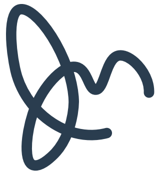

JAMESMOORE

YOUR COMPLETE GUIDE TO TRANSITION PLANNING

888-387-6851
www.jmco.com

When you own a business, your work is about more than day-to-day tasks; it's about what truly drives you. Taking care of your customers. Building a work family with your employees. Doing something you love. Serving your community. Leaving a legacy.

With so much on your mind, there's probably one thing that isn't: your endgame. After all, most of us don't want to think about leaving our business, especially if that departure is out of our control.

But it's something you must consider. Because at some point – whether it's by choice or circumstance – that time will come. And when it does, who will take care of your customers? What will happen with your employees? Will you still be able to do something you love? How will it affect your community? What will be your legacy?

There's a lot riding on those questions. Which means you'll need a transition plan to make sure everyone is covered, from clients to family to yourself.

A transition plan for your business outlines priorities, strategies and procedures for when it's time to change how much responsibility falls upon your shoulders. It protects your company's future, the clients it serves and the employees it supports. It also ensures your family is financially secure and helps protect them from uncertainty or prolonged disputes.

Transition plans take time to develop; and since we can't predict the future, they have to be ready for use at a moment's notice. So your first steps in transition planning should be taken long before retirement or a career change is on the horizon.

And oddly enough, that first step begins... with the end.

What do you want?

When making any plan, you need to establish end goals before you outline the steps to get there. Creating a transition plan is no different. You need to know what you want for your business and for yourself.

So the first phase of the transition planning process is a time to ask yourself some serious questions (and provide yourself some honest answers).

- Do you want your business to continue running?
- What do you want out of your post-exit life? (e.g., complete retirement, do some consulting work, embark on a completely new career)
- How much do you need do you need to retire and live the lifestyle you want to have?
- How much is your business currently worth?

Next, you have to identify your gaps - the difference between what you have now and what you'll need at the time of your exit. This involves figuring out how much your business is worth and how much money you'll need to live the life you want upon retirement. You'll also have to set your business up so the people you want in charge can actually be in charge when the time comes.

Choose your path.

Your next step is to choose your exit path. There are several possibilities; the best one for you depends upon your financial and succession needs.

Path 1: Transfer the company to family members. Owners who consider this exit path usually do so for a host of non-financial reasons:

- Put the company in the hands of a known entity–specifically one's own flesh and blood–who the owner believes will run the company like they did.
- Provide for the well-being of the owner's family.
- Perpetuate the company's mission or culture.
- Keep the company in the community.
- Allow the owner to remain involved in the company.
- The major disadvantage of a transfer to family members is your heightened exposure to financial risk. Family members are often incapable of paying the amount of cash you want or need for the company. That's a clear downside if you must convert your company into cash for retirement. As a result, you might have to stay active with the company (and remain tied to its future financial performance) to ensure financial success.
- Additionally, you might not have children willing and able to assume ownership of a company. And of course, family dynamics are a wildcard. Choosing one or more specific members to succeed you (and therefore, not choosing others) can create rifts, resentment and other complications.

Path 2: Sell the business to one or more key employees or current co-owners. This path has many of the same advantages and concerns as a transfer to family members. On the plus side, you're trusting the company with someone you know and who is likely to uphold its culture. This in turn provides more company stability and allows the owner to remain involved.

On the other hand, it's once again probable that employees won't have the cash needed to purchase the business or the know-how to run it. This often requires continued owner involvement after the transition to provide instruction and continue earning an income.

That second drawback could be mitigated somewhat by selling to existing co-owners, since they're more likely to be experienced in running a business and in a better financial position for the purchase. However, you'll still probably receive less than full fair market value for your portion of the company.

Path 3: Sell to employees using an employee stock ownership plan (ESOP). ESOPs are qualified retirement plans (typically profit-sharing plans) in which all employees participate. ESOPs must invest primarily in the stock of the sponsoring employer. Like the other paths we've discussed, ESOPs appeal to owners who want their companies in the hands of known entities. However, there are a few additional benefits:

- Beneficial tax treatment. Using an ESOP, an owner might be able to defer or avoid taxes on the sale of the stock to the ESOP. Even more importantly, the company can pay for the owner's stock with pre-tax dollars.
- More cash sooner. The owner may be able to close the sale with the cash necessary for a financially secure retirement due to favorable tax treatment and the greater possibility of at least some outside financing.
- Motivated work force. Studies indicate that, with all employees indirectly participating in the benefit of ownership as ESOP participants, work performance may improve.

