The Vermont Employee Ownership Center, Let's Grow Kids, and Burlington Area Shared Services

present

Ownership Succession Options for Childcare Businesses

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Welcome!

Introductions

- Today's presenters

Today's objectives:

- Provide you with an understanding of the various pathways for ownership transitions
- Empower you to begin your exit planning now

Ownership Succession Options for Childcare Businesses

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Agenda

Transition overview
Planning for a transition
Transition pathways
Questions?

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Transition Overview

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Transition Overview

- All businesses will be sold or transferred, unless they are closed down and/or liquidated
- The challenge is that privately-held companies have no ready market for ownership sales - these owners must develop their own exit pathways
- Planning can optimize the chances of a successful transition at a good value

Transition Overview

- Childcare businesses face unique challenges. Many will not be saleable under their current mode of operation

- Many childcare businesses will need to adapt their operating model in order for an ownership transition to become viable

Planning for a Transition

Why Plan For Ownership Transition?

- May shift your operating focus in order to boost future saleability and selling price
- Will save valuable time and resources when the transition actually occurs
- May reduce tax liabilities, allowing you to net more of the sale proceeds

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Transition Planning Considerations - General

- Can you ensure your employees and customers are well cared for?

- Can you protect your business legacy and place in the community? Childcare is an essential business.

- What does the business require for success in the next generation of ownership?

Transition Planning Considerations - Timing

- How early should you begin thinking about transition?

- When is the right time to transfer ownership?
  - Are you, the owner, ready?
  - Is the business ready and saleable?

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Transition Planning Considerations - Saleability

Is the business saleable?

- Can the business survive without you as owner?
  - Are staff ready to cover your key responsibilities in marketing, customer relationships, regulatory compliance and financial management?
- Are your customer agreements transferable?
- Is your lease transferable and of sufficient length?

Transition Planning Considerations - Saleability

Is the business saleable?

- Are financial records in good order?
  - Are tax filings current?
  - Are monthly P&L's and balance sheets available?
- Is the business generating enough cash flow to support its sale?
  - Are you able to pay yourself a market salary?
  - Is there any profit?

Transition Planning Considerations – Sustainable Operation

- Is the childcare center truly being operated as a business?
- Does the center's financial operation follow the guidance of Opportunities Exchange's "Iron Triangle"?
  - Full enrollment, every day in every classroom?
  - Tuition and fees collected in full and on time?
  - Incoming revenue covers the per-child cost?

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Transition Planning Considerations – Sustainable Operation

- Is the business model sustainable?
- Will the business model require adaptation to make the business saleable?

Transition Planning Considerations – Sustainable Operation

- Would the business be strengthened by:
  - Combining with other centers to gain economies of scale?
  - Entering into shared services alliances to reduce administrative and back office costs?
  - Utilizing electronic record-keeping, billing and administration as possible to lower operating expenses?

Transition Planning Considerations - Valuation

- Will the proceeds from the sale of your business meet your financial needs?

Transition Planning Considerations – Valuation

A good business valuation will provide you:

- Feedback as to whether the business is saleable
- An objective sense of the likely value range of the business
- An understanding of the value drivers and detractors
- Identification of the viable exit pathways for your business

Transition Planning Considerations – Valuation

- Most business owners overestimate the selling value of their companies

- Valuation multiples rise with increases in company sales and earnings

Transition Planning Considerations – Valuation

- Value drivers, general:
  - Well-trained staff
  - Established, transferable customer base
  - History of revenue growth
  - Consistent profitability, without major swings from one year to the next
  - Established business processes, including good financial records
  - Well-known, positively recognized business image

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Transition Planning Considerations – Valuation

- Value drivers – childcare specific:
  - Proportion of infant, toddler and preschooler slots (profitability is higher for preschool slots than for infant slots, due to staffing ratio requirements)
  - Act 166 partnerships and funding for public pre-k
  - Childcare assistance funding from Vermont DCF
  - Grants and fundraising (likely negative impact on value)

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Transition Planning Considerations – Valuation

Valuation Examples

Number of Children	10	75	150	= full time slots
Estimated Revenue per Child	$10,000	$10,000	$10,000	per industry metrics
Total Annual Revenue	$100,000	$750,000	$1,500,000	= top line sales
Est. Owner's Salary & Benefits	$30,000	$50,000	$70,000	works full time
Est. Profit	0%	8%	12%	per industry metrics
	$0	$60,000	$180,000	
Seller's Discretionary Earnings	$30,000	$110,000	$250,000	add salary + profit
Valuation Multiplier	1.0	2.3	3.0	
Business Value	$30,000	$250,000	$750,000	add real estate if any

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Transition Planning Considerations – Valuation

Transaction Structure Examples

Business Purchase Price :		**$30,000**	**$250,000**	**$750,000**	from previous slide
Typical Purchase Terms with Financing:					
Est. Down Payment	25.0%	$7,500	$62,500	$187,500	
Financing Required		$22,500	$187,500	$562,500	= price - down payment
Annual Debt Service		-$2,998	-$24,980	-$74,939	
Est. Loan Term, Years:	10				
Est. Interest Rate:	6.0%				
Calculate Cash Flow Remaining for Buyer:					
Estimated SDE		$30,000	$110,000	$250,000	from previous slide
Subtract Annual Debt Service		-$2,998	-$24,980	-$74,939	from above
Remaining Cash Flow		**$27,002**	**$85,020**	**$175,061**	

(For owner's salary & benefits and to provide required debt coverage ratio)

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Transition Planning Considerations – Financing

