Business Transaction Marketplace

Information about Business Valuations, M&A and Corporate Finance September 2014

6 Ownership Transition Options – Part I

The number is: *$10.4 trillion* – the estimated amount of Business Wealth to be transferred by "baby boomers" by the year 2040 (Source: Robert Avery, Cornell University). Seeing this huge shift in wealth caught my attention in 1997 when I wrote an 8-hour course titled *Succession Planning: Exit Strategies for the Privately Held Company*. Since that time, I've come to believe that a better term is "Transition Planning" – ways entrepreneurs can *transition* from being business owners to the next stage of their lives.

Part I of this Article lists six (6) options to sell or transfer business ownership, along with advantages and disadvantages of each option. In the next issue of *Business Transaction Marketplace*, Part II of this Article will describe certain sale or transfer strategies under each option.

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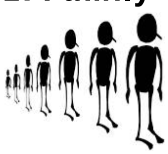
1. Family



Advantages
- The sale or transfer is to a known entity – the business owner's flesh and blood
- The family business legacy continues, along with the company's mission and culture
- The business can continue to provide family members with financial security in the form of employment and retirement opportunities
- The business owner can still remain involved in the business

Disadvantages
- Transfers by gift or bequest provide no liquidity to the business owner or his/her estate
- May require the owner's involvement after the transfer to include increased (or continued) financial risk (e.g. personally guaranteeing bank debt or performance bonds)
- Family successor may not have the ability or willingness to assume an ownership role and its inherent risks (e.g. guaranteeing company obligations)
- Treating other family members not working in the business fairly may be problematic, to include the perceived nepotism by non-family key employees

2. Other Owners

Advantages
- The skills and knowledge of the other owners are known quantities
- A sale to other owners often perpetuates the company's mission and culture
- Selling to other owners takes less time because of the reduced need for in-depth due diligence and limited breach of confidentiality
- The owner can still remain involved in the business

Disadvantages
- The selling price may be below fair market value because the other owner may not have the financial resources; or they may argue that part of the company's value is attributable to their *personal goodwill*
- The owner may need to take back an installment note for a substantial part of the purchase price; servicing the note may put the company in financial risk
- May require business owner's involvement after the transfer to include increased (or continued) financial risk (e.g. personally guaranteeing bank debt or performance bonds)
- Other owners may lack the necessary qualifications to both own and manage all facets of the business (e.g. operations, marketing/sales, accounting/finance and administration)

3. Mangement

Advantages

- The skills and knowledge of key management are known quantities; may become a way to reward the business owner's protégé by passing on ownership
- Selling to management perpetuates the company's mission and culture
- Selling to management takes less time because of reduced need for in-depth due diligence and limited breach of confidentiality
- The owner can still remain involved in the business

Disadvantages

- Most sales to management are completed without a competing bid, and therefore it's unlikely the owner will receive a top price; here again, management may argue part of the value of the company is attributable to their *personal goodwill*
- Management sometimes has a strong negotiating advantage over the owner by threatening to leave if the owner later decides not to sell to them
- May require owner's involvement after the transfer to include increased (or continued) financial risk (e.g. personally guaranteeing bank debt or performance bonds)
- Management may not have the ability or willingness to assume an ownership role and its inherent risks

4. ESOP

Advantages

- An Employee Stock Ownership Plan (ESOP) becomes a ready market for the owner's business – priced at fair market value
- Tax free rollover of sales proceeds for the owner if the company is a C Corp
- The ability to service ESOP debt with pretax dollars, along with conversion to an S Corp (a 100% ESOP owned S Corp would pay no income taxes)
- ESOPs can be a method to retain valuable employees, and becomes a motivator to increase productivity

Disadvantages

- A leveraged ESOP adds financial risk to the company; owner often needs to guarantee the Bank loan
- Price to a strategic buyer is often higher than fair market value (i.e. an acquisition premium is paid)
- Difficulty keeping middle management motivated and gaining acceptance of an "open book" culture
- ESOPs are complex with on-going administrative costs

5. Third Party Buyer

Advantages

- Greatest chance to receive the highest price and best terms
- A third party sale typically removes the owner from investment and financial risk
- Depending on the buyer, better chances for post-transaction growth for the company
- Allows the owner to control his/her date of departure

Disadvantages

- The M&A process normally takes from 6 to 12 months to complete, which increases the chances for confidentiality leaks
- Loss of owner's identity, and loss of the company's mission and culture
- Potentially detrimental to employees (e.g. loss of jobs), as well as to customers and suppliers

6. Voluntary Liquidation

Advantages

- For a declining business, a voluntary liquidation may be the best option to maximize net proceeds from the sale of: 1) tangible assets (e.g. real estate and equipment), and 2) intangible assets that can be separated from the business (e.g. customer lists and intellectual property)
- Discontinues any negative cash flows in preserving remaining asset values
- A shortened time frame to convert remaining assets into cash

Disadvantages

- Loss of any possible proceeds from going concern value, along with costs to liquidate
- Loss of employment for family members and other loyal employees
- The negative impact of closing the business on customers and other stakeholders (e.g. the community at large)

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6 Ownership Transition Options – Part II

In Part I of this Article, we listed the following six (6) options to sell or transfer business ownership, along with advantages and disadvantages of each option:

1. Family
2. Other Owners
3. Management
4. ESOP
5. Third Party Buyer
6. Voluntary Liquidation

In this issue of *Business Transaction Marketplace* (BTM), we will describe certain sale or transfer strategies for each of these six (6) options.

