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SANTA CRUZ COMMUNITY VENTURES

Business Succession Planning:

Economic Development Tool

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SANTA CRUZ COMMUNITY VENTURES

Established in 1989, **Santa Cruz Community Ventures** is a nonprofit organization working to support local economies through financial capability, asset building, and advocacy. Efforts include a focus on increasing democratic business ownership as a vehicle for wellbeing.

SANTA CRUZ COUNTY
WORKFORCE DEVELOPMENT

COMMUNITY PRINTERS

EL PÁJARO
COMMUNITY DEVELOPMENT CORPORATION

AMERICA'S SBDC CALIFORNIA
NORTHERN CA NETWORK
Cabrillo College

Thanks

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What we will cover today:

- **Why Succession Matters and How to Create a Supporting Business Succession Culture**
- **Succession planning options/models**
- **Conversion to employee ownership**
- **Technical Assistance for employee-owners**

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CONCERNED
CAPITAL


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COMMUNITY DEVELOPMENT CORPORATION


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YOU HAVE TO HAVE A LEADERSHIP SUCCESSION PLAN.
THERE'S A FREEZE ON HIRING, SO YOU'LL NEED TO PICK SOMEONE FROM YOUR STAFF.
SO, IF SOMETHING HORRIBLE HAPPENED TO YOU, I'D GET A PROMOTION?
THIS WAS A BAD IDEA.
www.dilbert.com scottadams@aol.com
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Why Succession Matters

1. Perils of Inaction Exercise
2. Succession is a Critical Issue
3. Data and Example
4. Creating a Succession Friendly Corporate Culture

Perils of Inactivity Exercise

1. Review your Image
2. Find your Group with related images
3. Identify the business, it's challenges, and impact on the community.

Image Group Example



Small Group Discussion Questions

1. What is the business?
2. How did it interact with the community?
3. Why did it close?
4. How did the closure impact the community?
5. What happened to the employees?
6. What could have been done to save it?

What is Succession Planning?

Succession planning is a process for identifying and developing **new leaders** who can replace old leaders when they leave, retire or die.

Succession planning **increases the availability** of experienced and capable employees that are prepared to assume these roles as they become available.

Taken narrowly, "**replacement planning**" for key roles is the heart of succession planning.

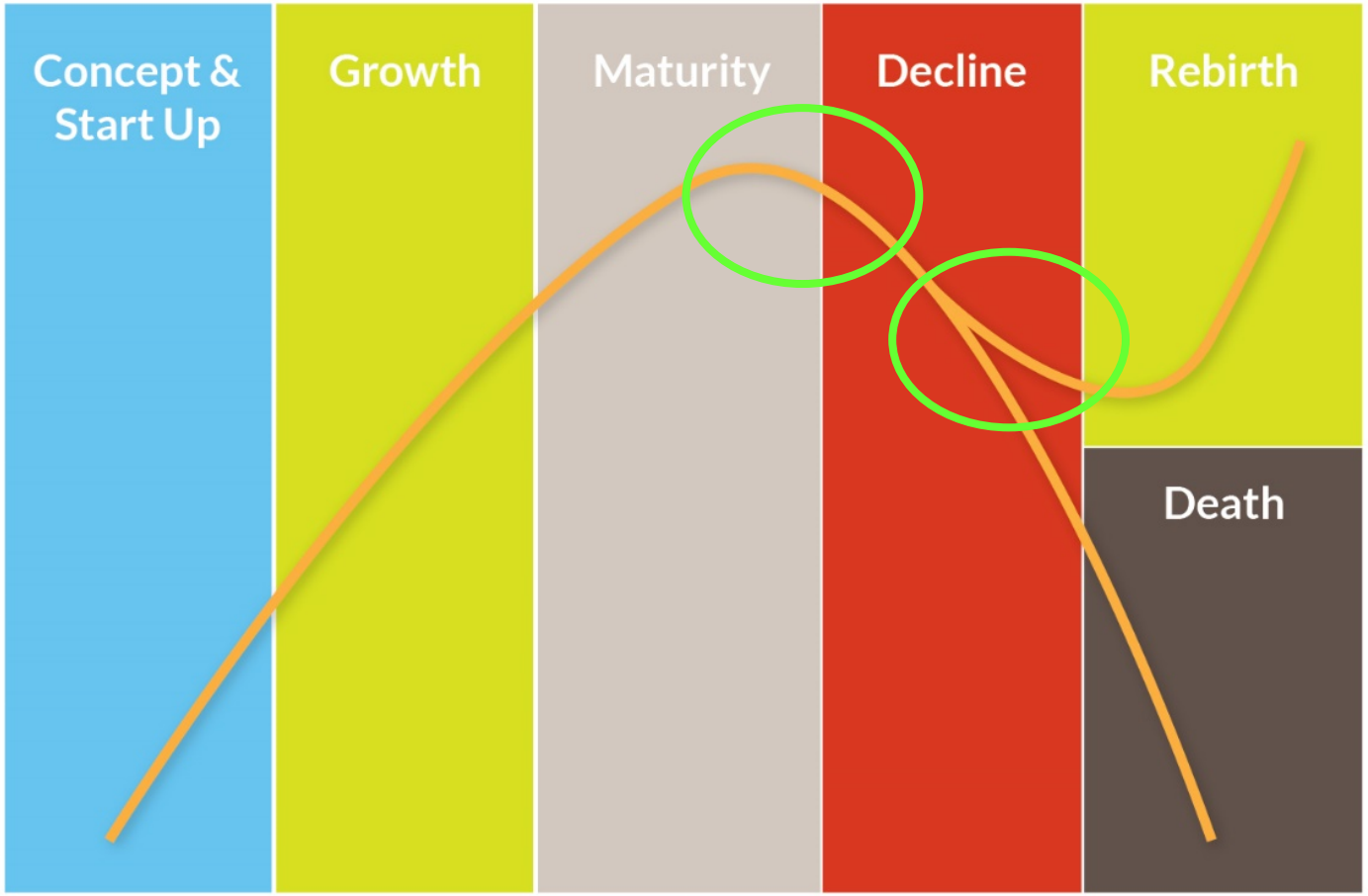
Succession is a Critical Issue for the Local Economy

- Most companies are never sold to third parties because they can't demonstrate profitability and don't have good records.
- Only **20%** of businesses listed for sale each year will sell to third party
- Economic development incentives that help start, foster and grow a company are defeated when a predatory consolidation and/or liquidation occurs.

Conversions are safer than Start-Ups

- Build on something with a **track record**
- **Startups that have no demonstrated market** (not even a wait list of customers), no beta-tested product prototype and no proven management structure
- Existing companies do have risks, but they are **known risks** that can be mitigated with proper planning and anticipation
- Job impact is much **easier to measure** for an existing company 'at risk for closure' than for a start-up
- Economic Development rationale for the work

Business Life Cycle



Business Life Cycle: To stay in Growth, or have a successful Rebirth, brands need to 'face the market.'

THE NEED FOR SUCCESSION PLANNING

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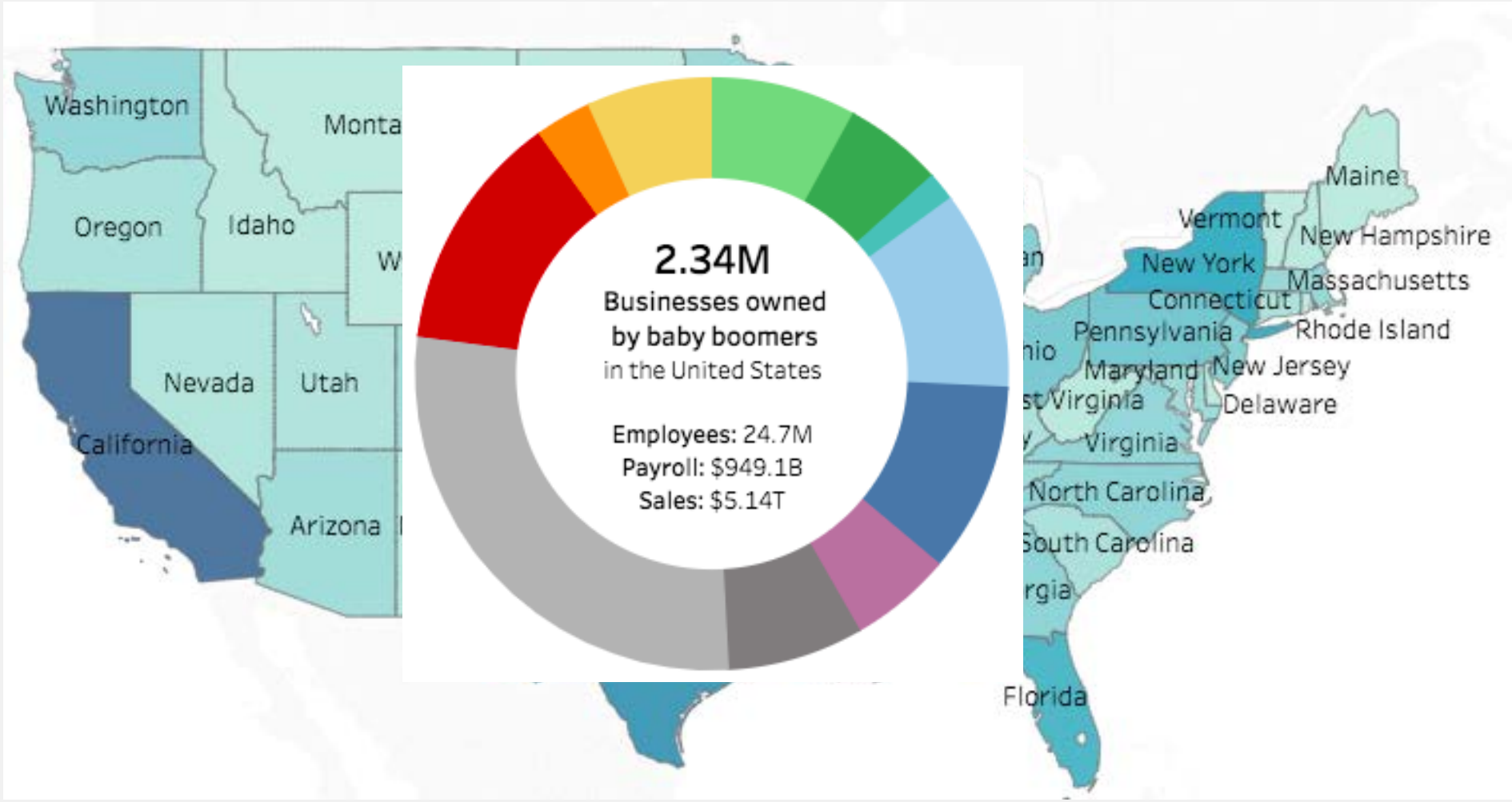
THE REALITY: Baby boomers own nearly half of privately-held businesses with employees in the U.S.



