Unlocking Business Value
Through a Sale to an Employee

April 2021

As a business owner considering your transition options, one common exit strategy is a sale to one or more key employees. Upon first glance this may seem like the simplest strategy, but as is the case with any transition event there is significant complexity involved. We recommend that business owners approach this process with due care and diligence to increase the likelihood of a successful transition. In a best-case scenario, transitioning to an employee would occur without disruption to the business and ensure the seller receives payment for the value they built. In a worst-case scenario, a seller would spend significant time working toward a sale to an employee that goes wrong; losing a potential buyer as well as a key employee.

This article explores the opportunities and challenges of a sale to an employee and provides some additional considerations for a successful transition of the business to an employee.

Opportunities

For a business owner considering a sale to an employee the simplicity of working with a familiar buyer who has a deep understanding of the business is very appealing. There is no need to widely canvass the market for potential buyers and risk confidentiality leakage. By negotiating with an employee it is possible to maintain the upmost confidentiality and unlikely that industry peers, customers or suppliers would become aware of a potential transaction until it is completed. Additionally, the ease of transitioning key relationships with peers, customers and suppliers is likely more seamless than it would be if transitioning to a third party.

Challenges

Conversely, having familiarity with a buyer may add emotional complexity and cause some transition-related conversations to be more difficult. For example, in the due diligence process a seller will have to disclose owner compensation, and when the buyer is a trusted employee it can be uncomfortable. As well, negotiations between two unrelated parties can be relatively straightforward, but when there is an underlying relationship it may be more difficult for the parties to communicate and form an agreement. The seller may want to maximize value to ensure the financial stability of their family, but as the price goes up it becomes more difficult for the buyer to complete the transaction. The buyer may want to pay a lower price but offering too low a price may send a message that the buyer does not value the hard work put in by the seller in building the business. Ultimately, there is a balance required to find a fair price that compensates the seller for the business value and sets the buyer up for future success.

Other considerations

When structuring a sale to an employee the most common questions that sellers have fall into one of the following categories:

Transition of control

When selling to an employee, one decision a buyer and seller must negotiate is when to transition control. Some sellers prefer to make a clean break and fully exit upon closing of the transaction, while others want to stay involved for a period of time to ensure a smooth transition. Continued seller involvement is especially important when a buyer has not fully paid for the business on closing and the seller is dependent upon the business' profit to pay the outstanding amount. Some sellers opt to retain an ownership position in the business and the employee becomes a minority shareholder in the medium-term, with a long-term goal of selling the remaining ownership position to that individual. There is no single right answer that applies in all situations and it is ultimately an individual decision based on personal and business goals. As such, a transition should be seen as a process not an event and be planned for accordingly.

Employee readiness

Often what drives the seller's decision to fully or partially exit is the employee's readiness to become an owner. To increase the likelihood of a successful transition the employee must be ready, willing and able to be an owner. In order to have sufficient time to determine employee readiness it is imperative to start the business transition planning process early. If the transaction does not unfold exactly as envisioned, this provides the seller with flexibility to explore other exit options.

Transaction structure

A common reason why a sale to an employee fails is because the employee cannot afford to acquire the company. Very often, particularly as a business grows, the value of the business makes it difficult for an employee to raise the required capital. While financial institutions generally have an appetite to lend to new owners of an existing business, the buyer must be able to contribute some equity to the transaction. This equity may come from savings, refinancing personal assets, or family contributions. A gap between buyer equity and bank financing is typically bridged with a vendor takeback ("VTB"). The debt owed by the buyer to the seller is subordinated to any debt issued by the primary lender and; therefore, can be at risk if the business fails. If the seller requires access to the full purchase price upon closing, a sale to an employee may not achieve their financial goals and may not be a practical sale option. Sellers should be wary of buyers who approach them with offers to acquire the business with minimal equity, a large VTB, or a VTB paid over a very long period of time, as these significantly increase the seller's risk.

Seek advice

As with any business transition, a sale to an employee must be planned well in advance of a transaction. A BMO Business Advisory and Transition Planning Specialist can be a trusted resource for navigating this complex process.

For more information, speak with your BMO financial professional.

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(03/21)21-0973ACC ID4688