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TRANSITIONING A BUSINESS: ISSUES TO CONSIDER WHEN MANAGEMENT AND OWNERSHIP CHANGE

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After spending years, or even decades, building a successful business the idea of transitioning to new management and ownership can be difficult to accept. However it must be done eventually and the prepared business owner is likely to experience a far more successful transition than the business owner who scrambles to pull a deal together at the last minute. All too often business owners contact their professional advisors after a Letter of Intent (LOI) to sell the business has been signed. This is too late. A tremendous amount of value can be added to the business owner in the years, months, and days leading up to the execution of such a letter.

When thoughts turn toward sale of a company initial musings tend to gravitate to two main topics; who would buy the business and how much would they be willing to pay? Let's look at each of these in turn. Who are the potential buyers? Are they likely to be internal; current employees or family members involved in the business, or perhaps family members who are not involved in the day to day operations? Or will they be external; perhaps a financial or strategic purchaser, each of whom will have unique expectations for the entity. The owner should identify in his preplanning who potential buyers might be.

POTENTIAL PURCHASERS

- One or more of the owner's children
- Current Employee(s)
- Current Co-Owners
- Financial Buyer that might want some management to stay on for a period of time
- A new operator who intends to buy the business and run it for their or its own benefit
- A competitor or another business in the same or related industry

Each of these buyers will view the value of the business through the prism of their own expectations and the business owner may find that one of these buyers sees far more value in the enterprise than the others. Selecting the most suitable purchaser will be driven by the expectations of the current owner. Does the owner hope to remain involved in the company in some capacity or do they intend to sell and never look back? Do they want the current employees and management to continue with the company or are they willing to sell the assets, customer relationships, and intellectual property of the enterprise? Where did the buyer come from? Was it an unsolicited offer? If so has the owner opened up avenues to explore other potential purchasers rather than just accepting the first and only bid?

Intimately related to choosing the "best" buyer is understanding the proposed purchase price and the terms of the sale. This is a critical issue and it is essential a business owner does their homework to understand what is likely a fair value for the enterprise prior to entering negotiations. As a general rule, the greater the proposed price the less advantageous the terms and visa-versa.

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UNDERSTAND THE VALUE OF YOUR COMPANY

Business owners should attempt, well in advance of entertaining a purchase offer, to understand the value of their company. How are other businesses in the same industry valued for sales purposes? Are there traditional formulas in the industry such as some multiple of EBITDA, revenues, or assets? Are there trade associations that can provide valuation guidance? Although an owner may not want to incur the cost of a business valuation without an interested buyer in the wings, he should attempt to look at valuation methods for his type of business so that he can get a high level understanding of what his business may be worth.

> **“INTIMATELY RELATED TO CHOOSING THE ’BEST’ BUYER IS UNDERSTANDING THE PROPOSED PURCHASE PRICE AND THE TERMS OF THE SALE.”**

One of the most important factors a prospective purchaser will consider when contemplating a business acquisition is free cash flow as it is cash flow that will provide a significant portion of the return on the buyers investment, as well as service any debt used to fund the purchase. In the years leading up to the sale the owner should take appropriate steps to increase cash flow.

A critical aspect of assessing a potential sale is gaining clarity on the price and terms necessary to allow the business owner to meet their ongoing lifestyle objectives. It may be that the probable sales price and terms will require the seller to ratchet down their lifestyle expectations. It is better to understand this prior to signing a LOI than completing a sale and having such a new, downsized reality slap you in the face. On the other hand the sales proceeds may be well in excess of that required to fund ongoing lifestyle objectives, opening up legacy planning opportunities that will no longer be available once the LOI is executed.

