Ownership Succession Options for Childcare Businesses
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?
Transition Overview
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
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?
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?
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

Vermont Employee Ownership Center
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
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)
### Transition Planning Considerations – Valuation

#### Valuation Examples

<table>
<thead>
<tr>
<th>Number of Children</th>
<th>10</th>
<th>75</th>
<th>150</th>
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</thead>
<tbody>
<tr>
<td>Estimated Revenue per Child</td>
<td>$10,000</td>
<td>$10,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>Total Annual Revenue</td>
<td>$100,000</td>
<td>$750,000</td>
<td>$1,500,000</td>
</tr>
<tr>
<td>Est. Owner's Salary &amp; Benefits</td>
<td>$30,000</td>
<td>$50,000</td>
<td>$70,000</td>
</tr>
<tr>
<td>Est. Profit</td>
<td>0%</td>
<td>8%</td>
<td>12%</td>
</tr>
<tr>
<td>Seller's Discretionary Earnings</td>
<td>$30,000</td>
<td>$110,000</td>
<td>$250,000</td>
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<tr>
<td>Valuation Multiplier</td>
<td>1.0</td>
<td>2.3</td>
<td>3.0</td>
</tr>
<tr>
<td>Business Value</td>
<td>$30,000</td>
<td>$250,000</td>
<td>$750,000</td>
</tr>
</tbody>
</table>

- Full time slots per industry metrics
- Top line sales
- Owner works full time
- Est. Profit per industry metrics
- Add salary + profit
- Add real estate if any
Transition Planning
Considerations – Valuation

Transaction Structure Examples

<table>
<thead>
<tr>
<th>Business Purchase Price</th>
<th>$30,000</th>
<th>$250,000</th>
<th>$750,000</th>
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Typical Purchase Terms with Financing:

<table>
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<tr>
<th>Est. Down Payment</th>
<th>25.0%</th>
<th>$7,500</th>
<th>$62,500</th>
<th>$187,500</th>
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<table>
<thead>
<tr>
<th>Financing Required</th>
<th>$22,500</th>
<th>$187,500</th>
<th>$562,500</th>
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</table>

<table>
<thead>
<tr>
<th>Annual Debt Service</th>
<th>-$2,998</th>
<th>-$24,980</th>
<th>-$74,939</th>
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</table>

<table>
<thead>
<tr>
<th>Est. Loan Term, Years</th>
<th>10</th>
<th>10</th>
<th>10</th>
</tr>
</thead>
</table>

<table>
<thead>
<tr>
<th>Est. Interest Rate</th>
<th>6.0%</th>
<th>6.0%</th>
<th>6.0%</th>
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</table>

Calculate Cash Flow Remaining for Buyer:

<table>
<thead>
<tr>
<th>Estimated SDE</th>
<th>$30,000</th>
<th>$110,000</th>
<th>$250,000</th>
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<table>
<thead>
<tr>
<th>Subtract Annual Debt Service</th>
<th>-$2,998</th>
<th>-$24,980</th>
<th>-$74,939</th>
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</table>

<table>
<thead>
<tr>
<th>Remaining Cash Flow</th>
<th>$27,002</th>
<th>$85,020</th>
<th>$175,061</th>
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</table>

(For owner’s salary & benefits and to provide required debt coverage ratio)
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
Transition Planning Considerations – Financing

• Information typically needed by lenders from sellers 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)
Transition Planning Considerations – Financing

• Information typically needed by lenders from sellers 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
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
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
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

www.veoc.org
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
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
"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.
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.
Worker Co-op Considerations

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

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

Employee Participation in Sale: As they’re putting direct skin in the game, EEs must be involved in the process.

Transaction: 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
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
Questions?
How to Contact

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