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Is it a good idea to buy your boss's business?

In a word … Yes! As buyers, the managers of small and midsize companies understand the nuances of your owner's business more than the typical outside buyer. This is a distinct advantage for you as a buyer and an opportunity for you to take the company to the next level of profitability and success!

There are a few common options as an inside buyer: A management buyout (MBO) and an ESOP.

A management buyout (MBO) is appealing to professional managers because of the greater potential rewards from being owners of the business rather than employees.

An MBO's advantages are that as the existing managers are acquiring the business, they have a much better understanding of it, there is no learning curve involved, and have a good working relationship with the seller. There are several structural ways to buy the company. Buying the company's assets or its stock with new equity capital or with debt capital, an LMBO. An MBO uses equity capital. The advantage of an MBO over a Leveraged Management Buyout, LMBO, is that the company's debt load may be lower, giving it more financial flexibility in good and not so good times.

However, there are several drawbacks to the MBO structure. While the management team can reap the rewards of ownership, they have to make the transition from being employees to owners, which requires a change in mindset from managerial to entrepreneurial. Not all managers may be successful in making this transition.

Also, the seller may not realize the optimum price and terms for the sale in an MBO. Also, keep in mind, if the existing management team is a serious bidder for the assets or operations being sold, the managers have a potential conflict of interest: they could downplay or deliberately sabotage the future prospects of the assets that are for sale to buy them at a relatively low price.

MBOs are viewed as good investment opportunities by private equity firms and large financiers. They usually encourage the company to go private so that it can streamline operations and improve profitability away from the public eye, and then take it public at a much higher valuation in a few years. While private equity firms may also participate in

MBOs, their preference may be for their team to manage the new firm. Their companies are run by managers they know rather than the existing management team.

ESOPs, Employee Stock Ownership Plans, are another common option for employees to purchase the owner's interest in the company.

The goal of the ESOP is to buy the shares of the departing owner. Owners of privately held companies can us the ESOP to create a ready market to sell their shares. Under this transaction, the company can make tax deductible cash contributions to the ESOP to buy out an owner's shares, or it can have the ESOP borrow money to buy the shares.

The ESOP is a separate entity, a trust, like an employee benefit plan similar to a profit-sharing plan. There is an independent trustee who has the fiduciary duty to protect the interests of the beneficiaries of the trust, the employees. The trust funds either raise funds from the employees to contribute to the purchase of the departing owner's shares, or the trust can borrow money for new or existing shares.

Most lenders prefer not to take all of the risk on the purchase of the company stock if the ESOP decides to borrow money to pay for the shares. The lenders prefer that the departing owner agree to consider a partial installment sale, a promissory note to the ESOP buyer in addition to borrowing money from the lender. ESOP transactions with lender financing require a business appraisal at the date of the sale and annual business appraisals for the benefit of the ESOP and the lenders.

The main financial benefit to the departing owners is that the sale proceeds may be considered tax free transactions to them. For further guidance on these strategies, discuss with your legal and tax advisors regarding your facts and circumstances and how ESOPs and MBO's would affect your legal and tax planning. It is best practice to discuss the tax impacts of these transactions earlier in the process for the advantages and the disadvantages of these agreements.

An essential skill for successful business owners

In many situations, business owners negotiate contracts with customers, suppliers and employees. There are basic guidelines to negotiation and like many processes, there are best practices to be effective in achieving your goals during negotiations. Negotiating may end up with a 'winner' and a 'loser' – that is, one party giving in completely to the other so that an agreement can be reached, but more often negotiation is about compromise so as to find an outcome that provides some satisfaction to both parties.

Negotiation, in a business context, is used in selling, purchasing, determining the details of a workplace agreement, arranging a loan, getting the best deal from suppliers and any number of other situations. In fact, you probably spend quite a lot of time negotiating in one way and another.

There are skills and techniques that experienced negotiators use to ensure that they come out of negotiations with a worthwhile result and the application of these techniques will improve your chances too of getting the best deal in your negotiations.

Analyze people's positions

Before beginning negotiations analyze what's driving the thinking of the other party. Basically, this means understanding what *they* really need to achieve, so that you can assess as closely as possible just what they might be prepared to accept. You should know what are the most important points that the other side is pushing and which are of lesser importance, ones they'll likely concede more easily.

This applies to your position as well. You need to have full understanding of your own position and know exactly what you want (2% cut in price from your supplier, an extension of 6 months to the loan repayment period or whatever) and where you'll have to 'draw the line'. Be very clear in your own mind as to what will constitute an acceptable outcome.

Plan a strategy

Decide what your approach will be. Are you going to start off by asking more than you really want and then fall back to a position where you seem to give in but actually achieve your goal? Do you play it tough all the way to the end or give up your original position in gradual steps?

