Business by design:
Exit with confidence
Part V

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For July, we ended part IV with an agreement between the buyer and seller as follows:

Sales price $240,000; annual equity payments of $12,000; bank financed cash-out of $156,000 at the end of seven years; buyer takes over the business; seller lives happily ever after.

The topic left open, last month, questioned the capability of the buyer to make those annual payments in the absence of an existing savings account. I suggested creating a bonus plan to boost the employee-buyer's earnings, enabling the seven-year, 35 percent equity target banks like to see when considering business purchase financing. Let's explore how such a hypothetical plan might be structured.

We will presume that your business is profitable at about $50,000 per year, your employee is earning his regular, previously agreed pay, he has many of the qualifications needed to operate the business, and annual profit growth has averaged 5 percent. Your task, until the buy-sell is complete, is to nurture your employee to become ever more business savvy, motivate him to work smarter, learn more management skills from you, and help him see a reasonable path to pay you $12,000 a year in equity payments. At the same time, it certainly would be beneficial for you to earn more profit during those seven years too! Realizing that an infinite number of pay plans may be structured, let's create one here as an example of what is possible.

Since your employee now must spend some extra time developing management skills, and assume more and more of your duties during the next seven years, you decide to pay a "longevity bonus" of $4,000 a year and "profit gain-sharing bonus" of 30 percent of the shop's net profit between $50,000 and $60,000, then 50 percent of the amount above $60,000.

Don't overanalyze this just yet, just follow the math. Your employee will earn an extra $4,000 to continue working for you and get part way to the $12,000 annual payment due. (Your net just dropped by $4,000 to $46,000, all else being equal.) Your employee is now even more motivated to focus on all the ingredients that affect net profit, as are you! The first year, your combined efforts yield a net of $60,000. Your employee receives a profit bonus of $3,000 (30 percent of the gain above $50,000), plus $4,000 from the longevity bonus. He now has $7,000 of the $12,000 due you.

In the second year, net profit attains $66,000. Your employee receives the $4,000 longevity bonus and profit bonus of $6,000 (30 percent of the first $10,000 above $50,000; 50 percent of the amount above $60,000), for a total of $10,000 toward the $12,000 due you. You can continue this hypothetically on your own, knowing that nothing moves in a straight trend.

Now we can review the logic of this concept. The reasons to consider some type of bonus plan are many: You need the buy-out to succeed; you improve the likelihood that your employee will continue working for you and not get discouraged; you earn your pay for the duration; your employee will likely be working harder/smarter to attain the profit bonuses, thereby making you even more money; the employee is extra receptive to your management instruction since every decision affects the bottom line; both of your efforts are aligned like never before, increasing odds of a positive outcome. And, yes, all business risks still apply.

As in the negotiation process over price, any assistance or incentives you wish to offer are subject to all of the practicalities and emotion that come with human interaction. The key is finding a mutually agreeable path toward success. My goal in this article is to open your mind to possibilities that help you achieve a result that is mutually rewarding. The limiting factor in so many owner/employee buy-out scenarios is lack of creativity. Where there is motivation, there is almost always a way to get it done!

Just do not wait until you are ready to retire to start planning succession. Succession can be planned as early as when your business first opens its doors. Once again, if you don't have a succession plan in place already, start soon!

Next month we'll discuss creating a draft of your intentions for use by your attorney and tax professional to help them formalize your succession plan efficiently.

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