- Size of childcare center:
  - Centers with 60 or more children are typically less financially stressed and can provide a buyer with the cash flow needed to meet monthly debt payments
  - Acquisition lending for smaller centers could possibly be viable if there are multiple revenue streams

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Transition Planning Considerations – Financing

- Information typically needed by lenders from <u>sellers</u> in order to consider financing a buyer:
  - Last 2 years of financials, including Profit & Loss Statements, Balance Sheets and tax returns
  - Breakouts of revenue sources (e.g. private pay, state subsidies, ACT 166, DCF, copays, food program, grants, municipal support, general fundraising)

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Transition Planning Considerations – Financing

- Information typically needed by lenders from <u>sellers</u> in order to consider financing a buyer:
  - If owned, the appraised building value
  - If leased:
    - Will the lease transfer to the buyer and on the same terms?
    - Is the landlord supportive of the childcare use?
    - Is the lease term at least as long as the potential acquisition loan?

Transition Planning Considerations – Financing

- Information typically needed by lenders from buyers in order to consider financing a buyer:
  - Personal financial statement and credit history
  - Business plan and financial projections (2 years)

Transition Planning Considerations – Financing

- Multiple lenders may partner on an acquisition loan:
  - VCLF, for example, may partner with banks, credit unions and/or municipal revolving loan funds
  - As the risk is shared across several organizations, the lender risk is lower and collateral requirements may be more flexible
- Federal SBA loan guaranty programs may be used if qualified and applicable:
  - 504 and 7a/Community Advantage

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Transition Planning Considerations – Financing

- Typical VCLF loan terms for childcare acquisitions:
  - 20 year amortization on loans (financials are reviewed every 5 years and loan can be extended for another 5 years, up to the 20 year maximum)
  - 10% down payment
  - Technical assistance from the Business Resource Center may be a requirement
  - On-going submission of annual financial and business tax reports is required throughout term of loan

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Transition Pathways

Transition Pathways – The Options

- Third-party sale to an individual, strategic acquirer or financial acquirer
- Sale or gift to family member(s)
- Management buyout / sale to *key* employees
- Sale to *all* employees via worker cooperative

Transition Pathways – Common Issues

- The process of selling a business can be lengthy – it's wise to allow at least one year
- There are no guarantees that a particular transaction will occur or that a business will successfully transition ownership
- Selling a business is often emotionally stressful and a major life transition

Transition Pathways – Common Issues

- Carefully negotiate on both price and terms to optimize your gain from the transaction
- Terms might include:
  - Earnouts
  - Escrows
  - Seller financing
  - Tax-advantaging strategies
  - Seller option to retain equity

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Transition Pathways – Common Issues

- A successful ownership transition is a great win for all parties!

Transition Pathways – Third Party Sales

- Often bring the highest selling price
- May offer opportunities for some tax advantaging of the sale proceeds
- Often include transaction terms such as earnouts or seller financing that bind the owner for several years post-closing

Transition Pathways – Sales or Gifts to Family

- Keeps business in the family
- Seller might also choose to be the banker
- IRS issues and setting of fair market value can be complex – professional accounting advice is required

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Transition Pathways – Sales or Gifts to Family

- Often need to carefully navigate the tension between providing liquidity/reward for the senior generation and opportunity for the next generation
- Transaction structure may use traditional financing and/or some intergenerational wealth transfer (estate planning)

Transition Pathways – Sales to Key Employees

- Owner might not receive the highest price
- Employees typically lack the cash down required for initial bank financing; may be able to work around via:
  - Buy-in over several years
  - Some seller financing
  - SBA programs to guarantee the bank loans

Transition Pathways – Sales to Key Employees

- Can help retain and reward essential employees, if agreed with employees well in advance
- May influence your hiring choices as you plan for your exit

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Transition Pathways – Sales to All Employees

"Broad-Based" Employee Ownership - Arrangements where at least all full-time equivalent employees have a path to co-ownership. Common forms:

- Employee Stock Ownership Plan (ESOP) - Ownership of company shares by a qualified retirement plan. For larger scale companies (20+ employees)
- Worker Cooperative - Direct ownership by employees.

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Worker Co-op: What is it?

- Cooperative: a business "owned & democratically controlled by its members for their common good."
- In a worker cooperative, membership is limited to those who work in the business; about 500 nationally, ~16 identified in Vermont at last count.
- Each co-op member buys one share and is a direct owner. Members elect the board and share in profit on the basis of hours worked or W-2 income.
- Employees can become members after a set trial period.
- Management can be conventional or flat.

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Worker Co-op Considerations

<u>Scale:</u> 3+ employees; can work at a large scale, but most are in 5-30 employee range in Vermont.

<u>Direct Employee Buy-in:</u> Employee-owners each hold one share that gives them a vote for the board and a share of profit. Share price is <u>not</u> tied to valuation.

<u>Employee Participation in Sale:</u> As they're putting direct skin in the game, EEs must be involved in the process.

<u>Transaction:</u> Structure generally requires a 100% sale, though a majority sale is possible.

Worker Co-op Steps

Overview of the transition

Explore	Learn Motivate key decision-makers
Assess	Check feasibility Gauge financial and operational needs
Prepare	Design structures: legal, financing, management, governance
Transact	Legally transition
Support	Build ownership culture Engage support networks

WORKERS TO **OWNERS**

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Financing Sources for Worker Co-Op Exits

- Member Shares (2-10%)
- Seller Note
- Specialized Lenders (Cooperative Fund of New England)
- Social Investors
- Friends/Family or Community Raise

Example: The New School of Montpelier

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Questions?

How to Contact

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