www.project-equity.org/communities/small-business-closure-crisis/

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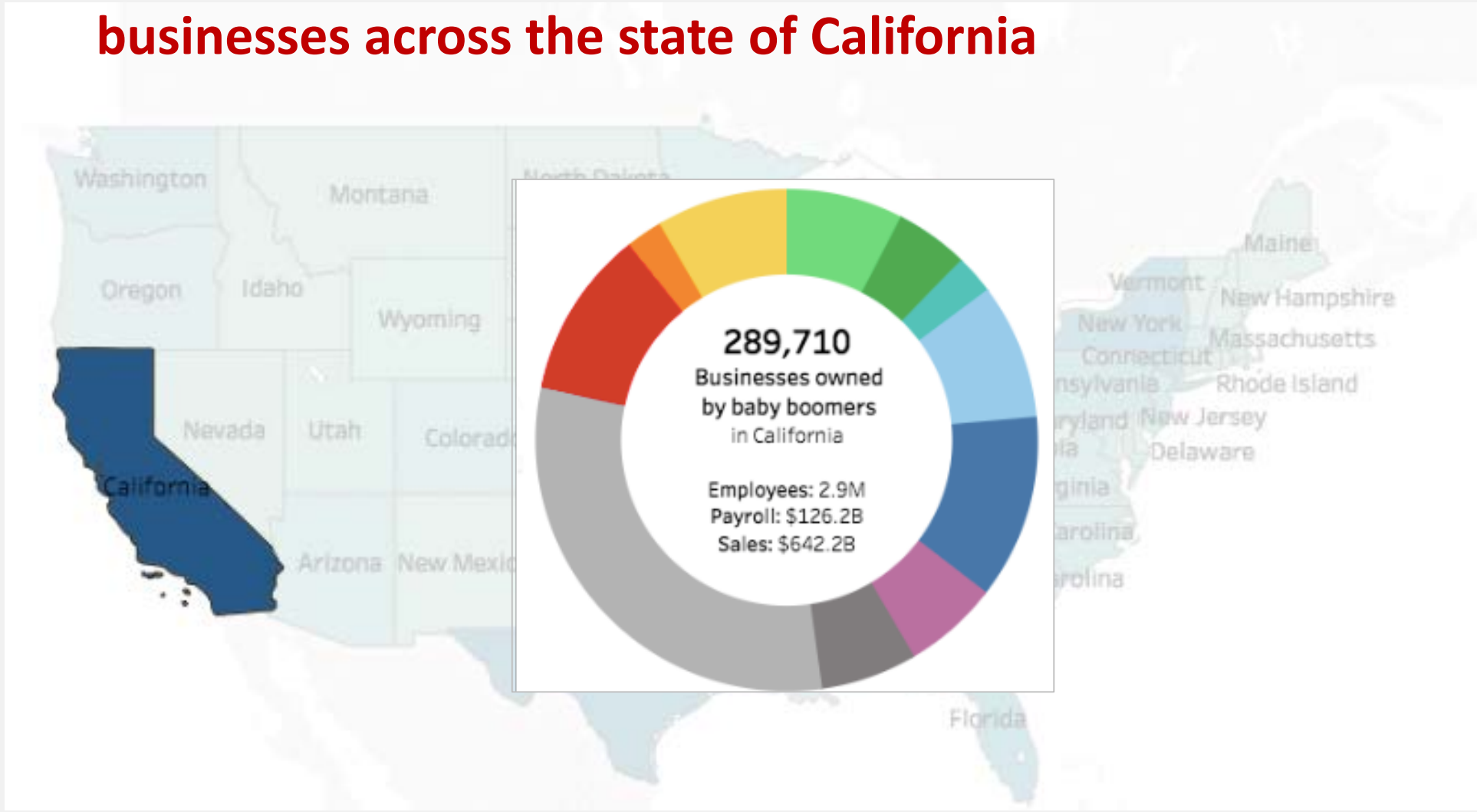
Baby boomers are estimated to own nearly 300,000 businesses across the state of California



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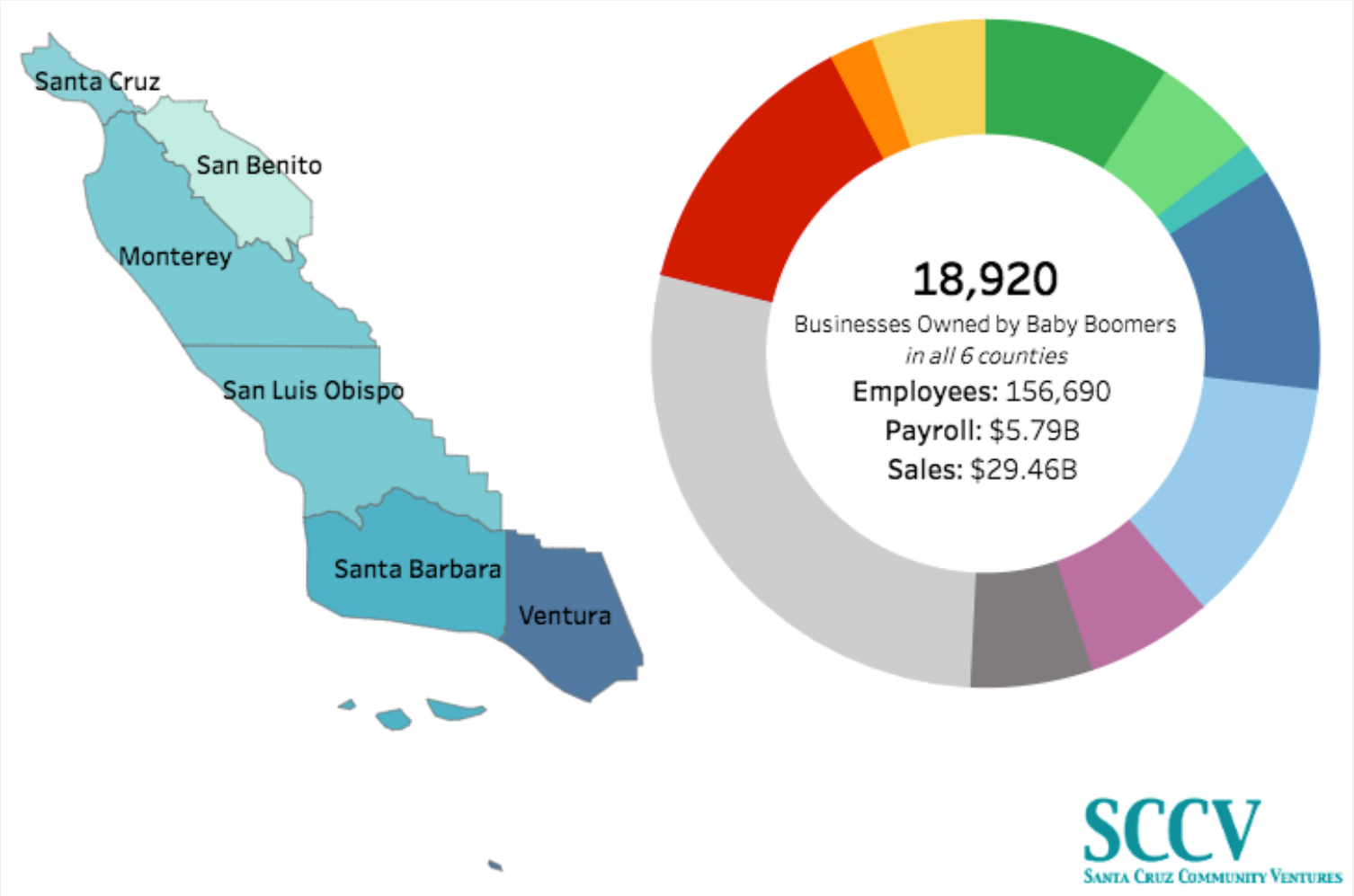
Nearly 19,000 of these are in the Central Coast region, providing over 150,000 estimated jobs



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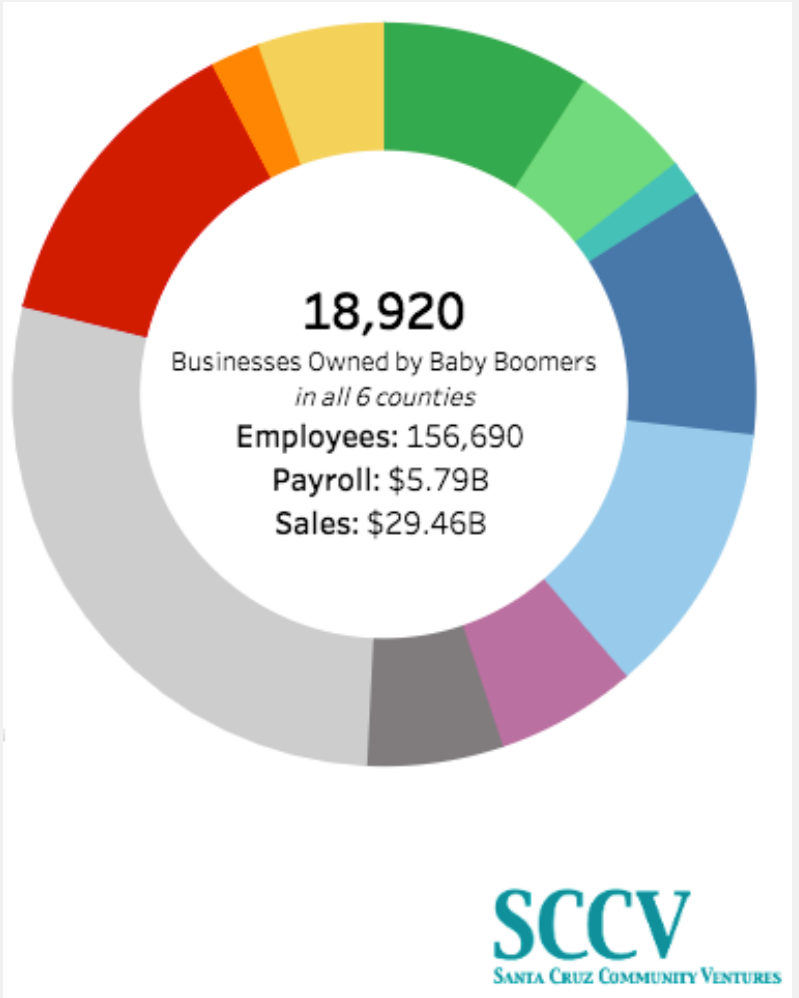

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TOM & GEORGE ARE

SELLING TO THEIR EMPLOYEES

As they retire, they are enabling their employees to become owners of a thriving local manufacturing company.

