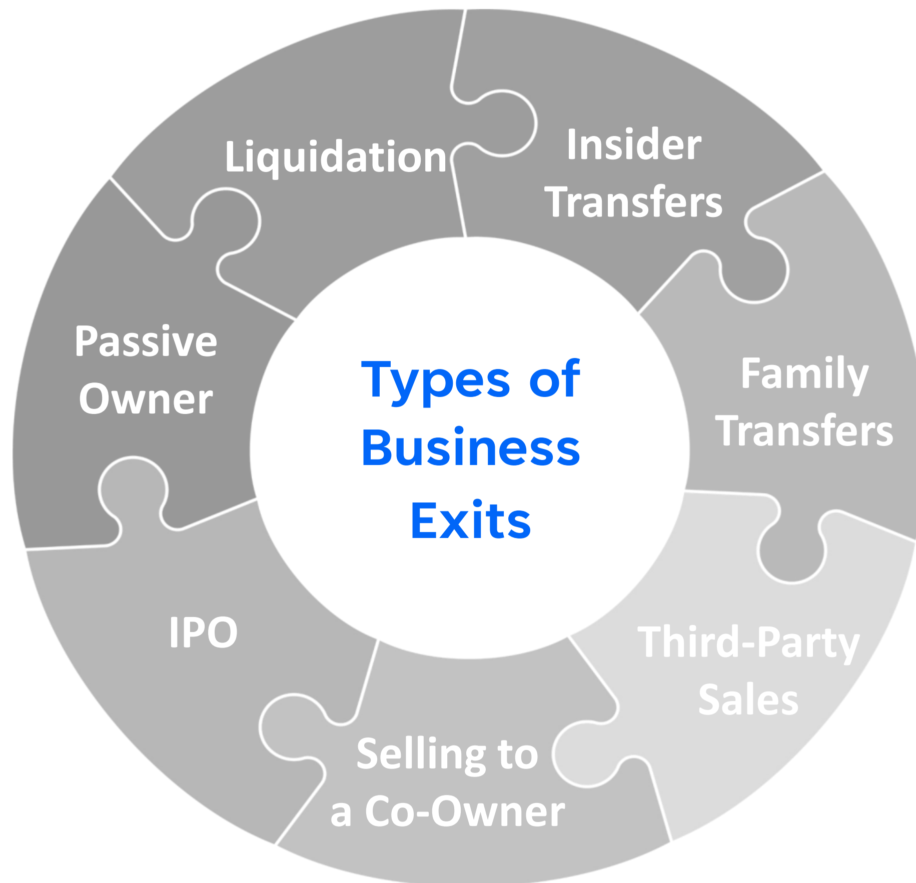
Business Exit & Succession Planning

Helping Business Owners Achieve their Business Exit Goals

Your Exit Plan

It likely took years of development and analysis to find the best way to make your business successful. Likewise, it can take years of refining a plan for exiting your business.



Your Primary Objectives

Generally, there are 3 primary objectives owners generally consider when it comes to reaching their exit objectives:

- Selecting the date they want to exit
- Getting the amount of cash they want
- Choosing a suitable successor to replace them

This comprehensive guide endeavors to address several important aspects of succession planning including building business value, the various transfer options, business continuity planning, estate planning, and gap analysis.

Assessing Value

As you prepare to exit your business, value drivers will play an important role.

Benefits

An accurate valuation of your business will enable you to:

Establish an End Date – Understand how much value you need to add to your business in order to exit.

Test Your Exit Objectives – Determine whether and when you will reach these objectives to monitor your progress.

Gain Important Tax Information – Provide a basis for estimating and minimizing the tax consequences of your eventual exit.

Set an Objective Basis for Incentive Plans – Enable you to design incentive plans that can motivate key employees to increase the value of your company.

Objective Evaluation

Generally, there are two ways to get an objective valuation, though the costs can vary substantially:

Intermediaries – Help you if you are ready to exit and plan to sell to a third party. They have the expertise to perform any number of complex activities involving the sale of your business.