That said, not all aspects of this path benefit the owner. There's the added cost and complexity of setting up and maintaining an ESOP. Your assets may be tied to the company as collateral when securing an ESOP loan. And while you'd likely receive more cash than the previous paths we've discussed, it won't be as much as if the business were sold to a strategic buyer.

Path 4: Sell to an outside third party. If your list of objectives starts with something like "leave for Tahiti the day after closing," this exit path is the one you want. It provides a clean break, allows you to control your date of departure and usually offers the best chance to get the maximum purchase price for your company. It also appeals to owners who want to propel their business to the next level on someone else's dime.

That said, there are potential pitfalls. There is typically a due diligence process prior to the sale, and it can be time consuming and intense if you're not prepared. Depending on the company, there is generally an indemnification holdback, as well as working capital adjustments and the possibility for part of the purchase price to be contingent on future performance.

Additionally, you must be prepared to walk away from your company entirely – essentially losing a meaningful part of your life. Also possibly lost: your company's corporate culture or mission as your business changes leadership or merges with a larger entity.

There's also the widely held misconception that a third-party sale means employees' jobs are at risk and their career opportunities jeopardized. This can often be the case in mergers/acquisitions among public companies. However, in our experience, few employees lose their jobs after a third-party sale. In fact, a larger company can often provide expanded career opportunities, boosted compensation packages and other benefits.

To alleviate these downsides, buyers and sellers will often agree to have the seller stay on in an employment or consulting capacity for a set period of time. This allows you to oversee the transition, be available to give advice and help implement changes in an inclusive and comforting way.

Path 5: Engage in an initial public offering (IPO).
IPOs are not common, but they attract the attention of business owners for two reasons. First, the valuation of the ownership interest is usually higher in an IPO than in any other form of transfer (including a sale to a third party). Second, an IPO brings an infusion of cash from a pocket other than your own, providing a boost for your business.

The primary disadvantage is that despite the high valuation placed on (and paid for) your interest in the company, the IPO is not a liquidity event for you. Your interest is exchanged, at closing, for shares of stock in the acquiring entity. You're typically prohibited from cashing out these shares until a prescribed future date and must do so at a specified rate. And that price per share varies – often significantly – from the price at closing.

An IPO can also restrict your departure date. You'll be required to stay on with the acquiring company, but you'll no longer have control. You may still be the CEO, but you're accountable to shareholders, analysts, the Securities and Exchange Commission and other governing bodies.

Finally, an IPO creates a public company. As such, it's subject to reporting requirements and must uphold fiduciary responsibilities not required in privately held companies. You might chafe under these additional requirements.

Path 6: Retain ownership but become a passive owner. If you want to maintain control while becoming less active in your business, you might consider passive ownership. Not only does this exit path help preserve the company's culture and mission, it also provides you with a consistent cash flow (and lower economic risk).

In some cases, especially in businesses with a value of less than $5 million, owners feel they're at less risk keeping their businesses than selling them when a third-party buyer makes a major part of the purchase price subject to a promissory note or some type of earnout. Passive ownership helps reduce that risk.

The disadvantages of this exit path, however, are fairly obvious. You'll remain tied to the business for the long term unless another transition occurs, delaying your journey to post-business life and keeping you subject to the risks of business ownership. You'll also receive little to no cash payout when you leave active employment.

Path 7: Liquidate the company. There is only one situation in which liquidation is appropriate: when you want to (or must) leave the company immediately and have no alternative exit strategy in place. Liquidation offers the two benefits most important to an owner in that position: speed and cash.

Not surprisingly, the disadvantages of this exit path are numerous. Liquidation yields less cash than any other option, primarily because no buyer pays for nonexistent goodwill. Additionally, owners who liquidate often must allocate a greater proportion of their proceeds to taxes than do owners in any other type of sale or transfer. Finally, liquidation can have a devastating effect on employees and (to a lesser extent) customers.

Given these disadvantages, few owners pursue liquidation unless they have no alternative or they operate in an industry that is clearly in decline. However, if you engage in significant tax planning years in advance of your exit date, you can accomplish significant income tax savings to help ease the blow.

What do you want?