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Keys to Successful Transitions

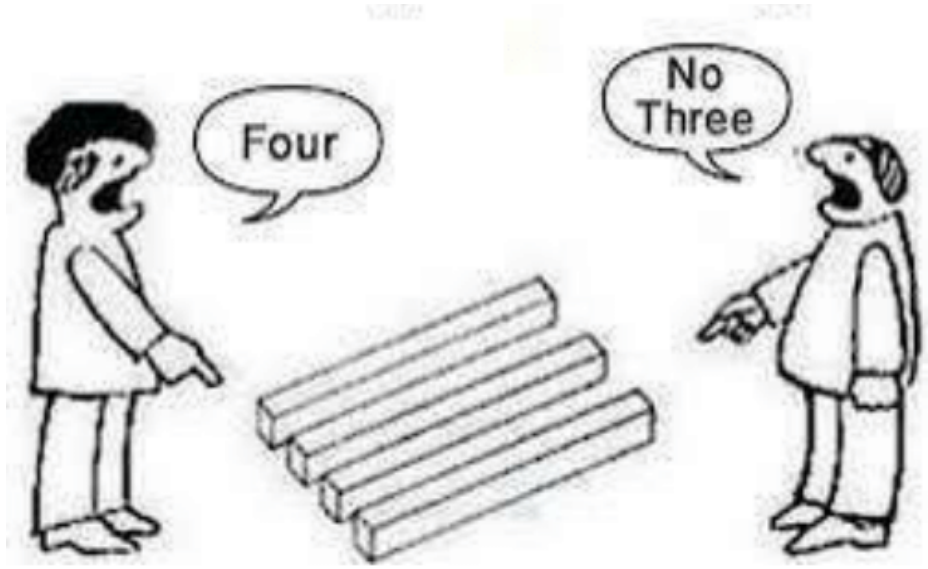
1. **Start Early:** Identify company **'at risk'** due to transition issue—age or health of owner, etc.
2. **Local Matters**: Identify reason(s) why company should stay local – job impact and tax revenue loss
3. **Understand the Valuation:** 'Windshield' vs 'Full'
4. **Resources**: What is needed for financing, research, permit issues, business planning
5. **Transition team:** translator, consultants, lawyers, lender, accountant, etc.

Psychology of Succession

- No exit plan
- Risk Averse
- Retirement is sale of business
- Recent Investments outside of business
- Valuation consternation
- Legacy and workers
- Low probability of sale

Owners & Buyers: 2 Perspectives

- Business Owner is selling *INTANGIBLE GOODWILL*
- Third Party Buyer is Buying : PROFITS
- Employee-Buyers understand the value of GOODWILL.



Competing Interests for Purchase

Speculators Or Investors

Dismantlers

Employees & Insiders

Competitors

SELLING TO INSIDERS:
PROACTIVE LAYOFF AVERSION STRATEGIES

June 25, 2019
Aptos, CA

Presented by
Concerned Capital, Inc.

WORKSHOP OVERVIEW

1. **Introduction:** Concern Capital's work
2. **Succession Strategy:** Bottoms Up Approach to Saving "At-Risk" Jobs
3. **Implementation:** Deal Mechanics & Examples
4. **Exercise:** Identifying "At Risk" Indicator
5. **Succession Plan Components**
6. **Rapid Respond & Succession Planning**
7. **Q &A:** Facilitated discussion

CONCERNED CAPITAL, INC.

- Concerned Capital is a social benefit corporation that specializes in **social impact investments**.
- We strive to **create and save jobs** by directing capital to low to moderate income communities.
- We are dedicated to supporting manufacturing and social enterprises which **generate wealth** for families in underserved communities.

OUR ROLE AS A CATALYST

1. Identify potential deals
2. Review business viability
3. Work with employee groups to prepare them as buyers
4. Letter of intent
5. Due Diligence
6. Manage expectations for sellers
7. Capital stack for purchase

WHEN LIFE GIVES YOU LEMONS…

- Shipping and logistics company
- 6 retail stores and a warehouse
- Founders want to sell due to medical issues
- Engaged CC to create plan to transition to workers

‘BOTTOMS UP’ APPROACH

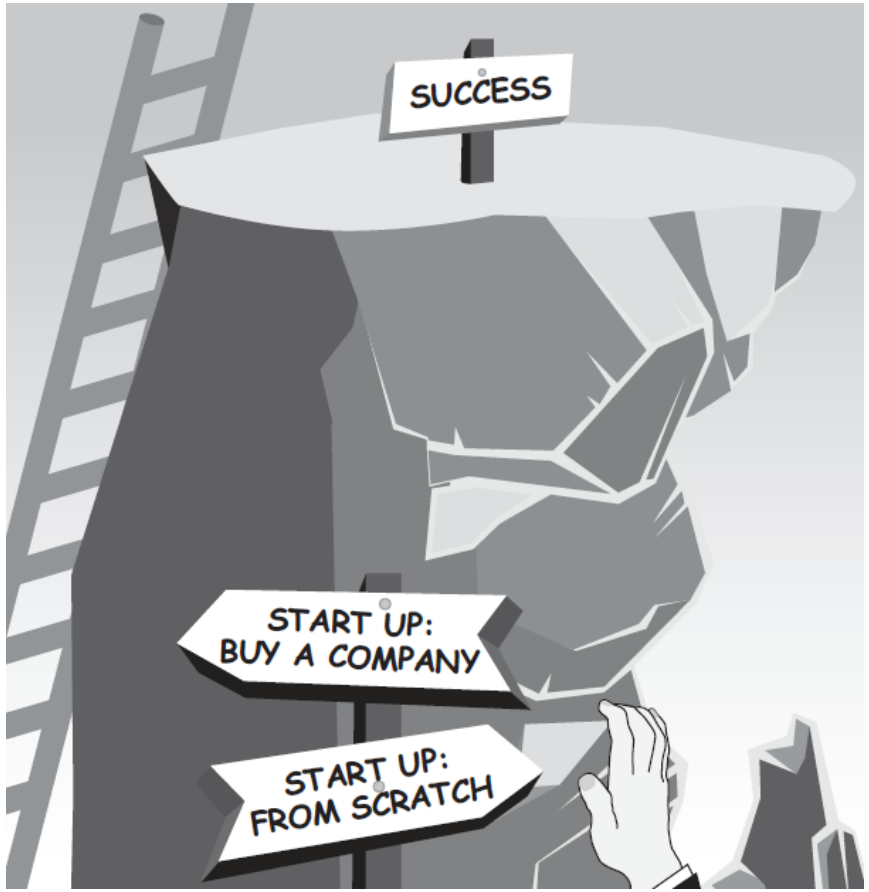
Why take the risk?
Strengths
Weaknesses
Opportunities
Threats
Improving likelihood of success
Outcome vs Process

SELLING TO INSIDERS AS ONE SUCCESSFUL OUTCOME

1. Faster
2. Keeps Jobs Local
3. Tax Benefits for seller
4. Longer Transition

BUYING A COMPANY MAKES SENSE

- Build on something with a **track record**
- Startups have **no demonstrated market** for their product
- Existing companies have **known risks** that can be mitigated
- Job impact is much **easier to measure** for an existing company