Business Appraisers – Prepare a calculation of value report based upon your company's financials, current economic and industry conditions, and tangible and intangible assets. These appraisals are useful for selling to insiders like employees and family members.

Value Drivers

Enabling as many value drivers as possible will help you boost your company's leverage in the marketplace when you are ready to sell your interest.

Popular Value Drivers

Next-Level Management – One of the most important value drivers is the presence of a next-level management team that knows how to grow companies and facilitate rapid growth. This team may include experienced managers you recruit from other companies or current managers you train to take on a more important role.

Operating Procedures and Systems – Developing and documenting your company's processes and systems as a turnkey operation will help strengthen performance and provide valuable insight into areas for potential growth.

Nurturing the Competitive Advantage – Developing and documenting competitive strategies that enable you to expand into new markets helps you to leverage one value-building technique against another.

Diversified Customer Base – Diversifying your customer base means profitability and cash flow are not reliant on only a handful of customers.

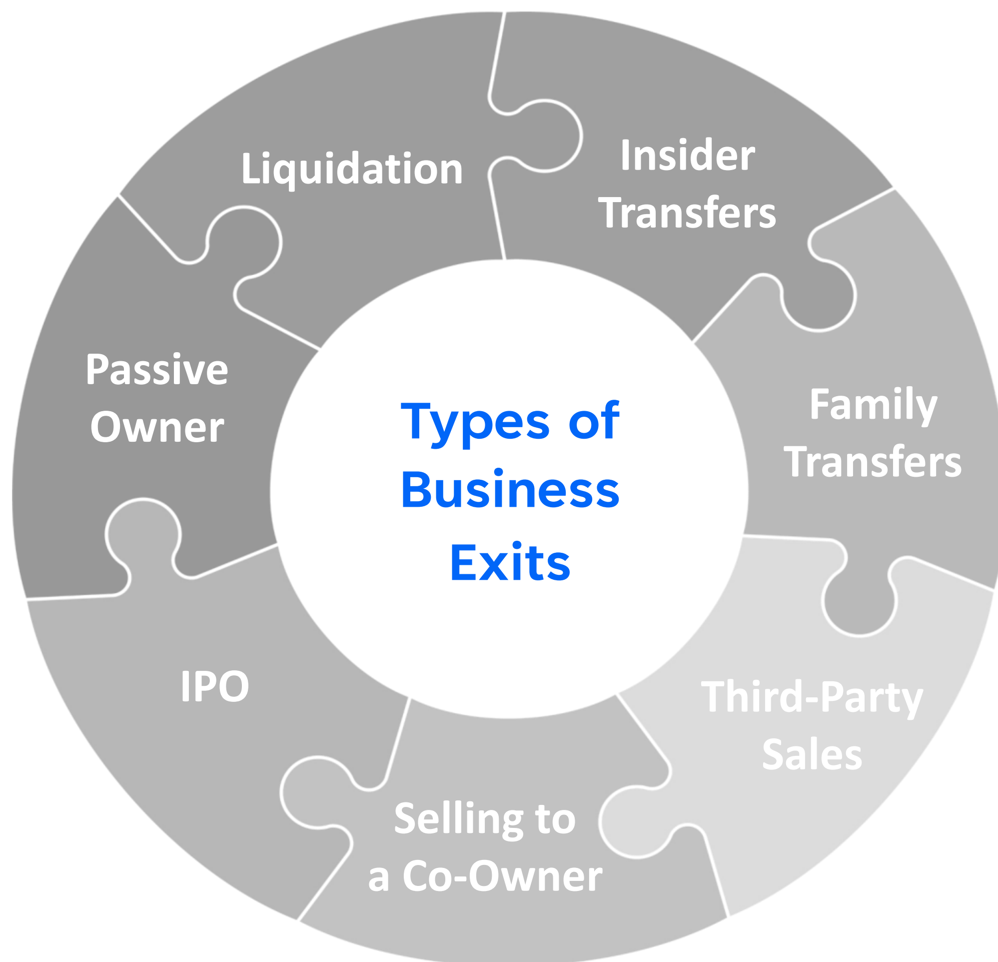
Realistic Growth Strategy – Creating a growth plan that describes your future anticipated growth, how it will be achieved, and what criteria it is based upon. Examples include industry dynamics, new product lines creating increased demand, business acquisition, and augmenting your territory, product lines, and manufacturing capacity.

