

Business Transition Planning®

VISTAGE MEETING

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Business owners have freedom, job satisfaction and the opportunity to be in control of what happens to their business after retirement. Planning for the transition at death or retirement is complicated and worth the investment of time and resources. The goal of transition planning is to maximize value for the owner or their heirs.

The three most important aspects include:

1. Developing the transition plan,
2. Preparing the business for sale, or
3. Prepare the business and the family for family succession.

Mass Mutual Insurance has studied sales of small companies and found that in 75% of all cases, the seller does not have a plan. For the 25% of those that plan, there is often no written document supporting the plan. The family may not be aware of the plan, so execution after an untimely death can be a challenge for unprepared family members and business partners. We see that in some of the large agribusiness companies in the Salinas Valley.

More than half of all small companies are simply not sold and allowed to perish. For family succession, the data is worse: over 50% of companies don't survive the transition to the next generation. Only 13% survive transfer to the third generation.

Having a Plan:

The business transition planning process allows the business owner to think about the pathway to success in achieving important goals, and the documentation can serve as a guide for decision making to stay on task. Also adequate time should be allowed to ensure success:

The ideal timeline for family succession is as much as 10 years,
For an external sale, a 3-5 year lead time for positioning is desirable.

Timing is not always a controllable aspect. The time to dispose of a business can come unexpectedly (health set-backs or even untimely death), so preparing in advance will ready a business owner to deal with the situation when it comes up. A succession plan can provide key information for your family and legal counsel in the event of an unexpected crisis.

The development of a plan creates an awareness of options. The owner needs to decide if there good candidates within the family for succession:

1. Will a family succession plan produce enough income for the owner's lifestyle and afford the next generation an opportunity to succeed?
2. For a sale to outsiders, who are the possible buyers,
3. Are there partners or managers that would be suitable.
4. What is the best method of selling?
5. For tax purposes, should the entity type be changed?

Planning can also can help focus the business owner on the appropriate estate planning documents and special issues such as buy-sell documents and adequate insurance for life and disability.

Elements of a Transition Plan:

In order to create the transition plan, the business owner will need several kinds of advice.

- **Personal Financial Plan:** What is an acceptable amount of assets and income to support the owner's lifestyle after retirement? A financial planner can help with an analysis of available resources.
 - Would a gift (or gift – sale) to the next generation be financially viable?
 - How would children not working in the business benefit in a family transition?
- **Estate Plan:** What are the estate planning needs and goals for the owner? An estate planning attorney is critical to understanding all of the complex options (GRAT's, ILIT's, Sales to IDGIT's, lifetime gifting, complex family structures, etc.).

- **Family Plan:** How the transition will work – plan for a sale to outsiders or employees, or transfer within the family. The plan should work for the family situation and be understood by key family members.
 - Note: If the owner has the opportunity to transfer to business to family, a plan should be developed to accomplish this. There are several elements to a successful family transition and a facilitator for family discussion can be useful.
- **Deal Plan:** What are the tax minimization and legal protections strategies for a business sale? The CPA and business attorney are needed here.
- **Valuation** for Sale or gifting the business? A business appraiser or business broker can be useful for this analysis.
- **Plan for a Buyer's Due Diligence:** For a sale, an accountant should be involved to assist in getting the business records in order. Most buyers will want financial statements prepared by an independent CPA; this lends credibility to the underlying numbers. Also legal expertise for liability protection (avoid allegations of misrepresentation) and industry experts can be necessary in technical and regulated industries.

Business Transfer Options:

Intra-Family Transfers: Sale and Gift Sale to the Next Generation –

- Discount Valuation techniques are useful

Internal Sale: Sell to Existing Partners or Management Group –

- A Streamlined Deal with insiders can limit transaction costs and due diligence costs.

Sale to an Outsider: A buyer that is not a strategic buyer-

- A Fair Market Value deal. Due Diligence may be limited.