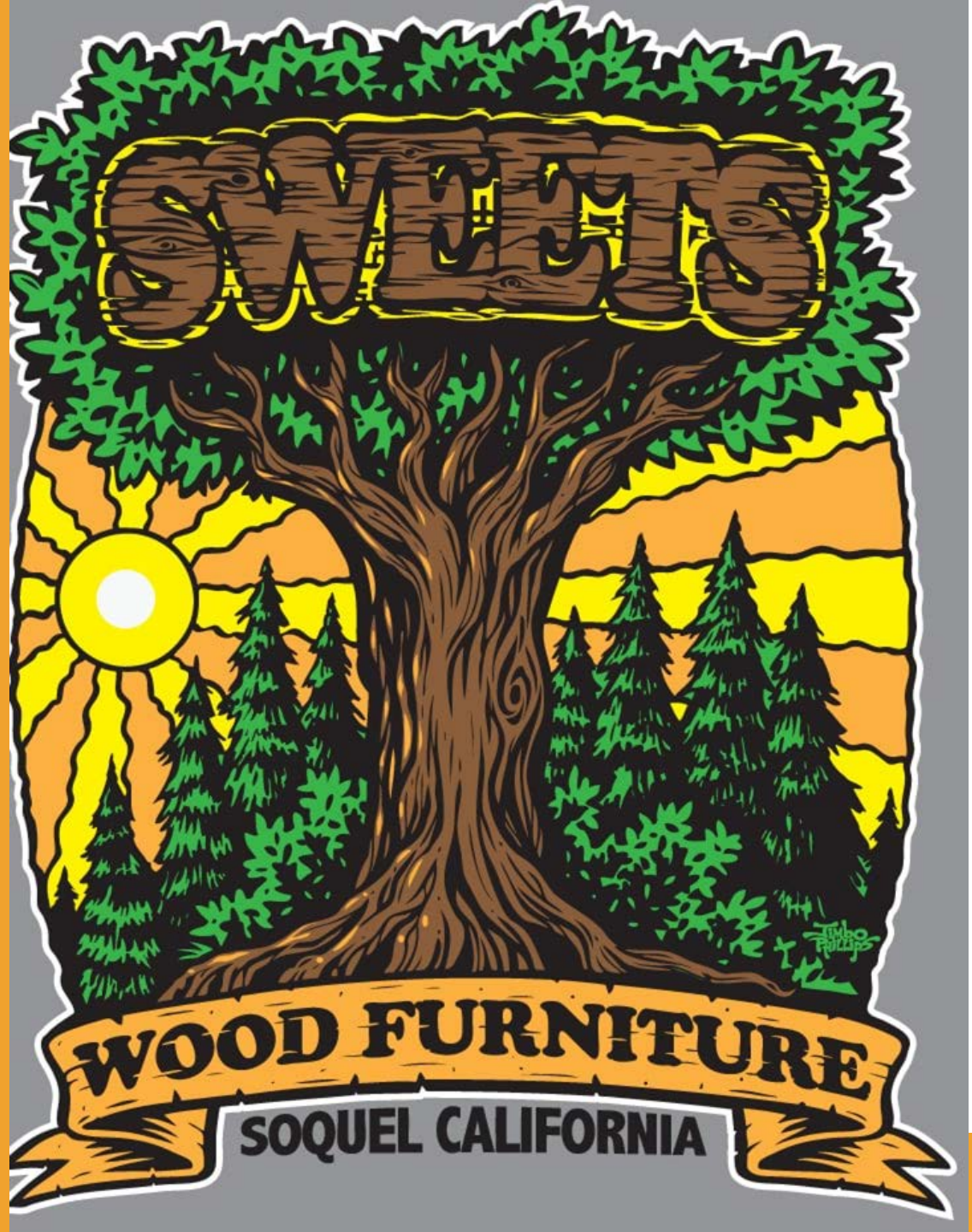


LANDSCAPE: RESOURCES & PLAYERS

COMPANIES AT RISK OF CLOSING: CAUSATION FACTORS

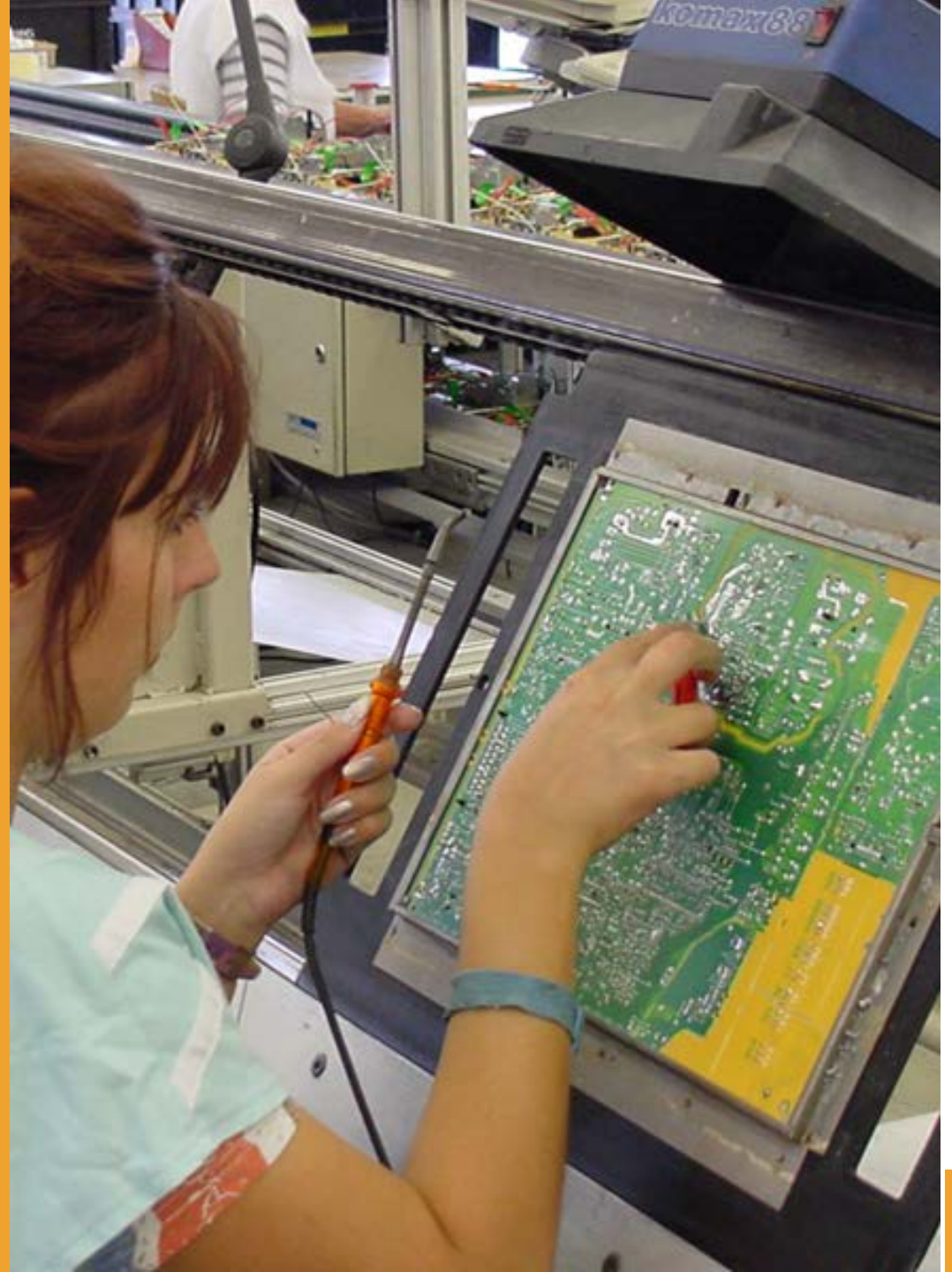
- Facility
- Organization
- Market
- Community

SWEET'S WOOD FURNITURE



LOS AMIGOS HARVESTING

DALLAS ELECTRONICS



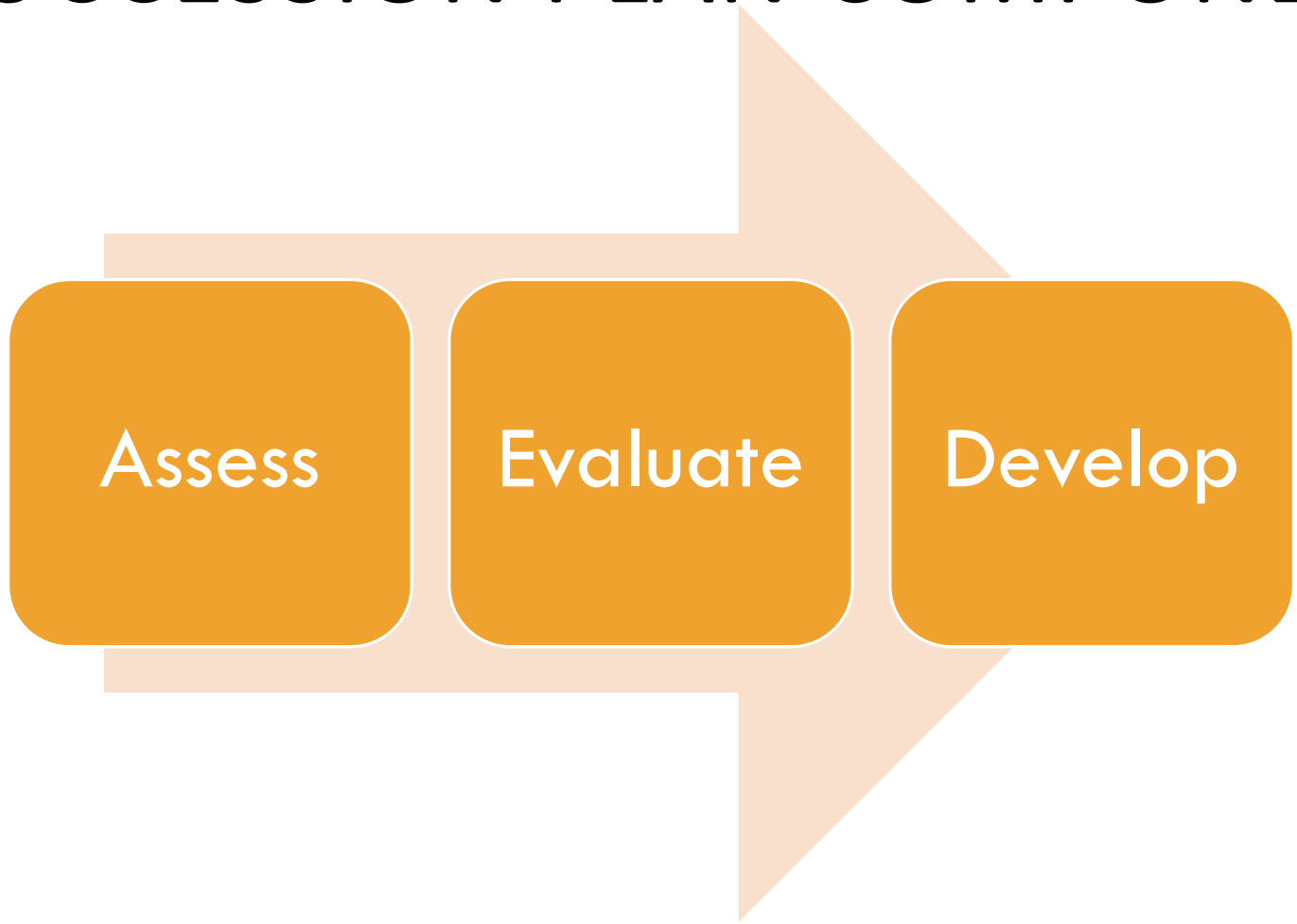
TARGET COMPANIES

Job Characteristics	Ownership Characteristics
20-75 jobs	Family owned with strong loyalty to staff
Family wage, primary jobs	Gross sales $ 3 - $ 10 million
Many long-term employees	In Industrial/Manufacturing areas
In Mature Industries	Requires new management
Potential to create new jobs	Strong goodwill and solid financial history

ROLE OF ECONOMIC DEVELOPERS

1. Identify company **'at risk'** due to transition issue—age or health of owner, etc.
2. Identify reason(s) **why company should stay local** – job impact and tax revenue loss
3. Identify potential buyers- **the insiders**
4. **Valuation study**- 'Windshield' vs 'Full'
5. Identify **resources needed**: financing, research, permit issues, business planning
6. Help assemble **transition team** (lawyers, lender, accoutnant, etc.)