Effective Financial Controls – A certified audit or verified financial statement by a CPA firm verifies to buyers that your company has effective financial controls in place to safeguard assets and that claims of profitability can be backed up by historical financial statements.

Stable and Improving Cash Flow – Focusing on ways to operate your business more efficiently by increasing productivity and decreasing costs will also contribute to stable and predictable cash flow.

Common Exit Types

Explore several common exit and succession avenues you can take depending on your specific situation.



Insider Transfers

Employees may not have enough money to buy the business, may not be able to borrow enough, and may not be able to finish paying for it.

The transfer methods below outline ways to overcome these situations.

Long-Term Installment Sale

Selling your business to key employees on an installment sale, transfers your business based only on a promise to receive the full purchase price from future cash flow. Several planning steps can help you reduce the risks associated with long-term installment sales:

Agreement – The owner and buyer agree on the company's value and adopt an alternative method of payment such as nonqualified deferred compensation payments, severance payments, or lease payments. With this method, tax-deductible payments are made directly from the company to the owner, minimizing the net tax cost of the buyout and maximizing cash to the owner.

Single Buyer – At least one employee agrees to buy the company using personal and business collateral, obtaining partial outside financing, or selling part of the business to a third party. To reduce associated risks the owner should transfer excess cash out of the company well in advance of selling and may want to remain involved with the business until satisfied that the stream of cash flow will continue.

Promissory Note – Employees sign a promissory note with installment payments over a 7–10-year period, with a reasonable interest rate and little to no money paid at closing. The note is secured by the assets and stock as well as a personal guarantee and collateral that usually consists of the buyer's residence.

Advantages

- Key employees are motivated by a business acquired with little or no money which can be paid for using future business cash flow
- Employee buyers generally receive the entire business in this type of transaction

Disadvantages

- You receive little or no money at the time of closing
- You are placed at significant risk of receiving less than the entire purchase price should the business default on the terms

Leveraged Management Buyout

A management buyout is an effort to streamline your operations, minimize financial risk, reward key employees, and improve profitability. It draws on your company's resources, equity, and financing as well as personal resources and private equity. To successfully negotiate such a transaction, your business should have the following in place:

- A management team capable of operating and growing the business without you
- Stable and predictable cash flow
- Possibility for future growth
- Concrete asset bases like inventory, machinery, equipment, and accounts receivable making it easier to finance
- Hold a fair market value of at least $5 MM to attract private-equity investors

Advantages
- Often viewed as good investment opportunities by larger financiers
- If supported by a private equity fund, they may be likely to pay an attractive price

Disadvantages
- The change from employee to owner may be a difficult transition for some buyers
- Existing team buyers may downplay or sabotage future prospects so they may buy the business at a lower price

Employee Stock Ownership

An Employee Stock Ownership Plan (ESOP) is a tax-qualified profit sharing or money-purchase pension type plan that invests primarily in the company stock. It is similar to a profit-sharing plan because the company's contributions are tax-deductible for the company and tax-free for the participants.