Sale to a Strategic Buyer (A Company in your industry) –

- Better Valuation: Strategic Value Deal. Expect comprehensive Due Diligence

Sale to a Public Company –

- Usually the Best Valuation. Look at their P/E ratio and figure your earnings will add to their stock value (example P/E of 15 means value to them of 15 times your earnings). Usually very intense Due Diligence

Family Succession Planning:

- Can be considered if it fits within your personal financial plan: will there be enough income for the retiring generation and the incoming generation? A financial plan should

be developed in order to resolve this question. The expected growth of the business is an important consideration.

- Is there a qualified family successor interested and able to ultimately take the business?
- Is the family behind a plan for a family succession?
- Is there sufficient time for education, training, and the development of the successor's experience? Is there time to accomplish a smooth transition that will be accepted by customers, management and employees?
- Can the owner step aside and let the next generation run the business?

Two sets of concerns for a seller:

Controllable:

The seller of a business has several important considerations:

- When to Sell (target date)
- How to set the price for sale
- How to formulate the transaction: cash deal, carry the loan, earn-out
- Who is the best buyer: strategic, financial or family deal
- How to prepare the business to maximize value, or prepare for a family member to take charge
- Who should represent the seller (the advisor group)
- How to prepare for the "Due Diligence" Process
- How to inform staff and customers

Not Controllable:

1. Timing (actual date-see the case studies from the real world below)
2. The buyer's goals

Valuation:

Fair Market Value or Strategic Value

Appraisers can determine the fair market value (FMV) or strategic value in determining the value of a company. This is a definitive term and is dependent upon the target buyer. The business owner should be aware of the issues related to this distinction in order to maximize their upside.

Fair Market Value:

The perspective of the company as it is, without the synergies of a strategic buyer:

The price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arm's length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts.

Strategic Value:

The perspective of the company as it would be with a synergistic acquisition:

For example: a buyer that can cut overhead by eliminating duplicate administrative functions and open up new markets for the existing products will develop a greater value for the company. The buyer will consider the price of the company versus the cost (or legal and technological barriers) to duplicating the seller's products.

Another common strategy is the acquisition of a company to obtain technology, processes and customer base.

Public Company Buyer: usually results in a more intensive version of a Sale to a Strategic Buyer. Greater value and more Due Diligence can be a result with a Public Company Buyer.

Transferrable Assets included in the Fair Market Value of the Business:

The part of a business that can be sold is the *Transferable Value*. For example, your special skills and knowledge known only to you are difficult to sell. This is referred to as "personal goodwill". Also, your charismatic client development and sales skills are personal characteristics. Personal characteristics can build a great business for you, but watch out for a buyer that is not capable of replicating these qualities. An unsuitable buyer may be headed for failure may believe the business was misrepresented. If the seller carries back a note, a ruined business could later be returned to the seller after a default (Case Study #1).

- Conclusion: Perform a Due Diligence on your buyer: Who are they: History in the business, deal track record, financial stability, ability to manage

A proactive owner will develop a process for transferring the goodwill of the business and to the degree possible, their personal goodwill. The transfer of personal goodwill is a greater challenge. For example, an owner that keeps all the client contact and applies their personal charisma to achieve unique level of sales and profitability may have a difficult time transferring goodwill to a buyer. Also, a charismatic owner has the ability to oversell the value of the company to an unwitting buyer:

- How might a mentoring seller have fared in Case Study #1? Could Case Study #1 worked out favorably if an initial partnership have been created for some number of years prior to the seller going on to retire? Mentoring is vital in these circumstances.

What if you give up client contact to non-owner staff? Mentoring the non-owner staff to the point of loss of client control led to the result in Case Study #2.