SUCCESSION PLAN COMPONENTS



OWNERSHIP TRANSITION FUNDING SOURCES

- **WIOA funding:** Layoff Aversion
- **SBA Loans:** finance 75% of all small business acquisitions
- **EDA RLFs:** provided jobs are NOT relocated
- **Hiring Tax Credits:** WOTC, CCTC
- **SBDC Counseling and Training:** needed for new owners
- **Assistance with plant relocation:** real estate drives many older company sales

LESSONS LEARNED

#1: It is a **highly competitive** marketplace.

#2: **Employees don't know** they can buy the company or even that it is for sale.

#3: Exiting owners **deplete a company of value** as they wind down their involvement and head for the door.

#4: **Tax consequences** can make or break a deal.

#5: **Working capital loan** after purchase is easier to obtain than money to purchase the company.

LAYOFF AVERSION & RAPID RESPONSE

- **'Full employment' economy:** job loss is now more a function of demographics
- **Department of Labor's** Work Investment Opportunity Act (WIOA) 2014
- WIOA **recognized employee buyouts** as one strategy to prevent plant closings- not just retiring owners.
- **Rapid Response** funds can be used to examine the viability of firms-in-distress, and to determine the possibility of an employee or management buy-out.

CONNECT WITH CONCERNED CAPITAL

www.ConcernedCapital.org

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@ConcernCapital

Job Retention and Small Business Preservation through Employee Ownership

Training presented to the
County of Santa Cruz
Workforce Development Board
Alison Lingane
6/25/19

AGENDA

1. Why employee ownership
2. Myth busting
3. Employee ownership 101
4. Candidate spotting
5. CASE STUDY: Proactive outreach
6. Q&A

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1. WHY EMPLOYEE OWNERSHIP

WHAT WE MEAN BY EMPLOYEE OWNERSHIP

- ✓ **Broad-based**: Ownership available to all eligible employees
- ✓ **Employee voice** in strategic decision-making
- ✓ **Financial benefits** accrue to the employee-owners

NOT: Manager or Key employee buy out

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EMPLOYEE OWNERSHIP IS GREAT FOR SELLERS

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EMPLOYEE OWNERSHIP CREATES QUALITY JOBS

Median income from wages is

33%

higher

Median job tenure is

53%

longer

Household net worth is

92%

higher

Based on a 2017 study from the National Center for Employee Ownership

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EMPLOYEE OWNERSHIP IS GREAT FOR FAMILIES & COMMUNITIES

ISLAND EMPLOYEE COOPERATIVE

Owned by Employees. Operated with Pride.

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EMPLOYEE OWNERSHIP

Benefits

Workers	Better pay and benefits Assets and business ownership Voice in key decisions
Businesses	Higher productivity & growth Lower employee turnover Improved longevity & lasting legacy
Society	Increased local spending Heightened civic engagement Community wealth building

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Employees purchase the business out of the profit their work creates

- ✓ The owner sells the business or its assets to a new employee-owned business
  - If ESOP, the owner sells the company shares to a trust that owns shares on behalf of the employees
- ✓ This sale is typically financed by debt
- ✓ The newly employee-owned company pays down the financing out of future profits

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2. MYTH BUSTING

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Employee Ownership: Common Myths

1. My employees can't run the company!
2. My employees don't want to buy the company.
3. My employees don't have the money to buy the company.
4. I won't get a fair price for my company if I sell it to my employees.
5. It's complicated and it sounds hard!

Photo created by Katemangostar – freepik.com

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Myth #1: My employees can't run my company!

- ✓ You're right, you may not have an employee who can run the company – that's the job of the CEO/GM
  - ✓ Identify internal or external CEO/GM candidates
  - ✓ Employee-owners may provide input into strategic decisions, through the new board of directors or direct voting

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Myth #2: My employees don't want to buy my company

- ✓ Ask instead: Do you want to be one of many employee-owners? And be ready to explain what this means.
- ✓ There's technical support and the training available to make it happen

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Myth #3: My employees don't have the money to buy my company

- ✓ These are leveraged buy-outs
  - The business (not the employees) takes out one or more loans for sale price, with seller also carrying a note
  - Typical lenders are Community Development Financial Institutions
  - SBA loan guarantees may become more available
- ✓ Employee equity between 0-10%
  - ESOP: Zero equity buy-in
  - Worker cooperative: 1-10%

Myth #4: I won't get a fair price for my company if I sell it to my employees

- ✓ Sale price is market-based and valuation aligned with a 3rd party valuation expert
- ✓ Unless there is a strategic buyer, expect similar price
- ✓ Potentially significant tax advantages

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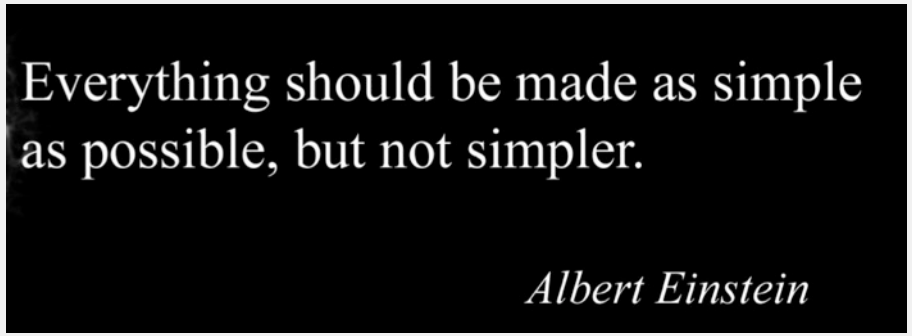
Myth #5: It's too complicated, and it sounds hard!

- ✓ All selling options take effort: Selling to employees—if you have the right supports—can be similar timeline to other types of sales transactions, and lower cost
- ✓ Employee ownership transitions are less familiar, but technical assistance is available to simplify



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Why sell a business to employees?

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3. EMPLOYEE OWNERSHIP 101

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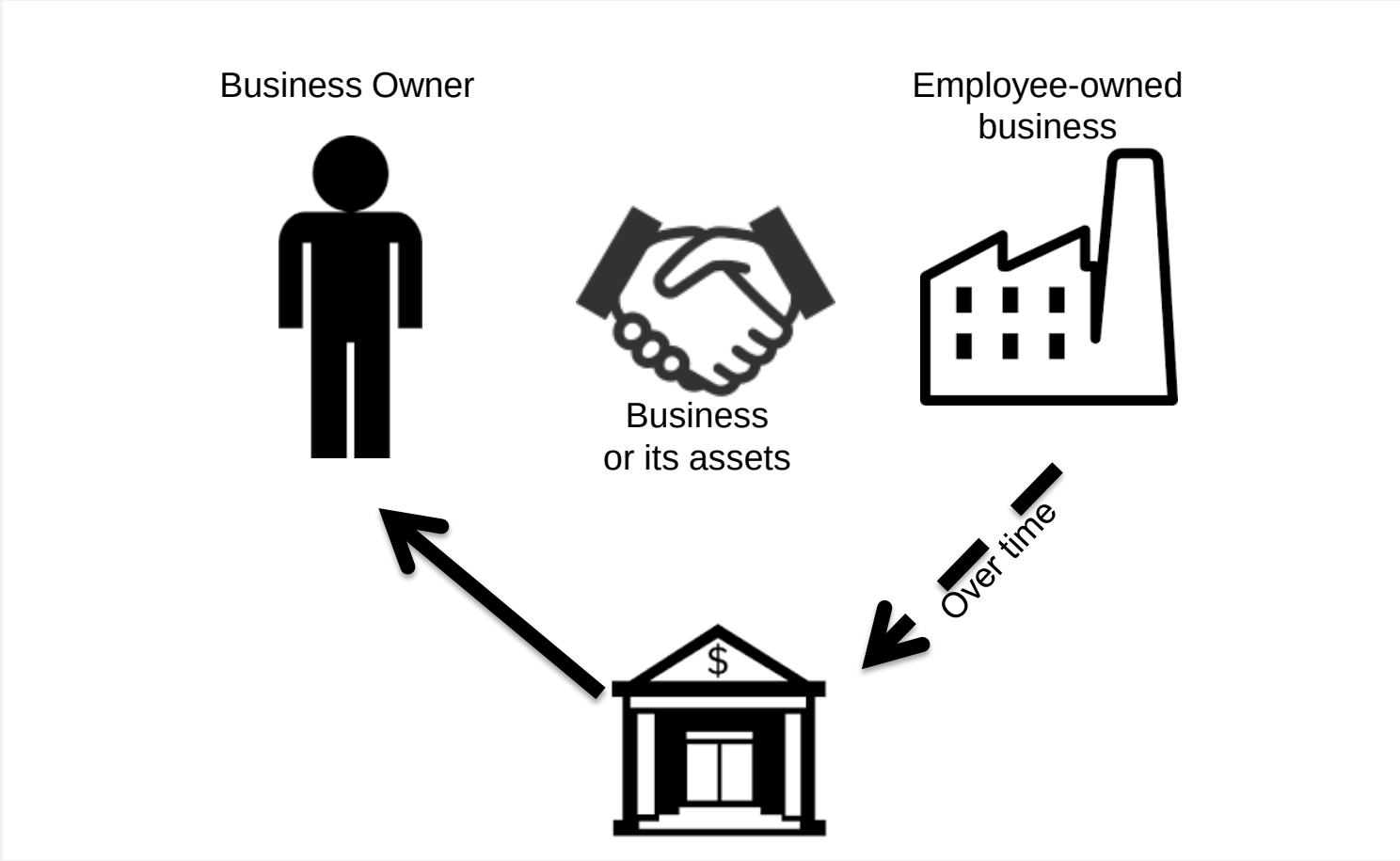
Employees purchase the business out of the profit their labor creates

- ✓ The owner sells the business or its assets to a new employee-owned business
  - If ESOP, the owner sells the company shares to a trust that owns shares on behalf of the employees
- ✓ This sale is typically financed by debt
- ✓ The newly employee-owned company pays down the financing out of future profits

