

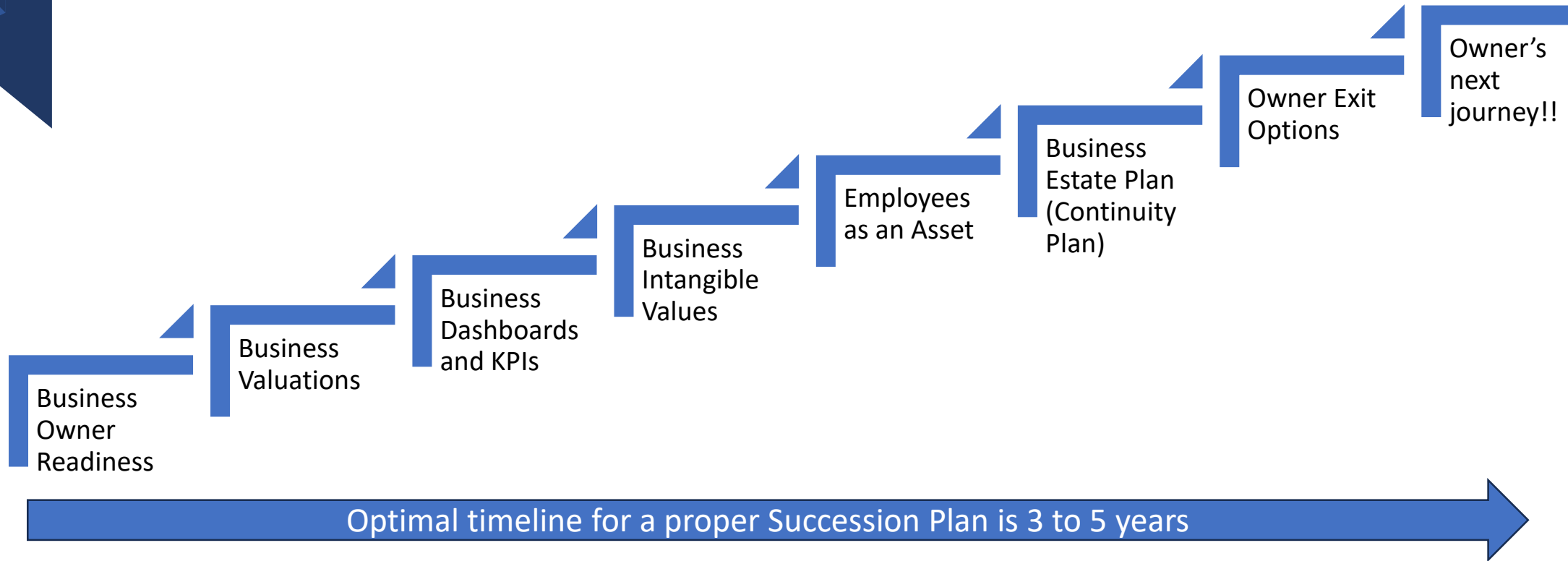


BUSINESS SUCCESSION AND EXIT PLANNING

Overview of Business Succession

November 16, 2023 – Tidewater Chapter of VSCPA

Business Succession Planning – The Journey



Business Owner Readiness – Changing the Mindset

- The business is usually a significant part of the business owner's net worth.
- The business owner's personal wealth is derived from the success and income of the business.
- To be ready to succeed from the business, the business owner's mindset needs to change to view the business as an asset and focus on creation of transferable value.
 - Business Optimization

Business Owner Readiness – Phase of Succession

- Understanding the stage of their journey is essential to begin the process of business succession planning.
- Knowing what stage will give the owner direction of where to go.
- Evaluating where you are and where you want your business to go are those two points to focus on.
- For the new business owner, it may be developing a certain financial goal within 5 years; for the seasoned business owner, it may be creating a certain value for the business within 5 years.