What about terms? Certainly the best and safest terms for the seller would be to receive all cash, delivered at the time of the sale. Often this is not possible, or if it is it comes at the expense of a greatly reduced purchase price. More common is for a large share of the cash portion of the purchase to be financed by debt secured by the company and for future payouts to be dependent on the ability of the new owner to successfully operate the business. There may be covenants allowing the seller to “take back” the business if terms of the sales agreement are not met. However if the fortunes of the company declined enough to trigger such a provision it is likely the company will be a shadow of the firm the owner initially sold. So how does one optimize price and terms? In the years prior to a sale there are steps owners should take to make the company as attractive as possible for future buyers. A first step is determining the appropriate entity structure. Given your business and likely purchasers what entity makes the most sense? Other considerations include determining whether



associated real estate should be owned by the company or held in a separate entity and whether other assets such as intellectual property, equipment, and goodwill, be held in a separate entity. Review the financial statements to be sure they are clean and transparent for at least the previous three years and accurately reflect revenues and expenses likely to be experienced by a non-operational owner with a hired and non-owner management team? Have they been audited for the previous three years and if not are they accurate and transparent enough to allow for a speedy audit? Are there accurate records of stock ownership in the company and are other company records, such as board meeting minutes and resolutions, in order and available?

ITEMS TO MAKE A SMOOTH TRANSITION

- Entity Structure (C-Corp, S-Corp, LLC)
- Separate Entity for Real Estate
- Separate Entity for Intellectual Property, Assets
- Clean and Clear Financial Statements
- Transparent Accounting Systems
- Accurate Records of Stock Ownership
- Does recapitalizing prior to sale make sense
- Audited Financial Statements

Often a closely held business, or family business, is barely distinguishable from the family itself. While this is typically the case it is critical to understand that the skills required to successfully run a business can be devastating to running a family. Separating the family always left out is a discussion of how the owner hopes to impact the lives of his children and grandchildren. If asked, no owners would want an inheritance to stifle the inheritor's ability to have productive and rewarding lives. Unfortunately all too often this is what business from the business of family is essential and preparing for a future sale offers a catalyst to explore how to best create and maintain a separation between the two. One way to go about this process is to separate ownership from employment. Family members who work for the family company can receive competitive salaries for the position they hold and the work they do. These same family members may also benefit from their ownership interest in the form of stock dividends and share price appreciation. Non-employed family members may also be owners. However, their return from the enterprise may be limited to the benefits of ownership; dividends and stock price appreciation. Each family will have a different view on how to best structure these issues and family members will have differing perspectives regarding what they think is "fair". In our work the most successful families are those that communicate regularly and are clear on difference between the benefits, risks, and obligations of being an owner and the benefits, risks, and obligations of working in the family business.

"IN THE YEARS PRIOR TO A SALE THERE ARE STEPS OWNERS SHOULD TAKE TO MAKE THE COMPANY AS ATTRACTIVE AS POSSIBLE FOR FUTURE BUYERS."

The business owner, whether contemplating an external sale or an internal transition of the company, should explore what he hopes to provide for future generations. Often the focus of such transition efforts is limited to how to transfer value to future generations minimizing income and transfer taxes. What is almost always left out is a discussion of how the owner hopes to impact the lives of their children and grandchildren. If asked, no owners would want an inheritance to stifle the inheritor's ability to have productive and rewarding lives. Unfortunately all too often this is what happens; the inheritors do not approach life with the same energy, passion, and desire to do something of value as the generation that created the wealth. Yet there is hope; by thinking through these issues prior to the sale of the family business, exploring the best structures to pass on wealth, and creating meaningful pre- inheritance experiences for the eventual beneficiaries, families can dramatically increase the likelihood that positive family values will also be part of the family legacy.

This summary only skims the surface of issues to be considered when selling a business. Regardless of the specific issues surrounding your own situation, effective preplanning for your transition can have a dramatic impact on the success of the sale. It is your business; you have worked hard to create and grow it, nurturing employees, customers and suppliers along the way. By thinking through a variety of issues well in advance of a sale and taking the steps to make your company more attractive, you can dramatically increase the odds of realizing the value you've worked so hard to create.

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