Try to anticipate the strategy of the other side as well. Study their previous negotiations and how they were conducted. It will help you predict how they'll respond to your actions as you proceed.

In general, when negotiating aim as high as you feel necessary in order to achieve the best deal for yourself. The other party may be able to get you to give way on certain points but in general it's a good tactic because giving way a little is easier than trying to get extras included as you go along.

Be clear on the details

Negotiations are often used to produce a contract, so it's necessary to consider the fine print in any negotiating situation.

Never allow a misunderstanding to arise. If you're in doubt on anything, ask questions until you're positive you know the answers and what they mean. You don't want to reach what you think is the end of negotiations, only to find out that you aren't getting what you thought you'd bargained for.

Be adaptable

You need to be ready to adapt quickly to meet changes in the other party's position. If they cave in earlier than you anticipated do you have a way of getting more out of them? If they prove to be tougher than you thought would it be best to call a halt and reconvene at a later time?

Try to anticipate what the other side may offer as a means of compensating *you* for giving in on something. Be ready to find ways of giving the other party something in return for a concession *they're* prepared to make.

Always keep in mind your objective

Negotiations can go on for extended periods of time. Often this is the result of a delaying tactic used by one side to wear the other side down in the negotiations. Another reason for going slowly is to frustrate the other side and try to gain concessions in return for speeding things up. Whatever else happens during the negotiations, remember what it is you want and what you're willing to accept. Don't be distracted by delays or by peripheral offers or concessions.

We use negotiation in everything we do but you have to be sure that it is done in the best way possible to achieve maximum benefit. The most important part is planning; good preparation is a definite advantage when negotiating.

Have you considered a Pareto Analysis?

The Pareto analysis is based on the principle developed by the economist, Vilfredo Pareto. It is known also as the 80/20 rule. It is a decision-making technique that separates a limited number of factors as having the greatest impact on the outcome. For example, profitability in businesses usually follows the '80/20 rule' – 80% of the profits may be from just 20% of the customers. The numbers vary from one business to another, but how do you go about figuring the value of your customers or customer groups so as to identify, and encourage those customers who are contributing the most to your company?

Here are four ways of classifying clients and assess their profitability. Some ways are better than others.

1. The total amount a customer spends: This is the most common one businesses apply. If Customer A spends $250,000 per year with your business and Customer B only spends $150,000 per year, it's likely you'll see Customer A as the bigger customer. It's straightforward but in fact it's by no means an accurate way of telling a 'good' customer from a 'not so good' one. You need to dig deeper to be certain.
2. The gross profits earned from each customer's purchases: Say Customer A's $250,000 buys them 250 basic units at $1000 each and your gross profit per basic unit is $185, then their profit contribution to your business is $46,250. If Customer B's $150,000 buys them 5 luxury units at $30,000 for each unit, and your gross profit per luxury unit is $8,500, then their profit contribution is $42,500. The mathematics is very simple and demonstrates that although Customer A spends $100,000 more than Customer B in a year, their contribution to your profits is only $3750 greater. Next, look at the number of purchases made by each customer.
3. The number of purchases each customer makes: Customer A makes 250 purchases a year whereas Customer B makes only 5 purchases per year. Customer A provides a profit contribution of $185 per purchase, while Customer B provides a profit contribution of $8500 per purchase. Or to look at it another way, each purchase made by Customer B is nearly 46 times more profitable than a purchase by Customer A!
4. The cost of servicing each customer: Calculate the costs of servicing them. Taking everything into account from selling costs to fixed overhead, it's still likely that a customer making five purchases per year is going to cost less to service than one that makes 250 purchases per year.

This sort of analysis reveals some interesting facts important to your profitability and maybe your marketing approach as well. Customer B – the ‘smaller’ customer, is really worth about the same to your business as Customer A despite the $100,000 difference in what they spend with you. When planning a profit strategy, you’d be better off getting customer B to purchase just one more unit than trying to get Customer A to make a lot of extra purchases, or to get more customers like B than A.

Take a new, more analytical look at your customers and their purchases. Look for their contribution to your net profit rather than just their turnover and you’ll start seeing them in a different light. Some probably won’t turn out to be as big – or as small, as you’d thought.

Regular Pieces

How To Make The Most Of Your Newsletter

Be sure to read each article with the mindset ‘How could this apply to our business.’ Thinking of it that way will guarantee that you get value. Better yet, take notes as you read and commit to having the ideas implemented by the time the next edition arrives. Also, make copies for each team member. To really make sure something positive happens, work with your business development specialist to talk your team through the ideas and how to set a schedule for getting them implemented. We’re here to help you get started.

An Important Message

While every effort has been made to provide valuable, useful information in this publication, this firm and any related suppliers or associated companies accept no responsibility or any form of liability from reliance upon or use of its contents. Any suggestions should be considered carefully within your own particular circumstances, as they are intended as general information only.

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