Transitioning to employee ownership



Financed by outside lenders or investors

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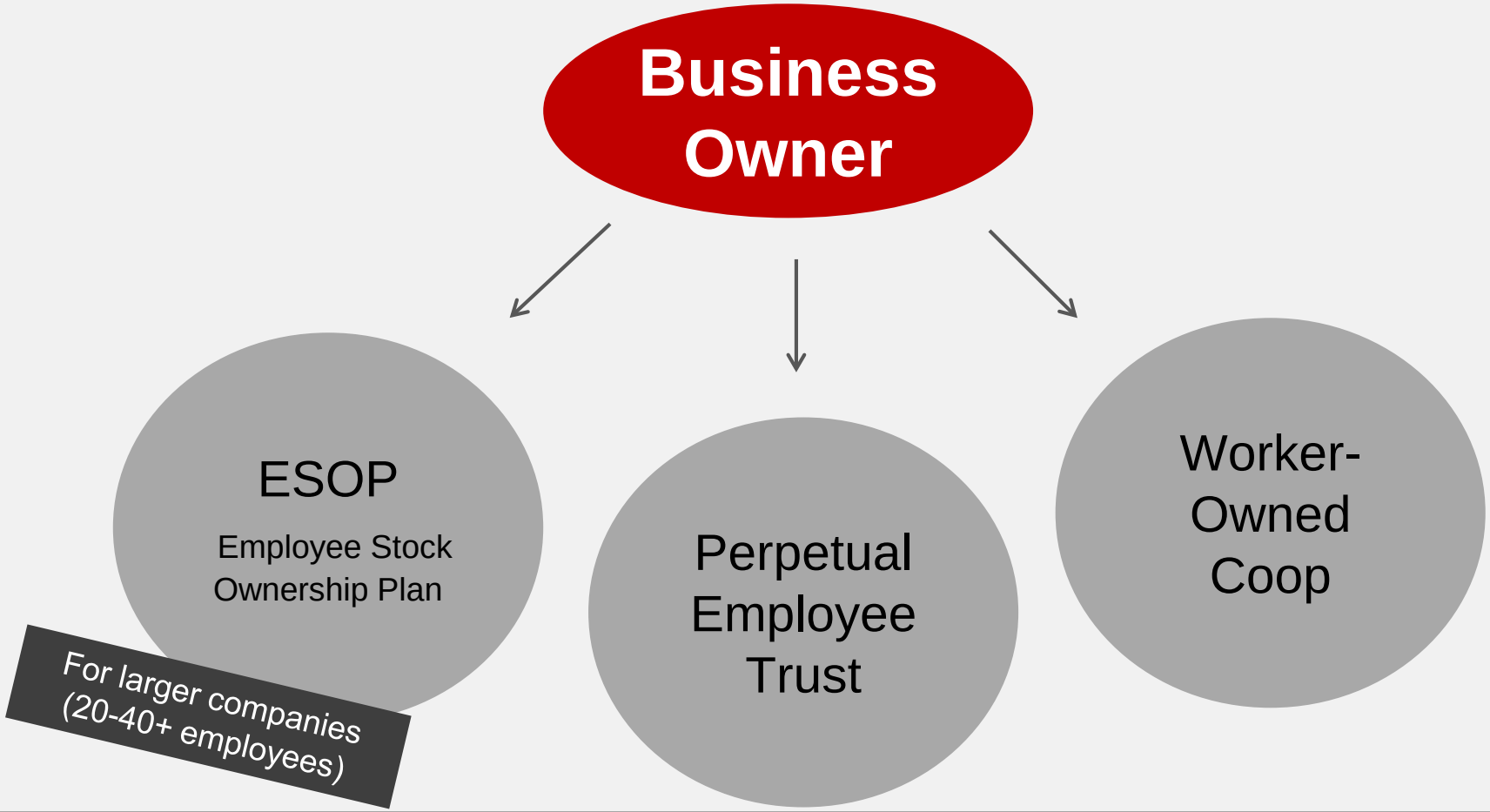
Employee Ownership structures meet different business needs



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ESOP example: Digital Dynamics
100% employee owned since 2018

- 40-year-old company; ESOP was the founders' exit strategy
- Design & manufacturing of industrial controllers and customized I/O system

ESOP example: Digital Dynamics
100% employee owned since 2018

> *"This move follows a process undertaken by the original founders and shareholders of the now 40 year-old company to* ***arrange for their succession****, and at the same time,* ***reward their loyal employees*** *with an ongoing equity interest in the business."*

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ESOP - Employee Stock Ownership Plan Overview

- All or a portion of the company's shares are held in a trust on behalf of the employees
- Retirement benefit, regulated by ERISA / DOL
  - Qualified defined-contribution employee benefit plan designed to invest primarily in the stock of the sponsoring employer
- Potentially significant federal tax benefits
  - Esp. at >30% of stock held by the ESOP
- Higher set up and ongoing costs
- Financed, employees don't pay for the business

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Worker coop example: Niles Pie
Worker-owned since 2017

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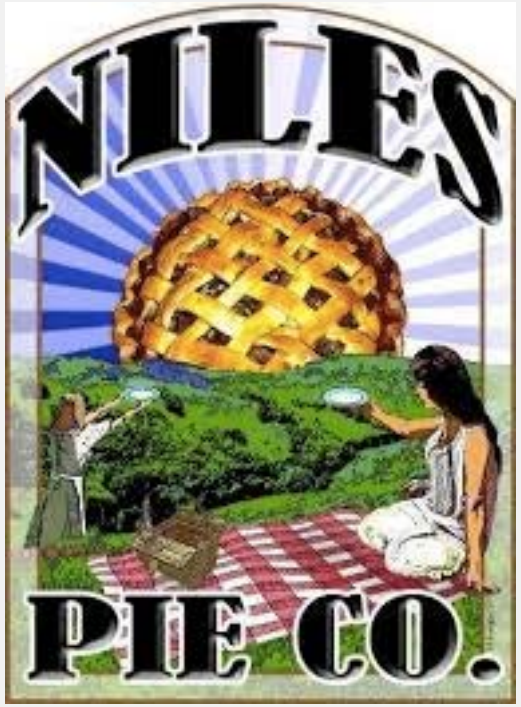
Worker-owned cooperative: Niles Pie
100% worker-owned since 2017

"Rather than trying to find outside partners, it made sense to look to people who are already invested in the business in every way except financially."



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Worker Cooperative Conversion

- Business owned and governed by its workers
  - 100% employee ownership, high employee engagement
  - Board of Directors made up of majority worker-owners
  - Profit-sharing via patronage, based on hours worked
- Flexible business form (Co-op Corp, LLC most common)
- Potential significant federal tax benefits
- Lower cost set up and ongoing
- Financed: employees buy in with a small % of equity

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Potential tax savings: employee ownership transitions

Depends on whether an S- or C-Corp, and specific tax code requirements

To the seller (ESOP and worker coop)

- Potential lifetime deferral of capital gains tax through 1042 Exchange (if >30% of business transitioned)

To the business (ESOP only)

- Contributions of stock or cash, or used to repay a loan for buying the shares are tax deductible
- In S-Corp: No income tax on % of ownership held by ESOP, so if 100% ESOP, no income tax

Financing example: Island Employee Cooperative

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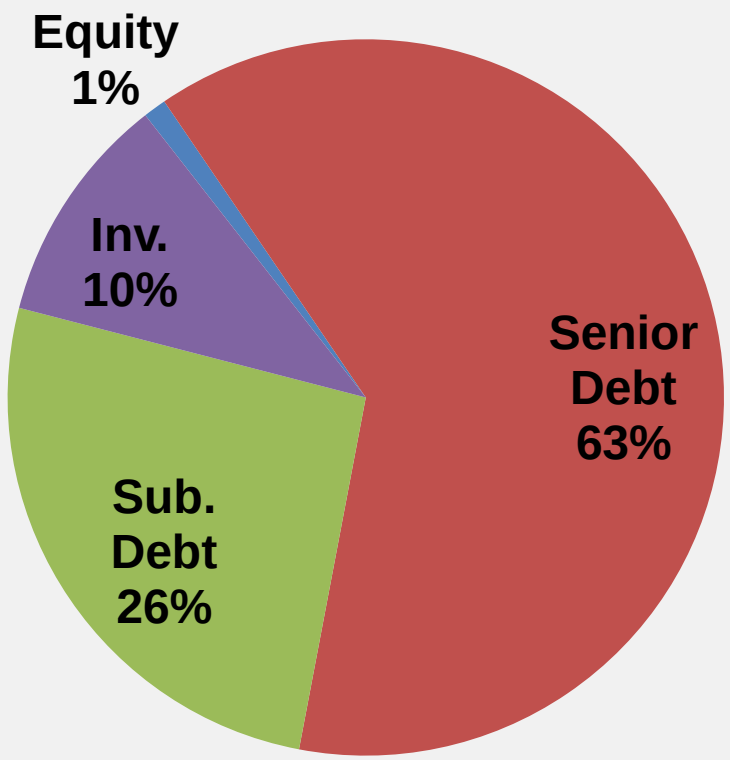
Financing example: Island Employee Cooperative

Debt	
Senior Lenders	$3,600,000
Seller (Sub.)	$1,500,000
Inventory loan	$500,000
Total Sources	**$5,600,000**
Purchase of Business	$4,250,000
Inventory	$930,000
Working Capital and Technical Assistance	$290,000
Closing Costs	$130,000
Total Uses	**$5,600,000**



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4. Candidate Spotting: How to know if this path could be a fit