Regardless of the exit path you choose, the value of your business plays a key role in your transition. The more valuable your company is, the better your financial position when you leave. And the best place to start is by building reliable operating systems that sustain the growth of your business.

Think about it: if you leave shortly after the sale of your company, what remains? If the answers are "capable management" and "highly efficient business systems," you'll be able to leave your business in style. So it's important to develop and document business systems that generate recurring revenue from an established and growing customer base.

Business systems include the automated and manual procedures used in the business to generate its revenue and control expenses (i.e., create cash flow), and the methods used to track how customers are identified and how products or services are delivered. The establishment and documentation of standard business procedures and systems demonstrate to a buyer that the business can be maintained profitably after the sale.

Put yourself in the shoes of the would-be buyer for a moment. As a buyer, you want assurance that the business will continue to move forward and that operations will not break down if (and when) you leave. This assurance can best be obtained when there are documented systems in place that will enable the buyer to do what you've done to generate income and grow the business.

There are several business systems that, once in place, enhance your company's value whether you plan to sell it now or decide to keep it. These procedures cover multiple aspects of running your business, such as:

- Personnel recruitment, training and retention
- Human resource management (e.g., an employee manual)
- New customer identification, solicitation and acquisition
- Product or service development and improvement
- Inventory and fixed asset control
- Product or service quality control
- Customer, vendor and employee communication
- Selection and maintenance of vendor relationships
- Business performance reports for management

Obviously, appropriate systems and procedures vary depending on the nature of a business. But at a minimum, you should document the resources and activities necessary for the effective operation of your company. This provides a solid foundation upon which an efficient and profitable business is based.

The best way to boost the eventual sale price when selling your business is to focus on key business value drivers today. These are several things you can do now to make your business more valuable in the eyes of buyers while reducing potential risks.

Hold regular and deliberate conversations with managers and employees to make sure everyone is on the same page. This helps reduce or eliminate redundant processes that waste money. It can also keep undone procedures from slipping through the cracks, resulting in costly errors.

Improve and maintain relationships with customers, suppliers and other third parties. This increases the likelihood of timely payment and receipt for products and services, which contributes to your company's wellbeing and financial bottom line. One way to do this is to implement paperless systems whenever possible for payments, document transfers and other interactions.

Ensure that your internal financial reporting is accurate, timely and meaningful. Keep lines of communication open with your accounting personnel and CPA firm, and work with internal and external IT support to automate reports within your company's accounting system.

Assess your human resources function and enhance it accordingly. Unless you run a sole proprietorship, your people are the backbone of your business. Proper HR policies and procedures make sure they're able to work to their full potential – not to mention protect your company.

Make sure your technology is up to date. This includes not only IT networks, hardware and software but also manufacturing floor machinery, large pieces of medical equipment and other industry-specific items. These technologies can evolve rapidly, so it's important for productivity, profits and business value to keep them updated.

Ensure your corporate records, contracts and other legal documents are all current and in good standing. This instills confidence in potential buyers that your company's operations and dealings are above the table and they won't encounter surprises in the due diligence phase of their purchase.

Develop a seasoned and experienced management team prepared (and financially incentivized) to help ensure a smooth transition. Can the business operate without the owner? Stable leadership that includes people with a variety of skills is extremely appealing, because good teams are hard to assemble and even harder to keep together.

Sophisticated buyers know that if an effective management team is in place, prospects are high for continued success.

Have a realistic strategic growth plan in place that enables buyers to realize positive return on their investment. Remember, the buyer won't understand your business as well as you do. Buyers pay premium prices for companies with a good plan because it demonstrates specifically how cash flow and the business itself will grow after acquisition. Since future cash flow is based on estimates of future growth, having a realistic growth strategy is vital to reaping top dollar for your business.

Business for sale - well, almost...

The time has come to prepare your business for sale (if you're going that route). But the first step must happen before you even put feelers out for a buyer. This is called due diligence readiness, and it's essentially an internal due diligence process.

Once a buyer becomes interested in your business, they'll perform due diligence to make sure it doesn't have any hidden issues. These could be tax concerns, inaccurate valuation of assets, reliability of reported profits, customer stickiness, uncollectible outstanding accounts... anything that could make a buyer doubt your company's credibility. Such issues can lead to bigger problems and even lawsuits down the road.

If the buyer's process uncovers issues, it can make the sale of your business far more difficult by prompting the buyer to hold back some of their payment for the business until problems are resolved. It could even kill the sale altogether.

