



## *Exit Planning*

# NAVIGATOR

*Exit Planning Strategies for the Entrepreneur*

Issue 49

### **Incentive Plans For Key Employees** ***Designing Performance Criteria*** *(Second Of A Two Part Series)*

The previous issue of **The Exit Planning Navigator®** discussed the primary reason that it is so important to motivate your key employees to stay with your company. Ultimately, your ability to get top dollar for your company depends on your ability to create, motivate and keep good management. That article further described the four characteristics of a successful incentive plan.

The fourth characteristic of a successful incentive plan is that key employees earn the incentive bonus based on a performance standard that, when attained, *increases the value of your business.*

Pay careful attention to the design—and consequences—of the performance standard. Consider the following:

- A performance criterion can be any standard that you dream up because incentive plans are “nonqualified,” (they carry no special benefits under the U.S. Tax Code) and therefore can be restricted to management.
- The performance standard, when met, must measurably increase business value. Because the goal is to provide more cash to you when you leave via the conversion of that increased value to cash, many owners decide to measure value in terms of increasing cash flow. In addition, buyers (especially those of service companies) typically use valuation formulas based upon a multiple of cash flow. Performance standards based on increasing cash flow are attractive to both key employees and owners.
- When you determine how best to measure cash flow for purposes of an incentive plan, start with the amount of cash the company generates and pays to you in the form of salary, bonus, distributions, and excess rent. Add to that the cash flow amount retained in the company that could be distributed to you, but that you elect to keep in the company for growth and capitalization. More or less, that sum is the available cash flow stream that should increase as the efforts of your management increase business value. This formula puts more money in your pocket today and on the day you sell.

Here are a few examples of formulas that work equally well for stock (equity) or cash-based plans:

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## Incentive Plans For Key Employees *Designing Performance Criteria* (Second Of A Two Part Series) (continued)

- Key Employees earn a percentage above a base cash flow amount (perhaps 30 percent of cash flow over \$100,000). If cash flow falls below the base of \$100,000, bonuses are not earned. The base amount can reflect last year's cash flow or the amount retained in business for capitalization purposes or a reasonable return on the assets of the company (cash flow the management team did nothing to create). Incentives can be paid in stock or cash and deferred until a specific date.
- The incentive amount can be a percentage above a base amount (as in the example above), except that it is a percentage of cash flow that adjusts cash flow increases or decreases.
- The incentive can be a percentage of growth in adjusted revenues of the company, or perhaps of adjusted revenues above a certain base level. For example, gross revenue less the Cost of Goods Sold (COGS) is the "top-line" reduced by a base amount, with Key Employees receiving a percentage of the amount above that base level.
- Some incentive formulas reflect the desired financial/cash flow condition of the company. If the goal is attained in a specific year, the Key Employees are allowed to buy a portion of the company—usually paid for with the future cash flows from the stock just purchased. For example, if revenues, (or revenues adjusted for COGS), or cash flow reach a base level of \$X (described in the incentive agreement), eligible Key Employees are entitled to purchase a pre-determined percent of the outstanding stock of the company.

These are just a few of the many formulas you can use to effectively motivate your key employees to increase the cash flow, the financial strength, and ultimately the value of your business. The professional who sent you this newsletter should be able to help you design a formula that works best for you, your employees and your company.

*Subsequent issues of The Exit Planning Navigator® discuss all aspects of Exit Planning.*

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