Internal Transition vs. External Transition

Stonemill Partners @2017

We often talk to architectural and engineering firm owners about transition. Many are open to selling on the open market with a very targeted approach while some are still thinking about an internal transition to key employees.

We often get questions related to the pros and cons of each type of transition. Here are some points of information for you to consider as you do your planning:

- In an external sale you typically are paid a purchase price for the value of your firm plus a salary/employment agreement for transition, all from an outside buyer to you, the seller. This is a desired situation.

- In an internal transition you many times establish an earn out where your payback for the firm is a function of profits or revenue (that you may or may not receive).

- Also common in internal transitions is that you, the selling owner, offers stock to new internal owners, where they pay for that stock with bonus money (many times against a note receivable for the stock) that you give them. This is essentially money that you would normally receive and pocket before "loaning it out to pay yourself back."

- Those that have done an internal transition have told us about the undo pressure on a new owner to replace the old owner.

- New owners require time allocated to ownership duties vs. spending time on business development, client transitions and employee transitions along with other duties they have done pre-ownership.

- Former selling owners that have to be replaced with increased staff results in higher payroll and expenses.

- Financial consideration needs to be given to new staff's salary in addition to payback for the selling owner.

- Ownership risks transition to new owners taking time away from business development, client transitions and employee transitions.

- New owners will have the burden of employee management as well as client transition management.

- Valuation - Fair market value (internal) vs. Market Value (external) – sometimes external market value can be double FMV.

- Consideration must be given to the Ability/Desire of an internal ownership candidate vs. a strategic external purchaser. Strategic purchasers are more apt to work hard to get a return on their investment of a purchase. Many times an internal candidate will never finishing paying for the firm. An exiting owner can't foreclose on their former firm, so they essentially never end up with any money for the firm value.

- Consideration must be given to the willingness of an internal candidate to accept ownership risks.

- Internal candidates usually don't have the same "complete" set of skills that the exiting owner has.

- Internal candidates usually don't have the same drive that the exiting owner had because they did not build the firm with their own sweat and tears. It was essentially given to them. You always take better care of something that you built with blood, sweat and tears than you do with something that was given to you.

- Internal Candidates need:
    - Willingness (workload + risks)
    - Commitment to the future
    - Leadership skills
    - Financial means
    - Management and Interpersonal skills
    - Client Relationship Building skills

- External transitions offer the opportunity for synergy with a purchasing company that an internal transition doesn't offer.

- Marketing and Business Development is a more difficult challenge than internal candidates think. An acquiring company is already doing this to a great degree as well as client relationship maintenance.

- Greed hurts an internal transition on both sides.

- CONCLUSION: Past experiences have told us that owners would recommend to not do an internal transition again because of all the above considerations.

To learn more about the process of selling or making an acquisition, understand more about what we are seeing in the market and finding out what you could expect, contact us:

Stonemill Partners, Inc.
www.stonemillpartners.com

Patrick Neal – Managing Partner – Direct Line - 770-510-9367 – patrick@stoneillpartners.com
Al Lautenslager – Managing Partner – Direct Line – 630-740-1397 – al@stonemillpartners.com