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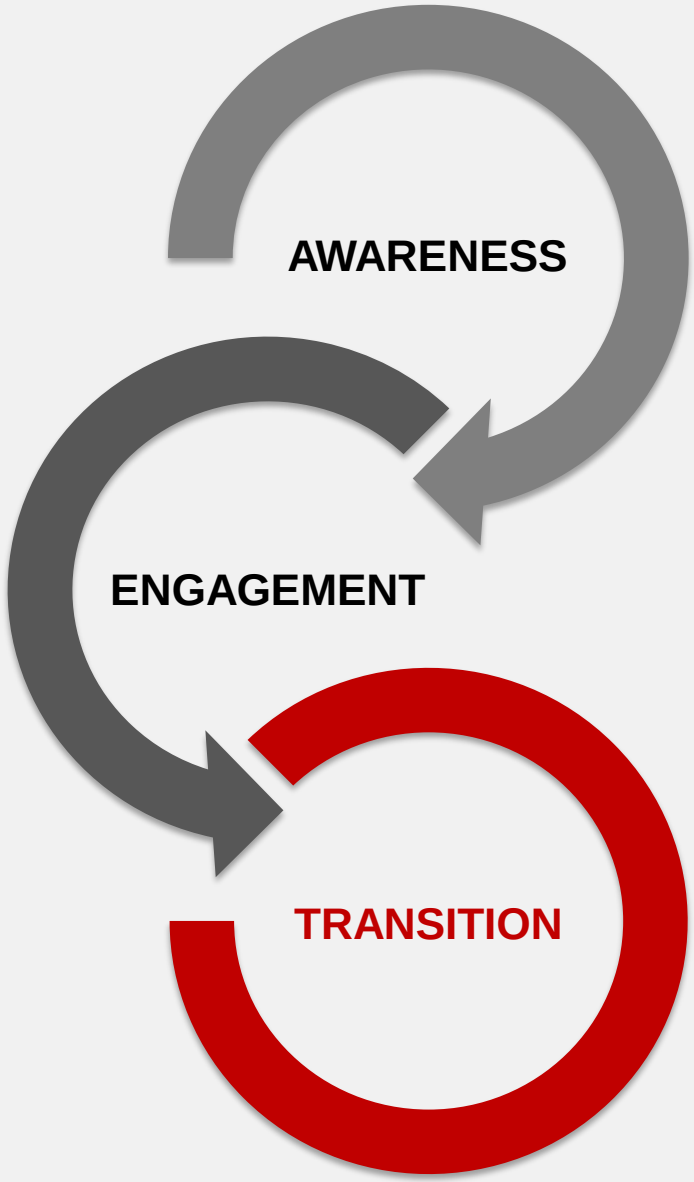

AWARENESS

- Media
- Stories
- Events
- Presentations

BUSINESS ENGAGEMENT

- Business connectors
- Free consults

TRANSITION

- Assess
- Prepare
- Convert

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What makes a company a potential fit for an employee ownership transition?

Must have's

✓ History of profitability

✓ 10 or more employees

Bonus

\+ Have groomed a management successor

\+ Have engaged employees

Show stoppers

X Some professional firms

X Special licensing that employees can't get

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How Project Equity supports a business interested in transitioning to employee ownership

Step One

Assess

- Financial feasibility
- Assess leadership transition needs
- Employee interest
- Timeline and roadmap

DECISION TO PURSUE

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How Project Equity supports a business interested in transitioning to employee ownership

Step Two

Prepare

- Plan leadership transition
- Sales agreement
- Financing
- Set up ownership structure
- Employee education

FORMAL COMMITMENT

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How Project Equity supports a business interested in transitioning to employee ownership

Step Three

- Execute sales agreement
- Close financing
- Finalize bylaws and governance
- First board meeting

SALES TRANSACTION

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How Project Equity supports a business interested in transitioning to employee ownership

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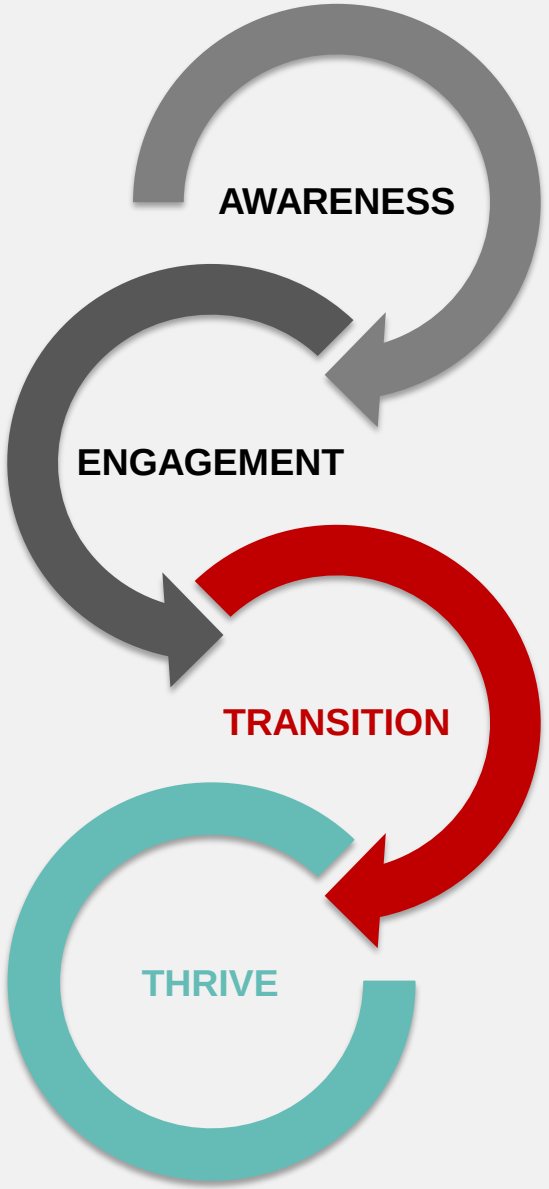

AWARENESS

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TRANSITION

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THRIVE

- As employee-owners
- As a business
- As a community

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ACCELERATE EMPLOYEE OWNERSHIP
$4M of loan capital available through Project Equity / Shared Capital

- $4m in capital to finance employee ownership transitions
- Collaboration between Project Equity and Shared Capital Cooperative, a national CDFI loan fund
- To create and sustain high quality jobs in local communities
- Combines tailored financing with Project Equity's hands on technical assistance
- SCCV will also be raising capital to develop a local loan fund

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LANDMARK FEDERAL LEGISLATION SUPPORTS EMPLOYEE OWNERSHIP

August 13, 2018
The Main Street Employee Ownership Act was signed into law.

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We are available to speak with businesses

Free consultations
to explore succession options
and employee ownership

www.project-equity.org

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CASE STUDY:
Proactively identifying businesses

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PROJECT EQUITY PARTNERS WITH CITIES TO ANSWER THIS QUESTION

What is the retention risk of the city's small businesses?

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HOW WE ANSWER IT

Business license and data analysis of companies over 10 years old and by sector

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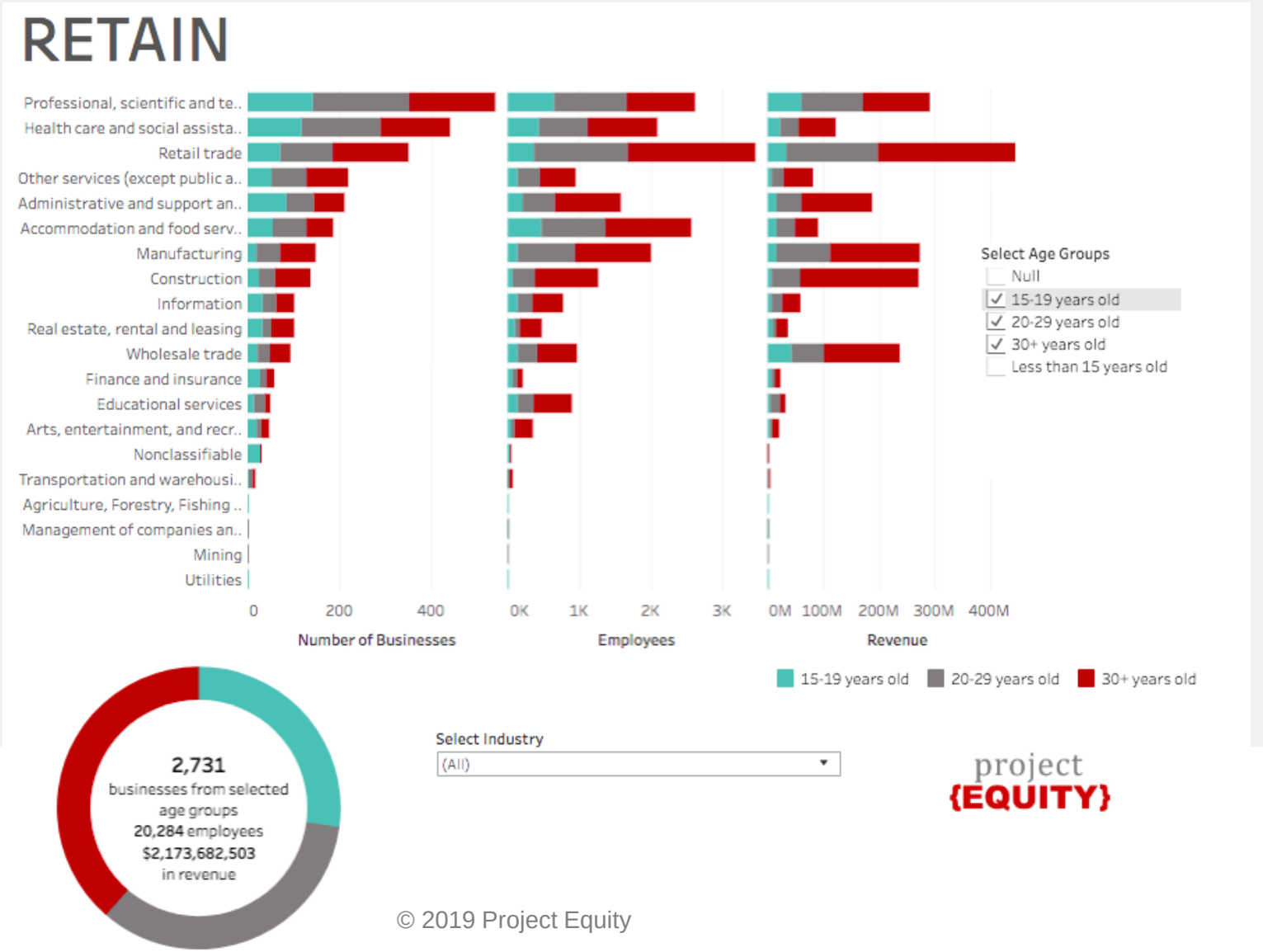
SAMPLE OUTPUT TO THE CITY



SAMPLE PUBLIC REPORT THAT RAISES AWARENESS AND GARNERS PRESS

1,200 businesses in **Berkeley** are over **20** years old.