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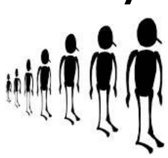
1. Family



Advantages: Transferring or selling an ownership interest within the family allows the business legacy to continue; and, provides the owner and family members with financial security in the form of employment and retirement opportunities.
Gifts: Transfer a minority interest which will allow the owner/donor to take advantage of *valuation discounts*, removing the asset from the owner's estate at a reduced transfer tax cost. Take advantage of the annual $14,000 gift tax exclusion per family member/donee ($28,000 for both parents). For sizable gifts, take advantage of the $5.34 million applicable exclusion. If the business entity is a corporation, *recapitalize* the company with non-voting stock which becomes the equity interest that is gifted; the owner still retains voting control.
Installment Sale: Sell a minority ownership interest to a family member over time under the installment method. The price to the family member becomes more affordable, plus provides retirement income to the owner. The transaction must be at arm's length (i.e. at *fair market value*) to avoid gift tax consequences.
GRAT: A grantor retained annuity trust (GRAT) is where the owner/grantor transfers an ownership interest in a business – that's likely to appreciate – into an irrevocable trust, while retaining the right to receive annual annuity payments. In a "zeroed out GRAT", the owner pays no gift taxes.
IDGT: Similar to a GRAT – but with more flexibility – an intentionally defective grantor trust (IDGT) is a grantor trust that is "defective" for income tax purposes, but "effective" for transfer tax purposes.
Other Strategies: Private annuities and self-cancelling installment notes (SCINs) also provide cash flows to the owner, while removing the business interest from the owner's estate.

2. Other Owners

Advantages: Selling to other owners are known quantities, while retaining the company's mission and culture. An inside sale lessens the amount of buyer due diligence required, and minimizes the chances for breach of confidentiality.
Buy/Sell Agreement: The owners enter into a buy/sell agreement that spells out the following: a) the structure of the buyback (i.e. cross purchase, redemption, or hybrid), b) the triggering events (aka the "Dismal D's"), c) valuation (fixed price, formula, appraisal), d) financing (e.g. operating cash flows, life insurance), and e) payment method (down payment, term, collateral). The December 2009 issue of BTM discusses buy/sell agreements in more detail.
Reorganization: The owners may want to divide up the business rather than one owner buying out the other. This can be accomplished by what's called a "split-up" under the tax free "D" reorganization rules of the Internal Revenue Code. This strategy is particularly useful when owners what to separately own and operate individual business segments.

3. Mangement

Advantages: Again, the mission and culture of the business if often retained. The skills and knowledge of key management are known quantities, with a reduced level of due diligence as key management would have intimate knowledge of the business.
Note: Without an outside equity sponsor, the operating cash flows of the business is often the major funding source when there is an internal ownership transfer (of any kind). Because of this, the concern is that the financial viability of the business may be jeopardized by being overleveraged and "cash flow starved".
Boot Strap Acquisition: This strategy is designed to preserve the financial viability of the business, by extending the management buy in over time. For example, management acquires minority interests directly from the owner - at affordable discounted prices - over a period of years (a cross purchase); the owner still maintains voting control. At a future date, the company repurchases the owner's remaining stock (a redemption) at a predetermined price, funded by a third party loan or a company note.
PEG Sponsor: For larger businesses, management often does not have the financial capability to make the purchase; the financial impact of a boot strap acquisition would be too burdensome and risky for the business. Also, the owner wants to be cashed out immediately. In these instances, management could possibly partner with a private equity group (PEG) who would provide the needed capital to make the acquisition. The December 2010 issue of BTM discusses PEGs in more detail.

4. ESOP

Advantages: In certain situations, an employee stock ownership plan (ESOP) becomes the ready market for an ownership transfer. ESOPs are often used to retain valuable employees, and a motivator to increase employee performance and produtivity. There are also several tax advantates with ESOPs for both the company and the selling owner. The March 2010 issue of BTM discusses ESOPs in more detail.
Liquidity and Control: The owner achieves liqudity upon the sale, particularly when the sponsoring company secures financing from a third party lender in a leverged ESOP; selling a minority interest allows the owner to maintain voting control.
Section 1042 Rollover: For C Corps - when the ESOP purchases at least 30% of the owner's stock - the owner can defer gain recognition from the sale if the proceeds are reinvested in *qualified replacement property*.
C to S Conversion: Once the sale to the ESOP is closed (and rollover completed), convert the entity from a C Corp to an S Corp. Should the ESOP own 100% of the stock, the business essentially becomes a non-taxable entity.

5. Third Party Buyer

Advantages: Selling to a third party buyer will likely produce the highest price and best terms. A third party sale typically removes the owner from investment and financial risk to include personal gurantees (e.g. bank loans, bonding).
Controlled Auction: Sell the business without a price – the market determines the price – by creating competition amongst buyers. See the March 2013 issue of BTM for details.
Recapitalization: Sell a controlling interest (e.g. 51%-75%) to a financial buyer (e.g.PEG), allowing the owner to realize some liquidity. The owner's retained interest is rolled over, and along with the PEGs interest, later sold for another "bite at the apple" – often at a higher price.
Earnouts: A structuring strategy where the owner can increase the transaction price by participating in the future growth of the company after the sale. The September 2009 issue of BTM discusses earnouts in more detail.
Top 10 Strategies When Selling a Business: See the June 2013 issue of BTM.

6. Voluntary Liquidation

Advantages: For a declining business, it might be the best option to preseve the value of remaining assets of the business, maximize the net proceeds, and limit exposure to future liabilites.
Identify Intangibles: Review customer lists, processes and intellectual property to identify assets that can be sold separtely from the going concern value of the business.
Orderly Liquidation: Develop an orderly plan of liquidation to dispose of the company's remaining assets. If possible, return inventory to vendors for credit; hire an auction company to sell remaining tangible assets.