Advantages
- It may motivate employees to participate since part of the business can be acquired at a reduced price
- Key employees generally receive operating control of the business
- You receive cash at closing
- Equity investors may be tapped as an additional financial resource

Disadvantages
- It requires the use of debt and/or private equity investment which may be difficult to attract
- Key employees may want all or most of the company and may not be satisfied with a minority sale
- It usually places a burden of significant debt on the business

Modified Buyout

This method works best for owners who want to transfer their businesses to key employees, motivate and retain them, and receive the full value for their business. There are generally two phases in this type of transfer. First, is an initial selling of minority interest to employees of any outstanding stock that is converted to non-voting shares. The next phase consists of selling the balance of ownership interests.
Benefits to employees for this type of insider transfer include:

- A discounted value is generally necessary to make the purchase more affordable
- Key employees ultimately receive the entire business
- The potential for stock appreciation
- Participation in possible S distributions based on stock ownership
- Receiving the fair market value for their stock owned when sold to a third party
- Ability to participate in the daily business operations
- Opportunity to be appointed and serve as directors under any bylaw terms
- Potential to determine which additional key employees will be offered stock

Advantages

- You may receive a substantial portion of fair market value for the business
- You maintain control of the business until the full purchase price is received
- It offers flexibility in how you proceed after the initial key employee buy-in, such as selling shares to a third-party, selling the owner's interest to an ESOP, or even selling the company altogether

Disadvantages

- You do not receive the entire purchase price of the business for several years
- You must remain active in daily business operations until the initial employee buy-in is complete.

Family Transfers

Co-ownership is rarely permanent, especially once parents are out of the business. Often the fairest plan when it comes to family transfers is to leave the business entirely to one business-active child and then make an equitable distribution of the balance of family assets to the inactive children. To avoid hard feelings among all children, there are six ingredients usually necessary for a successful family transfer.

1. You have completed your business succession planning. We have a seven-step business exit planning workbook you can use to get started.
2. You have the desired amount of cash in the bank before transferring ownership
3. One child logically becomes the sole successor due to their active participation in the business
4. The business-active child has shown a willingness and capacity to run the business for a significant period after you leave
5. Your estate plan ensures fairness among all children in dividing equity and assets
6. You have a backup plan in place should something go wrong

A backup plan is important if, for example, you die or become incapacitated before the transfer is complete, if the business-active child does not possess the drive or skill needed to carry on the business, if the business value increases to the point of making a buyout too costly for the business active child, and should you find yourself unable to provide equal assets to the other children.

Third-Party Sales

The potential to sell a business for cash often incentivizes owners in third-party sales. That's because third-party sales are typically faster than the other succession methods and tend to offer owners the most money.

Advantages

- You may attract the highest sale price
- You have an opportunity to receive the entire purchase price at closing
- Time factor means the sale is relatively quick compared to other exit plans
- Reach values-based goals such as equally distributing cash to all children
- Key employees are often kept on after the sale because they offer a tangible contribution

Disadvantages

- You may believe your business is worth more than an objective buyer might be willing to pay for it
- There remains the potential for severe tax consequences if careful tax reduction action is not made well in advance of the sale
- You may not receive the entire purchase price in cash at closing, running the risk of relying on the new owner's performance
- Personal tax consequences from the sale mean you may find you cannot afford to sell the business for the price offered
- You may be upset by radical changes made to the company after the sale

Great care should be made to avoid tainting the marketplace. This occurs when, due to lack of preparation or buyer's remorse, an owner puts the business on the market only to pull it off without selling. Under these circumstances, the consequences to business value can reverberate for many years.

Selling to a Co-Owner

If you plan to sell to a co-owner or co-owners, this type of succession plan generally shares the same advantages and disadvantages as an insider or family transfer.

Advantages

- The buyers are known to you and share the same values
- It offers a seamless continuation of the company's mission, vision, and culture
- Depending upon the transfer, you can remain involved in the company
- There is an opportunity for incremental sales that are staged over several years
- You may maintain a voting interest until the transfer is cashed out and complete

Disadvantages

- You must rely on the success of the business for some time before cashing out
- You may take on more risk from an extended transfer and payout
- You may be required to remain involved post-close
- You may ultimately receive less than the full fair market value of the business

Other Options

Initial Public Offering (IPO)

Making a company available publicly can offer an extremely attractive option for some business owners.