Components of Transferable Value:

A business has several **intangible** attributes that make it more valuable than just a collection of **physical assets**. This is commonly referred to as **Goodwill**. **Goodwill includes:**

- History of Persistence Profitability (this can be the most Important Attribute for Goodwill)
- Infrastructure: Work-systems including the Supporting Documentation
- Business Identity: Brand, Reputation, Location, Phone number(s), and Web Presence
- Renewable lease
- Management Team ability – cross training
- Workforce ability, training plans and process, tenure, and ability to regenerate (HR Skills)
- Product or Service Lines (more Diversification is better)
- Geographic Reach (more Diversification is better)
- Repeat Customers (Diversify away from key customer dependence)
- Referral Base
- Reliable Accounting Records
- Shop Lay out – the business process
- Key Supplier Relationships (Diversify away from key supplier dependence)
- Banking Relationships

In addition to Goodwill, there may be other intangible assets that add value: such as Copyrights, Patents and Trademarks.

Valuation Methods Used by Appraisers:

Brokers and industry analyst often have “rules of thumb”. These are often expressed as a multiple of EBITDA (earnings before: interest, taxes, depreciation and amortization). Valuation standards and common sense require appraisers to go beyond “rules of thumb” because of the lack of analysis in a rule of thumb discussion. The “*quick and dirty*” rule of thumb calculations

can leapfrog positive and negative issues within the complexity of the multivariate systems that make up a business. This leads to false assumptions concerning the value of the business.

A qualified appraiser will consider three main valuation approaches including the asset approach, earnings approach, and the market oriented approach. The soundness of a particular valuation method is based upon the relative circumstances relevant to the business. Considerations include the nature of the business, economic conditions in the region and the industry, the purpose for the valuation (example: a sale to a strategic buyer is handled differently than a sale to an insider), and the subject percentage of the business being transferred. Also specific company risk and advantages are considered. A SWOT analysis is relevant.

In general, a valuation for an acquisition will likely consider an earnings approach and focus on future cash flow, requiring the development of a projection. For a synergistic valuation, a projection of future earnings is developed, taking into account the expected synergies. Projections can be very deceiving: we sometimes see optimistic forecasts that are unsupported. The key assumptions in a forecast need to be understood and accepted by knowledgeable parties in the deal.

The Application and Use of Valuation Adjustments:

Intra-Family transfers provide opportunities for value discounting. Discounting leverages the benefit of the annual exclusion and the lifetime exemption. This strategy benefits the founding generation in planning for the business transition to future generations. Discounting is possible for transfers of non-control interests. These can be leveraged through the placement of transfer restrictions in the relevant organizational documents.

Other Uses of Discounting Shares: In order to give management a piece of ownership and to wed them to the company future profits, a compensatory transfer can be useful. This usually involves an appraisal of the business along with valuation discount adjustments. The employee is taxed on the transfer at the most tax efficient level possible. The value of the shares is deducted by the company as compensation.

Steps for preparing your company for sale:

1. Determine the company's expected value. The valuation conclusion should take into account whether the buyer is financial or strategic. A synergistic acquisition may add value. The value depends on many factors including expected growth, profitability, business fundamentals and associated riskiness, client concentration, competition, innovation and regulatory and legal challenges. A detailed SWOT analysis is necessary.

2. Be sure records are up to date, detailed financial and company records will need to be readily available.

3. The employees are an important asset, prepare the staff for the deal and do everything possible to train and properly compensate your best personnel to ensure they will be motivated to work with a new owner. Consider employment deals, retirement accounts, profit sharing bonus arrangements and other benefits that will keep your best people around. If the deal is significant, consider a deferred compensation plan with vesting and / or profit benchmarks.

4. Protect the revenue stream, ensure persistence of revenue: Customer diversification, if you have any customers who represent more than 10% of your business, now would be the time to add new revenue sources (products or lines of business), in order to minimize the potential impact (and valuation challenges) that the potential loss of a large customer could have on your business.

5. Assemble a planning team. The sale of a business usually requires the assistance of outside advisors. A good team should consist of a business advisor, transaction attorney, accountant and an appraiser. The performance of the company during the time it is on the market is crucial, so working with a transaction team will allow you to focus on the ongoing operation of the company while the team handles the sale.