This is why your own due diligence readiness process is so important. By preemptively finding and addressing any skeletons in the closet, you help assure that the buyer's process runs smoothly. This increases their confidence in your company and their chances of success once they take ownership.

Okay... now we have a business for sale!

Now that you've dug up those skeletons and tossed them aside, you're ready for takers. And when a potential buyer is serious about a possible purchase, they'll provide a letter of intent (LOI). This letter will set out proposed terms such as their preferred purchase price, a tentative plan for deal structure and other important matters.

Once you receive this letter, you'll review it to make sure you agree with these terms and submit changes as you see fit. In most cases, the letter is complete after one or two versions. However, it's not unheard of to have several versions of this letter to go back and forth between seller and buyer until both parties are satisfied.

It's critical to have an experienced transaction attorney look at an LOI during your review process and give a final go-ahead before you sign it. Buyers sometimes include complicated language, stipulations if something goes wrong during the process, etc. An attorney experienced in business transactions will know the pitfalls to look for and make sure your best interests are upheld.

Finally, it's important to note that an LOI is not a contract; it is the starting point of negotiations. Its purpose is to simply make sure both parties are on the same page when it comes to the structure and goals of the sale. You can modify an LOI if there's language you don't like or it contains an element you haven't discussed. So beware of any buyer who tries to submit a binding LOI that doesn't allow for changes.

Once the LOI is set, the buyer will start their due diligence process (as we discussed earlier) and work out any issues that might arise. Meanwhile, management, attorneys and other professionals will start working on the draft purchase price agreement. The outside CPA will often assist with the due diligence process by assisting with the financial and tax related elements. It's also important to work with them on the tax ramifications based on the structure of the deal and understanding the working capital components and other financial aspects proposed in the agreement.

Eventually, everyone comes together with the final agreement. What happens next depends upon the deal structure agreed upon by both parties. There are a few ways a purchase can be funded:

Cash Purchase

Your buyer pays the entire amount up front, either with cash on hand or through a loan from a bank or other institution. A cash purchase presents the lowest risk to you as a seller; the entire transaction is done at once, so it's the best structure if you're looking for a quick, clean exit. However, the final selling price is generally lower for the convenience. You also surrender control of your business immediately unless you and the buyer come up with an arrangement for a slower transition.

Seller Financing

You can finance the sale yourself. The buyer makes a down payment, and the remaining balance is paid in installments (with interest) over a set timeframe. While deal structure comes with a higher risk should your buyer not be able to pay, you're also likely to get a higher price for your business. However, you do also retain some control of the business during the financing term (which allows you to stay on and help the new owner learn the ropes). It also spreads your sale out over several tax years to minimize the capital gains impact.

Earn-Outs

Similar to seller financing, an earn-out is an arrangement in which the seller finances the sale. In this case, however, the buyer's monthly payment is based on the business's performance over a set number of years. If profits are high, the payments go up and the loan is paid off more quickly (the reverse is true if profits are low). The amount of this earn-out depends on the profitability level of your business. In addition to the benefits of seller financing, an earn-out arrangement incentivizes the buyer to do well once he or she takes over – which is also good news for you and your employees.

Don’t forget life after the race.

Imagine you’ve trained for years to run a marathon. You finally get to race day and cross that finish line – quite an accomplishment after all of your hard work. But then you realize there’s no water to quench your thirst, no place to sit, no plan on what to eat after you’ve expended all that energy.

The moral of the story? Think about life beyond the finish line. Your transition plan should do more than get you to the line itself; it should also include how your wealth is handled once you cross it.

Chances are your plan’s exit path results in a partial or entire loss of regular income. So you need an arrangement that preserves and grows your funds depending on your goals. Do you want to uphold a particular lifestyle? Leave a financial legacy for your family? Provide a nonprofit with a generous gift? Each of these goals requires a tailored approach to investment strategy and fiscal management.

This is where a wealth management professional factors into your transition planning process. A knowledgeable partner in this effort can guide you through budgeting, planning, investing and tax strategies to help you maximize your wealth.

The path to your exit is a long one, with emotional decisions requiring careful strategies. A thorough, well-thought-out transition plan removes as much uncertainty as possible ahead of time.

By taking thoughtful steps to craft your plan and involving the right CPAs and other professionals, you’ll have a blueprint for a successful transition — and peace of mind for yourself and everyone else involved.