Advantages

- There is generally a higher valuation of your interest than in any other form of business transfer
- An IPO generally infuses cash into the business

Disadvantages

- You will lack liquidity at closing since your interest is merely exchanged for shares of stock in the acquiring entity
- Restrictions on your shares mean you may be prohibited from cashing out until a future date, you may be limited at the rate at which they can sell them, and you may find the price per share varies significantly from the price at closing
- You are generally required to stay on, without the control you were accustomed to, and with added accountability to shareholders, analysts, the Securities and Exchange Commission, and other governing entities

Passive Ownership

In some circumstances, you may find that assuming passive ownership is less risky than an insider or family transfer, or a third-party sale because of the involvement of a promissory note or debt required for such a transfer.

Advantages

- Ability to continue to maintain control of the business
- Option to select how less active you may want to be in the company
- You maintain the ability to preserve the mission and culture
- Minimizes risk associated with other types of transfers
- Allows you to preserve cash flow

Disadvantages

- You may not be able to permanently leave the business
- There is little or no cash payout when you leave active employment
- You indefinitely delayed exiting your business
- Your risks involved with business ownership continue indefinitely

Business Liquidation

Situations arise where you find yourself in a position where you must leave the company immediately without an exit strategy in place.

Advantages

- Enables a fast exit
- Offers the ability to get cash fast

Disadvantages

- Liquidation provides less cash than any other exit strategy
- Generally, quick liquidation means a large portion of proceeds will go to taxes than with other options
- It may result in a devastating effect on employees, vendors, customers, and the community who have come to rely upon the business

Business Continuity

Business continuity is a tool for handling the transfer of a business to a different owner when the original owner leaves, dies or becomes incapacitated. A continuity plan protects short-term and long-term business interests and is one of the most important components of business exit planning.

Death or Incapacitation of an Owner

The death or incapacitation of an owner often sets off a ripple of events for a business if it is not prepared for continuity. This loss of direction can lead to losses of financial resources, vendors, key talent, and ultimately loyal customers. Below are the key issues that can occur when owners do not create a plan, along with the ways to mitigate them:

Loss of Financial Resources

Vendors may decide to discontinue their services to the business, especially if the business defaults on its contracts. The banks, lessors, bonding, and financial institutions you do business with may end their relationship with your company. How to handle these situations depends on the type of ownership:

- **Sole Owners** – your death can put enormous pressure on the business to continue its performance should third parties refuse to lend money or make guarantees based on the health of your company. Continuity planning can help offset the loss of leadership.

- **Partnerships** – the loss of financial resources can be mitigated by funding a buy-sell agreement, which places a significant amount of money in the company reserves should you die.

Loss of Key Talent

Another issue that can create problems with business continuity is the loss of your key talent. If the remaining owners do not have your experience or skills, the business can suffer as if it had been a sole ownership. Your experience, skills, and relationships with customers, vendors, and employees may be difficult to replace, especially in the short term. To overcome this situation, begin grooming and training successive management capable of filling your shoes. You should also begin preparing for the transition early because training your replacement can take years.

Loss of Employees and Customers
Particularly with sole ownership, as vendors end their relationship with the business, employees will be unable to satisfy their obligations to customers. This can hasten the employees' departure, taking with them key skills and even client relationships.

- **Stay Bonus –** To mitigate the loss of key employees, you can incentivize them to continue their employment through a written Stay Bonus that provides bonuses over a specified period, generally 12-18 months. This bonus is designed to substantially increase their compensation, usually by 50% to 100% for the duration specified. Typically, this type of bonus is funded using life insurance in an amount that is sufficient to pay the bonuses over the desired timeframe.

Steps to Creating a Continuity Plan

For businesses with only one owner, it should be obvious that there will be no continuity of the business unless a sole owner takes the appropriate steps to create a future owner. Whether it be grooming a successor or creating group ownership, this step should be addressed early. Even if your business is owned by your estate or a trust, you will need to provide for its continuity, if only for a brief period while it can be sold or transferred.