6. Consider this checklist for opportunities to maximize value:

1. Records should be formalized and clearly document all transactions. Potential buyers want germane information so they can easily evaluate the company. New management wants process documentation and training so they can be successful.
2. Examine all supplier and customer contracts. Make sure terms and conditions will not expire or require renegotiation just as a new owner steps in. Terminate contracts that might trouble a potential buyer or that drain the company financially or serve little purpose.
3. Start codifying company policies and procedures that exist as unwritten rules. If necessary, create a procedure manual that documents exactly how to best run the business; be sure to include unspoken, undocumented techniques.
4. Review real estate leases, especially if the business is tied to its location. Make sure the lease does not expire or require renegotiation within the time frame that you plan to sell the company. If the company's location will discourage buyers, consider moving the location before you place the business up for sale.
5. Analyze the equipment leases and other material contracts from the buyer's perspective.

6. Fully evaluate and catalog company assets, from property to warehouse inventory to employees. If you delayed investing in computer upgrades designed to manage and control the flow of inventory, now is the time to modernize.
7. If company assets include real estate, separate or sell the property before the company hits the market. Real estate can devalue a business simply because it complicates the financial records, which in turn can make potential buyers hesitant to assume a new business with added expense.
8. Limit risk through diversification of products, cross train personnel.

The Target Buyer:

The buyer can be someone looking for an opportunity to run their own business, possibly your employees or the core management group, or strategic buyers.

“Strategic Buyers” — these are companies for whom your business adds strategic value. For example, you may have products that their existing customers would like to buy or you have customers who would buy their products. The combination of the two companies creates an additional value called: “Strategic Value”.

Structuring the transaction:

The Process starts with an NDA (Non-Disclosure Agreement):

- Legal protections for both sides

Due Diligence:

- Both Sides should do this:
- The Buyer wants to consider and review financials, regulatory issues, key customers, existing and potential litigation, forecasted sales, planned product roll out, union issues, pension funding, etc.
- The seller needs to look at the past history of any other deals conducted by the buyer, and ability to live up to commitments and fulfill the financial obligations.
- The bigger the deal the more expertise will be needed.

The Letter of Intent:

- Can be simple or creative:
- Tax issues should come into play: example IRC Section 338(h) Election Considerations, Section 1060 allocations, and possible direct payments to owners for personal goodwill and covenants against competition.

- Terms are relevant: asset versus stock purchase, earn-out, contingencies, owner continuation etc.

Negotiations:

- Structure the final terms: Price, transaction payment details, how contingencies will be handled and all the terms of the deal.

Closing:

- Be ready for numerous phone calls with your deal team. This is where the attorneys earn their money. *Hopefully your attorney is drafting the documents for the other side to review.*

The structure of the transaction can eclipse the price as the biggest challenge in the deal in some cases. Deals can be over structure. The business sale cannot close until all parties agree to the structure. The elements of risk for the buyer and the seller come to the forefront at this point in negotiating the deal. The seller is concerned with getting paid in full while the buyer wants to be sure the business will perform as represented and there are no contingent liabilities or leftover problems. It is important that a business owner is prepared to address this aspect, and know their bottom line as to what they will be able to live with. For example, agreeing to the allocation of purchase price among the assets (under IRC Section 1060) can be a struggle as each side seeks to maximize deal related tax benefits (see Tax Considerations below). Asset deal versus stock deal is a major deal point. The buyer will often want reserves for contingent liabilities and performance issues. An internal buyer such as employees or core management may limit the scale of contingency issues.

Reserve accounts held in an escrow against contingencies may be lost; the seller should negotiate this issue well. Note: this issue can become a cause for post deal litigation.

Common Alternatives for Selling a Closely held business include:

- Cash Deals
- Outside Financing
- Seller Financing with security
- Earn outs

Tax Considerations for a Business Sale Transaction:

Some of the tax issues that should be considered with your tax advisor are indicated below. Other tax issues that are specific to your situation may be relevant. Always consult tax counsel early in deal planning as you develop your succession plan or negotiate a deal.

