Time Is Essential in a Transfer to Insiders

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We have identified several elements that are part of a well-designed transfer to insiders. The first element we've identified is time, and important qualifier.

We suggest that an owner considering a transfer to insiders first ask the following: Am I willing to take time (typically three to eight years) to execute and complete an insider transfer? If the answer is no, then this type of exit is off the table.

Transfers to insiders take time: time to plan and, most critically, time to implement. The good news is that in the typical case, the more time owners take to transfer the company, the less risk they incur and more money they receive from the new owners.

Time to Plan

Advisors trained in Exit Planning know how to design successful transfers to insiders. If you call your advisor today, it could take as few as 60 to 90 days to create your plan to exit via a transfer to insiders. Those days are vital and necessary, but just the beginning.

Time to Implement

The lion's share of the time needed for an insider transfer is spent implementing that transfer. During this three- to eight-year period, owners work to build the value of their companies, transition management responsibilities to their management teams, and actually sell a substantial portion of their ownership to the insiders.

Building Value

Because the company's cash flow supports the purchase price, owners must focus their energy on supporting business value and cash flow. We recommend that they concentrate on the Value Drivers we've talked about (and will talk about again) in this newsletter. To review, those Value Drivers include the following:

- A stable and motivated management team.
- Operating systems that improve sustainability of cash flows.
- Operating profit margins, at least as good as industry average.
- A solid, diversified customer base.
- A competitive advantage.
- A realistic growth strategy.
- Effective financial controls.
- Good and improving cash flow.

Keep in mind that there may be additional value drivers specific to your industry.

While owners pursuing a sale to a third party also work on enhancing their companies' Value Drivers all of the value those owners expect to realize must be created before the sale event (as that determines the amount of money the seller receives).

In a sale or transfer to insiders, however, the initial transfers of ownership often begin many years before the transfer of the bulk of ownership and control. This allows the KEG (key employee group) to demonstrate a serious interest in growing business value because it owns part of the company and because increasing the cash flow of the business will enable it to buy more in future years.

As the insider buyout occurs, the owner receives increasing amounts of cash (payments for his/her ownership interest) at ever increasing values and is entitled to increasing cash distributions with respect to his or her remaining ownership.

Thus, a central feature of most well-designed insider transfers is to keep the original owner in control over time (perhaps 3–10 years, depending on the owner's objectives) so that the owner receives most of his or her sale price before leaving the company.

It bears repeating that the key to successful insider transfers is to create a generous time frame so that:

1. owners can make incremental annual transfers of small percentages of ownership interest as insiders/buyers attain the performance standards the owner sets. (Those performance standards are designed so that the KEG is only permitted to acquire more ownership if cash flow increases each year.) And
2. the KEG has ample time to pay for the ownership that they are acquiring.

Transferring Management Duties

As owners work toward their exits, they need to transition a variety of management duties to the new owner. To do so, it is important to create, at least five years in advance of your target date, a time-based plan that determines who will take over which tasks within a set timetable.

Some owners can accomplish this fairly quickly because they've already delegated management responsibility. Your advisors can help you figure out where you are on the management transition continuum. We'll just provide an overview of the types of duties that need to be transferred:

- Financial Matters
    - Budget development and management.
    - Cash flow management. Invoicing and collections.
    - Increasing or reducing debt.
    - Funding for future growth.
    - Business contracts and obligations
- Infrastructure/Capital Investment
- General Business Duties

As always, contact me for the answers to your questions about the time required to plan an insider transfer or about any other exit planning issue.