Steps to Create a Continuity Plan – These steps should help business owners move through the process of creating a continuity plan:

1. Create a written Succession of Management plan that expresses your wishes regarding what should be done with your business over a period of time, until your eventual departure
2. Name the person or persons who will take over the responsibility of operating your business
3. Ensure your plan specifically states how the business transfer should be handled, whether continued, liquidated, or sold
4. Notify heirs of the resources available to handle the company's sale, continuation, or liquidation
5. Meet with your banker to discuss the continuity plans you have made. Showing them that the necessary funding is in place to implement your continuity plans will help the eventual transfer of ownership to proceed smoothly
6. Work closely with a competent insurance professional to assure the amount of insurance purchased by the owner, the owner's trust, or the business can cover the business continuity needs to be outlined in your plan

Buy-Sell Agreement

For businesses with more than one owner, continuity can be achieved by creating a buy-sell agreement.

Such an agreement stipulates how a co-owner's interest in the business is transferred and is often funded using life insurance or disability buyout insurance. It can also be funded through an employee stock ownership plan (ESOP) by creating a privately held corporation. It is important that you keep the buy-sell agreement updated to avoid creating additional problems with business continuity. There are several types of buy-sell agreements to consider:

- **Cross-Purchase** – Another business partner agrees to purchase the business from the owner or the owner's family. All business owners generally purchase, own, and are the beneficiaries of an insurance policy insuring each of the other business owners.

- **Entity Purchase** – The business entity agrees to purchase the business from the owner or the owner's family. In this case, the insurance policy is usually owned by the business.

- **Wait-and-See** – The buyer of the business is allowed to remain unspecified, and a plan is put in place to decide on a buyer at the time of a triggering event (e.g., retirement, disability, death). The policy ownership and beneficiary structures vary, depending on the type of the agreement.

Deciding when to begin business continuity planning is complicated and likely depends on your health, family circumstances, and overall business financial wellness. We suggest you seek the advice of a business planning professional to help you sort through your options.

Estate Plan Benefits

A well-thought-out estate plan allows you to determine what happens to your property, the well-being of your family, the guardianship of minor children, and how to minimize or eliminate taxes.

An estate plan can also cover the extent of medical treatment you desire. As a business owner, you have other aspects to consider like transferable value, financial security, and choice of successor.

Transferable Value – is the value a company has without its owner. You will want to:

- Obtain a business valuation
- Create a business continuity plan
- Buy life and disability insurance to help fund the business and employee incentives if you are a sole owner
- Plan for tax efficiencies

Financial Security – to provide financial security, you will want to:

- Provide for your family's income needs after death
- Protect assets from creditors during your lifetime and at your death
- Provide for an equitable distribution of your estate to your children
- Grow your personal estate in preparation for a business succession

Choice of Successor – helps you determine how to divide assets equitably. Consider:

- The business-active child to transition control and who would eventually own the business
- Draft a buy-sell agreement if there are multiple owners

Gap Analysis

The difference between what business owners have now and what they need for financial freedom is called the asset gap. There are several underlying reasons for this gap.

Asset Gap Causes

Gap analysis endeavors to determine if your financial security goals are realistic and it uses objective, accurate information rather than estimates. Business owners may:

- Hold biases, believing the business is worth more than it is, based upon personal investment
- Lack the time to build assets by inadvertently waiting too long to begin the process
- Hold reservations about the cost of valuation and avoid this necessary step
- Underestimate how long they or their spouse or partner may live
- Underestimate the rate of return that can be expected on invested assets
- Overestimate the growth rate for business value and cash flow
- Under- or over-estimate the net proceeds that can be expected from the business sale
- Discount post-business spending habits

You should determine if your financial security goals are accurate or unrealistic, whether you have the personal and business resources available to bridge any gap, and what you must you do to correct the situation.