Entity Driven Issues

- C –Corporation - Standard Taxable Corporation
- S-Corporation – Non-taxable “pass through” entity (that is not a former C- Corporation)
- S-Corporation – That is a former C-Corporation
- LLC
- Partnership
- Proprietorship

A seller needs to determine the nature of the transaction for tax purposes. The total return available to the seller will be significantly impacted by the tax treatment for federal and state tax purposes. For example, in the sale of shares in a C -Corporation, the seller receives very favorable long-term capital gains treatment (for shares held for more than one year). Combine that with an installment sale and you leverage the rate of return on the deal. In most business acquisitions, the buyer does not want to purchase the corporate stock.

CASE STUDIES FROM THE REAL WORLD **[Cases Our Office has worked on]**

Case Study #1: “Lost opportunity, default on sale”

The seller of a small manufacturing company has a great track record, profitability & growth above the industry average, excellent cash flow, and a great reputation in the industry. Seller has a key member of the management team set to buy him out. Seller is very charismatic, holds all the key contacts with key customers, and is cautious about turning these contacts over to other members of management. The seller has many outside interests and has built up large amounts of wealth. The seller decides to sell to his key manager. An appraisal of the businesses is performed, and on that basis a sale price is agreed upon. The seller carries back 80% of the sales price, with a 20% down payment. The note is secured strictly in the stock of the business. As an insider the buyer is willing to purchase stock from the seller, (as the buyer is knowledgeable about all the possible contingent liabilities and is not concerned). As a result, the seller gets an ideal tax deal: a stock deal with deferred income from an installment note resulting in the deferral of 80% of the capital gains tax. As it is a stock deal all the gains are eligible for capital gains treatment (no depreciation recapture or double tax as there would be from an asset sale).

What you think the problems are? 1. The seller did not sufficiently mentor the buyer on dealing with sales and customers. 2. The buyer does not have the charismatic skills of the seller. The buyer has weaknesses such as timely meeting the expectations of the key customers. After 3 1/2 years into a six-

year note, the buyer defaulted. The seller who is now out of the industry and has not maintained contact with key customers or other stakeholders relevant to the business must take the business back. The seller's life is disrupted. And even worse, the buyer has ruined or sold off a lot of the equipment that was in the factory. Essentially the buyer was paid about 60% of the original price.

As a final note, the buyer had lost his personal residence in a short sale and was essentially bankrupt. While the purchase contract provided plenty of legal authority for the seller to sue the buyer, there was no financial incentive to go after the buyer. Tangential litigation was brought against the deal advisors.

Case Study #2: "Staff walks with business"

The business owner runs a prominent public relations firm. The company has grown quickly and the owner has allowed several key staff members significant client contact. The owner has invested in the mentoring of staff and reduced his time contact of key clients. From time to time the owner brings up the possibility of transitioning the business to the key management group. The key management group is aware of the significant profitability of the company. The decision to make the core management group co-owners is deferred without explanation.

Finally the core group of managers turns into a mutinous party of renegades. On a Sunday, the renegades meet at the offices of the company and proceed to copy everything of any importance. On Monday a new firm opens, and the sole shareholder of the old firm receives several resignation letters. The new firm hits the ground running and is immediately profitable. The owner of the old company retains counsel and obtains some restraining orders and ultimately enters a lengthy legal battle. The damages case ensues for lost profits. The president of the old company prevails and wins the case against his ex-employees. Legal fees on each side were approximately \$1 million (\$2 Million total). The damages are substantial and consequential and the court orders immediate payment.

The ex-manager group own homes however these properties are all leveraged. Other than pension assets (protected by the bankruptcy statute) there are no assets to liquidate. The clients of the old company are distraught and feel that the people that they trusted to take care of their public relations needs are no longer accessible and do not return to the president of the old company as it had been so long since they had a professional relationship with him. The clients scatter and seek new representation.

What you think the problems are? 1. The president of the old company missed an opportunity to provide advancement for the key players in his success. By giving the core management group some small ownership he would have been entitled to be protected from their actions through a covenant against competition. 2. Compensation for the core management group could have been adjusted to reflect an amount that compensated their advancement in the industry, based on the growth they bring to the firm, and account for monthly payments for the acquisition of stock from the business owner. As the company grew and prospered more stock could have been sold to the insider group and ultimately a final block of stock would be sold leaving the president of the old company with a great buyout scheme and a great relationship with his core management team.

