stock on highly preferential terms. The effect is to reduce the total cost of the stock purchase, while retaining closely-held control among the primary shareholders.*

Essentially, the ESOP is a retirement plan for the employees. It is similar to a 401(k) plan, which invests substantially all of its assets in company stock. The stock is held in a trust under the control of a trustee appointed by the board of directors. Administration of the ESOP requires annual valuations by an outside party. The first valuation is more expensive, but the annual cost is often around a few thousand dollars. Since the loan to purchase stock is made through the ESOP, a qualified retirement plan, the principal payments are a pre-tax expense. Thus, the company can purchase stock from the retiring owner dollar for dollar.

The capital gains tax will come due when the replacement investments are sold, but can be avoided completely if the replacement investments pass into the estate of the selling shareholder. In the right situation, a sale of some or all of a business to an ESOP can give everyone involved significant tax breaks.

ESOPs can make a management buy-out easier for the company and beneficial to the selling shareholder. Further, it will continue the business as an operating entity, controlled by chosen management and may have a positive impact on employee motivation.

Comment: If the principal owner who still owns a majority of the stock wishes to sell the company, ESOP's can be very challenging for a third party acquirer to deal with and can become deal breakers for some prospective Buyers.

Sell, gift or transfer the business to family members.

Many owners have a dream of passing their business legacy on to family members, often their child or children who is of age and involved in the family business.

This type of transfer of ownership can have significant tax savings that should be explored; the rules on "gifting" can be very attractive however; it also has many of the risks associated with selling to other employees.

The significant difference is often these family members will be the ultimate recipients of a portion of the proceeds from the business at some future date in any event. At a certain point in ones' life, the goals of the parents and the future generation become closely aligned.

Comment: If one has a child or other family members in this situation, this can be a viable option; some of you may have gotten into the business this way. If so, you should be congratulated as US records show that 90% of the 21 million US businesses are family owned, only about 30% of family businesses successfully survive into the second generation and unfortunately, only about 15% survive in the third generation. Experts claim the reason for this is the lack of solid succession planning and that some offspring are not interested in operating the family business.

Liquidate the business.

Liquidating the business in our industry is rarely a profitable or desirable exit strategy.

It may only make sense if there was nothing of value to sell and/or you must close your doors almost immediately. A prudent business person would strive not to allow such an environment to develop, if it does happen due to a sudden disabling injury or illness or some other reason, get information on your options from a knowledgeable industry advisor as soon as possible and be prepared to act quickly, to maximize whatever is possible to salvage.

Comment: This is typically a desperation response rather than a planned strategy in the staffing industry.

Sell to a third party acquirer.

Obviously, this is the option that we at R.A. Cohen Consulting have the most experience with and it is the most commonly used mechanism to create an exit strategy. As with all approaches it has its pluses and risks that should be carefully considered.

Selling to someone outside the business or family means the new owner may change the business operationally, but sometimes a "strategic buyer," a competitor or related business, can offer the highest price.

The process of selling to an outsider begins often with hiring a business advisor/broker to represent the sellers' interests. Ideally, someone you know who is knowledgeable about the industry, respected and with a proven track record. Typically, this is not an area a business owner should try to handle on their own, it is far too important with too much at risk to leave to someone who doesn't do this all the time. We hope you choose our firm to represent you; however it is most important for you to select someone you can trust and rely on during this process. You will also need a capable financial and tax advisor as well as attorney, ideally with experience in M & A transactions.

As the seller, you must control the ultimate decision-making, your M & A team is there to advise you and protect you as best as possible and they should be encouraged to stick to their area of expertise and leave other areas for the other professionals more familiar with that discipline and vice versa.

You may also want to consider what the Buyer is getting by acquiring your firm. What benefits will the Buyer receive by acquiring your business?

Why should the Buyer pay top dollar for your business; are your margins above industry norms for your sector; are you growing each year faster than your competitors; what is special about your business that a Buyer can translate into a faster, safer and better return on their investment in your firm?

Positive answers to these questions can make for a faster and more profitable sale of your business and will likely improve the transaction terms of your deal.

A good advisor/broker should be helpfully involved at every stage of the process. For this often once in a lifetime decision, you are not looking for a dating service; you want a full service advisor, knowledgeable in our industry whose references are solid and can be verified.

Comment: Part of the seller's due diligence ought to be to find out as much as possible about how a particular acquirer handled the staff and how they operated the business on previous acquisitions. Often sellers are overly focused on what appears to be the most lucrative offer, however, since most offers today involve an earn out, how your staff and customers are treated post-acquisition will often determine what you will actually see from the earn out. If you prefer to accept only all cash at closing, be prepared to accept a very steep discount on the acquisition consideration. Buyers prefer to share risk going forward even if they end up paying more overall. They feel at least they paid for what they got and are not left chasing their initial investment.

Be cautious about who you tie some of your future earnings to, do your homework on them. They will do their homework on you. Another part of your homework at an earlier stage is to check out prospective advisors, its worth your time, as good advisors will provide more value than they will cost you and that can make all the difference. ■

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