They account for **$1.6B** or **60%** of revenue.

These businesses employ **1** in **3** workers.

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THEN, WHAT DO WE DO ABOUT IT?

Outreach and action plan to support business succession to local ownership, prioritizing employee ownership

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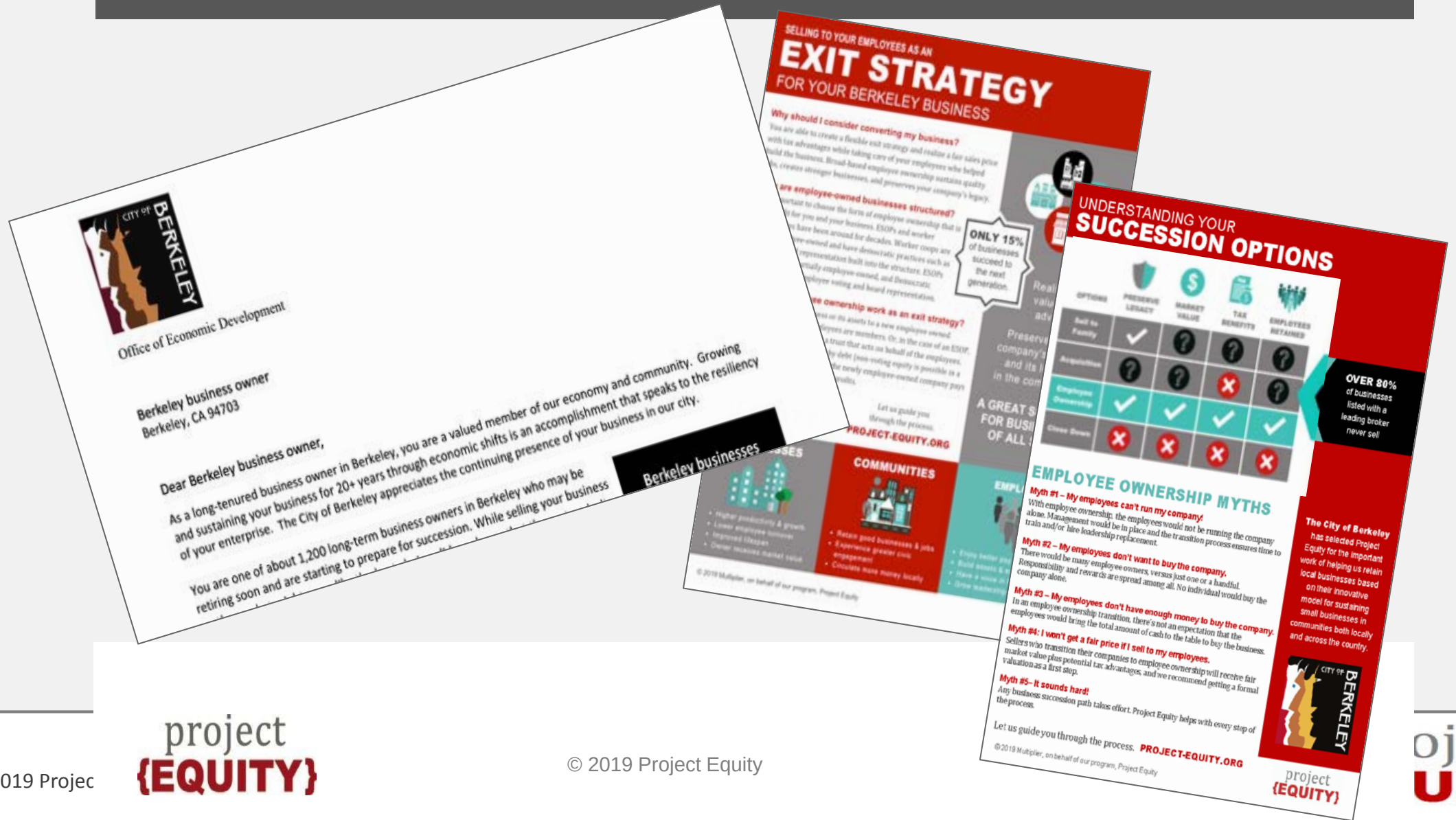
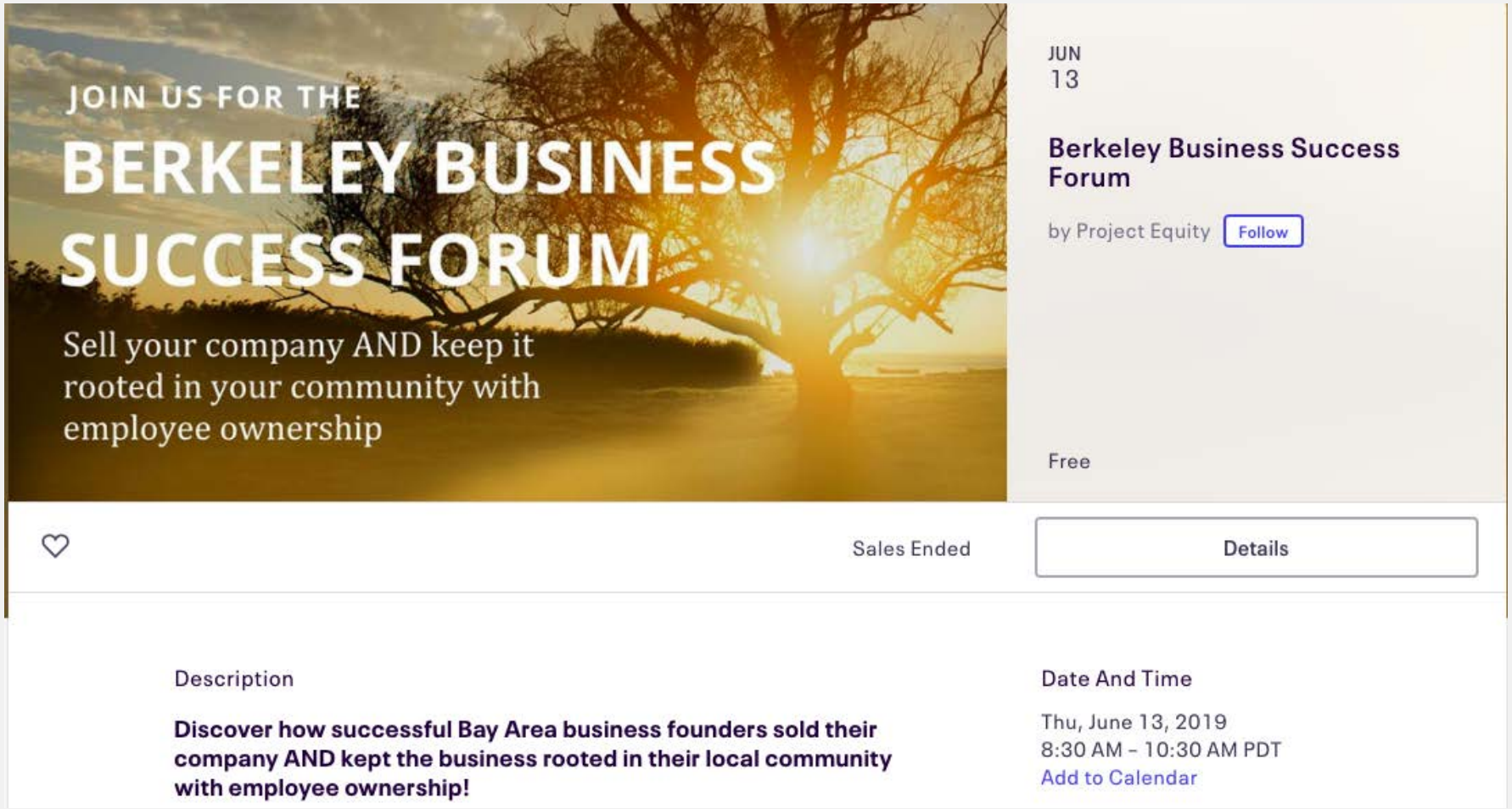
OUTREACH TO LONGSTANDING SMALL BUSINESSES



OUTREACH AND EVENTS FOR LONGSTANDING SMALL BUSINESSES



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SUBSIDIES FOR FEASIBILITY STUDIES CAN MOVE A BUSINESS OWNER TO ACTION

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Q&A / Discussion

Alison Lingane

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510-684-6665

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COMMUNITY DEVELOPMENT CORPORATION

“Promoting equal access to economic opportunity and transforming peoples life through entrepreneurship”

OUR SERVICES:

- Start-Up Assistance
- Business Coaching
- Specialized Business Consultation
- Low-Cost Trainings
- Commercial and Agricultural Loan packaging
- Marketing Assistance
- Strategic Planning and Expansion
- Business Incubation

PROGRAMS

- **EMPRESARI@ -** Business Education & Loan Program
- **Plaza Vigil-** Retail Business Incubator
- **Kitchen Incubator –** Food Entrepreneurship Program
- **Family Child Care** Development and support
- **Access to financing and Micro-Lending**
- One-on-One Business Counseling

Services area includes Santa Cruz, Monterey and San Benito Counties

EL PAJARO CDC SUPPORT TO NEW EMPLOYEE OWNERS

- **Assessment**
  - Preliminary valuation- analyzing internal books and tax returns.
  - Due Diligence: the next steps
    - Funding
    - Licensing
    - Legal Structure
    - Management Team
    - Final Transition-Succession

TRAINING + COACHING

- **Presale phase**
  - **Understanding day to day business operation**
    - 8 Hrs. Training for new team
      - Changing mindset from employee to owner -manager
      - Customer service
      - Human resources managements
        - Analyzing the new roles and positions
  - **Financial management and record keeping**
  - 8 Hrs. Training for new team
      - Accounting and recordkeeping
      - Reviewing and analyzing financial statements
        - Understanding Break Even Point

Training + coaching

- **Business operation plan**
  - Will assist owner-employees to develop and create a business operation plan for the company
    - Budgeting - projections
    - Vision for future
    - Marketing Strategy
  - **Business coaching-** on going support during first 6-12 months on areas that employees are not familiar. Approx. 60-100 hours.
  - **Leadership Training** – Identify leaders within the company to develop management team
    - Team building exercises
    - Communication skills

Contact Us:

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SCCV
SANTA CRUZ COMMUNITY VENTURES