Case Study #3: “Transfer your Goodwill, without even trying”

A dentist has a successful practice which he has operated for more than 35 years. He believes that he has hired his replacement and future buyer. Over time he suffers from health issues and progressively two things happen: his client base shrinks due to his health issues and related loss of energy and his associate dentist becomes the main operating dentist in the practice. Many of the remaining patients believe the associate is their dentist now. Finally, the owner offers the practice to the associate. The owner of the practice had a consultant in several years ago to advise on best practices and perform a valuation. The owner has a number in mind for the selling price to the associate. The practice is offered to the associate and she is shocked at the asking price. The owner is locked into a number from the past and does not understand his weak position. Negotiations ensue initially a deal could not be made. The associate leaves, acquiring a very small practice in the same town. The associate does not directly contact any of the older Dentist’s patients. The newspaper announcement(s) of the new practice draw a significant number of the older dentist’s patients to the associate’s new office. The associate has not done anything to violate fiduciary or business laws and the older dentist has no legal recourse.

What you think the problems are? The older dentist had a situation that could have been managed through the planning process. He and his advisors did not recognize his weakening position. While he did some planning (with the consultant) he failed to follow through.

Case Study #4: “Buy your own business”

The owner of a plumbing contractor company (they do mostly large profitable commercial jobs for new construction), has a great general manager. The GM worked his way up in the company; he can do any job well, and has been in his position several years. The GM is trusted by the contracting community and the local developers. On that basis, the GM has enhanced the reputation of the company and develops a lot of new business for the company. Revenues have doubled in five years. The owner pays small bonuses to the GM and the salary for the GM has increased at the rate of inflation. The owner wants to sell half of the business to the GM. The owner wants to factor in the current level of revenue. The GM wants credit for his business development.

What you think the problems are? There was no long term plan for transitioning the business. There was no ongoing communication between the parties concerning the proposed transition plan. The GM is resentful that “he has built a great business for the owner” and now is being asked to buy it. The owner believes this is fair as he risked the capital that made it possible for the GM to prosper and now have an opportunity to share in the equity.

As a final note: We appraised the business *with and without* the growth accorded to the actions of the GM. The parties were able to negotiate a resolution.

Case Study #5: “Contingency versus legal fees”

The Seller was in poor health and as a result of failing to plan, the business was not in a good position for a sale. The process was a difficult journey for the seller and his family. The buyer successfully negotiated a substantial portion of the purchase price to be escrowed for contingencies. The Seller died before the contingent period had lapsed. The Family did not want to litigate with the buyer over the escrowed funds. The buyer ended up retaining a significant portion of their purchase price and the funds ultimately going to the family were greatly reduced.

SPEAKER BIO

Clark Savage, CPA, ASA/ABV

Clark is a Certified Public Accountant and holds a Master's degree in Federal Income Tax. He is an Accredited Senior Appraiser with the American Society of Appraisers with a specialization in businesses valuation. He is also accredited in business valuation by the American Institute of CPA's.

Clark has appraised over 750 companies for sale and transition planning and litigated matters. He has qualified as a business valuation and damages expert in Superior Court in 3 California Counties, and testified in numerous probate, family law and civil cases, including judge and jury trials, and mediations.

A frequent speaker for business and professional groups, Clark's recent presentations include:

- Panel of Experts in Discount Valuations: Community Foundation @ the Steinbeck Center
- Maximizing the Value of a Business for Sale
- Tax Relief for Cancellation of Indebtedness Income
- Tax Loss Benefits Available to Investors
- Business Valuation for Civil Litigation and Family Law
- Business Valuation and Succession Planning
- Estate Tax Valuation and Valuation Adjustments
- Valuation discount Adjustments for Family Limited Partnerships
- Due diligence for Investors
- Valuation of Start- up Enterprises