Necessary Steps

There are several calculations that financial professionals use to determine your asset gap:

- They determine the amount of money you think you need to live on
- Estimate the anticipated number of years of your life expectancy
- Project your rate of return on non-business investments
- Determine what your company's net sale proceeds need to be by calculating the amount of investment capital needed to pay the income you identified, using current actuarial tables and assuming a percent investment return
- They will also determine what your business might be worth today

From these calculations, you should get a good estimate of how many years you must plan in advance of leaving your business so that you may bridge any gap. This is why starting the process of gap analysis sooner rather than later is beneficial.

Derailing Success

The following list outlines general pitfalls and owner failures that can derail a business exit deal.

Lack of Preparation – unprepared owners often fail to gather all the information a buyer needs to make an offer. It may not kill a deal, but it may lead to a smaller payout.

Going Solo – failing to take bias and objectivity out of the process by not relying on a team of professional advisors.

Hiding or Minimizing Problems from Advisors – as experts, advisors can only provide the best possible advice when they have the best possible information from you.

Hiding or Minimizing Problems from a Buyer – hiding flaws that could be treated or minimized can be a deal-killer.

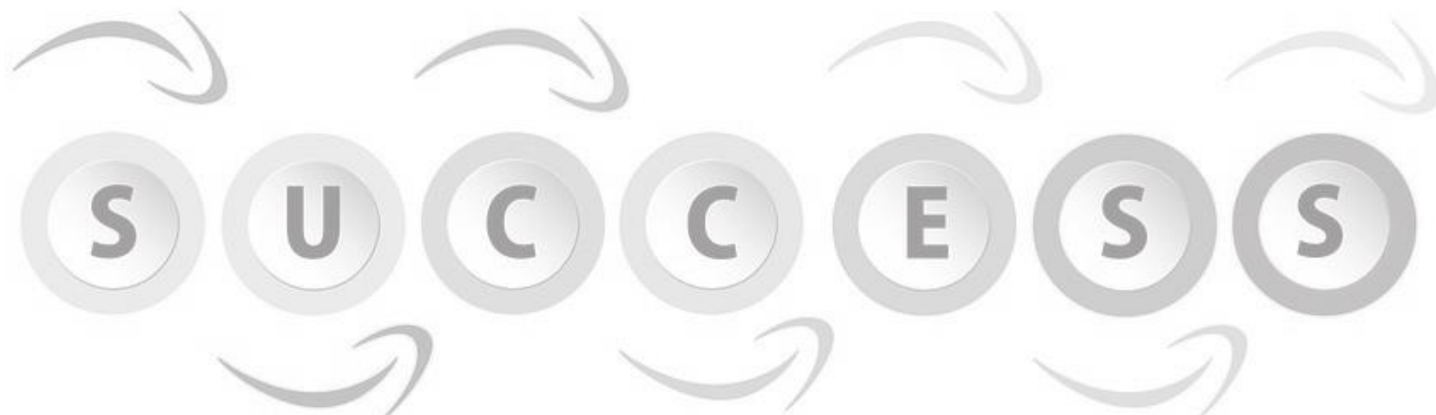
Leaving Your Advisor Out – negotiating with a buyer without an advisor's knowledge can create confusion and stall the process.

Distractions – allowing the sale process to distract from daily business operations.

Overlooking Third-Party Consent – it may be necessary to secure consent from other entities and shareholders such as landlords, lien-holders, lenders, major customers, and vendors.

Indiscretion – sharing business secrets with friends that are shared with others.

Lacking Perspective – sales can be an emotional rollercoaster. Professional advisors help keep the deal on track.



We are Here to Help

Seek Professional Advice

We recognize that if you are like most owners, the business is your most significant asset, and the number of possible succession options can seem unlimited.

Your financial advisor* can coordinate efforts with your attorney and tax preparer to help you create a business succession plan that suits your needs and purposes and helps achieve your financial and personal goals.

This material has been provided for general informational purposes only and does not constitute either tax or legal advice. Although we go to great lengths to ensure our information is accurate and useful, we recommend you consult a tax preparer, professional tax advisor, or lawyer.

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