



Exit Planning

NAVIGATOR

Exit Planning Strategies for the Entrepreneur

Issue 51

Buying Out Your Partner

Hypothetical case study

MMS, Inc., a computer service business, had survived the recent industry fallout through the persistent efforts of its owners, Ralph McMillan and Janet Shaw. In fact, MMS had enjoyed good cash flow for the past three years and its future was looking better than ever. All of this made Ralph, age 59, more anxious to leave the business. Meanwhile, Janet was ready for him to leave. But neither of them had a clear idea of how to proceed, who to ask for guidance or even how to take the first step.

Janet and Ralph need to know how to find the starting line before they can run the course to the successful dissolution of their partnership.

First, Ralph must assess his income needs and timing of his exit. Ralph must determine how much of the purchase price he needs (or wants) on the day he leaves and how much he is willing to receive after he leaves. This is a very different question from how much is his interest worth yet the questions are related because the cash Ralph needs must be attainable from the sale of his interest.

Second, Ralph must obtain an *independent* valuation of his ownership interest, and a professionally performed future cash flow projection.

Note: Ralph is not going to leave unless he gets full value for his ownership interest (hence the need for the valuation) and unless that value is enough to meet his retirement needs (hence the need for a retirement income needs analysis).

Third, because Janet may be uncomfortable with the amount of risk/liability she and the business assume in the buy-out, that risk should be balanced by an opportunity for continued growth in the value of business interest. Janet is likely to be unwilling to buy Ralph's interest if doing so puts her (or the business) at too great a financial risk. The future cash flow projection is necessary for Janet to determine if the business will likely have enough cash flow after Ralph leaves to finance the purchase of Ralph's interest without stifling the growth and prosperity of the business.

The concerns and risks of buying out a departing co-owner can be reduced by taking the three steps described above. Based on the information gained in those steps, Ralph's Exit Plan can be designed to:

- Use the available cash flow in the most tax-efficient manner possible.

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- Plan the long-term ownership structure of the company. For example, after Ralph is gone, what does Janet (the remaining owner) intend to do with the business? Does it not make sense to consider her future exit when Ralph's exit is being designed and implemented?

As Ralph is contemplating his exit, perhaps Janet should consider:

- Selling all of the ownership to an outside party. The business must be marketable and Janet (and perhaps even Ralph) may need to remain for a year or more after the sale. The advantage to Ralph (and, ultimately to Janet) is a better chance of getting at least the bulk of the purchase price.
- Selling Ralph's interest to key (or all) employees. This strategy depends on the existence of motivated management willing to assume ownership. Often, a partial sale to a younger management group, (keeping control firmly in the hands of the remaining principal owner) makes great sense. This strategy starts to pave the way for eventual sale of remaining owner's interest to this group, can be a great motivation tool and handcuffs this management team to business.
- Selling all (or just Ralph's interest) to an Employee Stock Ownership Plan (ESOP). This design can offer tax and cash flow savings for both Ralph and the buyers.

This article mentions just a few of the many ways to design the exit of a co-owner. Before *any* group of co-owners can create a successful exit plan they must:

- 1) assess the departing owner's needs (a retirement income needs analysis);
- 2) secure an independent valuation of ownership interests; and
- 3) assess the remaining owner's risk tolerance (dependent on a cash flow projection).

In each of these assessments, owners should employ the services of professionals.

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

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