Business Owner Readiness – Taking stock in you

- My focus starts with the business owner ... Not the business.
- The business owner needs to take a personal assessment of all aspects of their personal lifestyle and understand the lifestyle they want when they are ready to succeed from the business. This is not limited to financial wealth but personal interest, family interest, spiritual needs.
- The last thing I want to hear from a business owner after they exit is ... NOW WHAT ... WHY DID I SELL???
 - **The business owner must retire TO something not FROM something.**

PHASE I

- A major consideration in this phase is financial readiness.
 - What type of lifestyle does the business owner want?
 - What assets will they need when they exit?
 - Will there non-business assets be sufficient to cover their life styles?
- Options for the Business Owner:
 - Change the lifestyle to a more realistic lifestyle based on your financials or
 - Optimize the business for sale.
- **Team Member: Financial Advisors, CPA**

Business Valuation – Valuation Early

- If you do not know what your business is worth today, how do you know if it is sufficient at the time of sale to meet your lifestyle goals.
- If the present business value is deficient, understanding the industry markers or KPIs that are used in the business valuation is key to improving the business value.
- The market sets the multiples to determine your business value. You set what multiple to use.

PHASE II

- Understanding the present value of your business will help answer whether you have to work on your business to optimize it for sale.
- If the valuation is not sufficient, you have to work on your business optimization and start finding areas in your business that you can improve and create transferrable value.
- Understanding the market multiples and key performance indicators used in the business is essential to improve the business value.
- **Team Member: Business Valuation Appraiser, Commercial Real Estate Appraiser, CPA**

Dashboarding and Scorecarding

- How do business owners measure success for their business? Typically, they are comparing their financials to their financials from the previous year.
- This can be good but when you compete against yourself shouldn't you win every time???
- The true scorecard is not comparing your past performance but comparing your actuals to market indices and KPIs.

PHASE III

Year	Record	Div. Rank	Points For	Points Against
2020 NE	7-9	3 rd	326	353
2019 NE	12-4	1st	420	225
2018 NE	11-5 – Super Bowl	1st	436	325

Year	Record	Div. Rank	Points For	Points Against
2019 AFC Ravens	14-2	1 st	531	282
2019 NFC San Fran	13-3	1st	479	310
2019 KC	12-4 – Super Bowl	1st	451	308

Year	Record	Div. Rank	Points For	Points Against
2020 AFC KC	14-2	1 st	473	362
2020 NFC Packers	13-3	1st	509	369
2020 TB Bucs	11-5 – Super Bowl	1st	492	355

Team Member: CPA

The Intangibles

- In the last slide, the Super Bowl winner did not have the best record, scored the most points, or defended the most points. But they achieved perfection for that season!
- Every business has some form of intangible worth. Intangible worth can come from employees (human capital), customer relations and experience (customer capital), systems and processes (structural or organizational capital) and business reputation (social capital).

PHASE IV

- Understanding business intangible assets that are drivers for your business is essential. Once you know the business intangible assets, you will understand what you need to protect.
- Converting Intangible Assets into a transferrable asset will enhance the business value at transition. The goodwill of the business is the value of the intangibles for the business.
- The multiples set by the market are usually a range (2x to 5x). The intangibles of the business can enhance where it falls within the multiple spectrum.
- The goal for the business is to become “best in class” (5x).
- **Team Member: Business Coach, Human Resource Consultant, CPA, Attorney, Marketing Consultant**

Protecting Human Capital

- The cost of losing a good employee is more than the salary you paid them. You have a new unknown performer, lost the institutional knowledge of that former employee, and production from the position will take months to return to the levels of the former employee.
- Rewarding employees with the right benefit package that the employee wants is key to having a happy workforce. Benefits should motivate and engage your employee.
- Not all benefits are available for all employees and not all employees are potential owners. Recognizing what incentives motivates your workforce creates a valuable asset – human capital.

PHASE V

- How do you retain them and keep them happy and engaged?
- Understanding the different options with executive compensation and the pros of cons of each is key in building attractive compensation packages.
- Not all employees should be owners.
- Fictitious ownership with economic interest such as Phantom Stock or Change of Control Agreements may be better than offering actual ownership.
- Deferred Compensation Plans with vesting schedules or Supplemental Executive Retirement Plans for retention of executives may be appropriate.
- **Team Member: Benefits Consultant, Life Insurance Consultant, Financial Advisor, CPA, Attorney**

BUSINESS ESTATE PLAN ...

- When you hear estate plan, what comes to mind is an owner's or individual's personal documents – such as Will, Trust, Power of Attorney and Advance Medical Directive.
- Why does a business need an estate plan – huh?
- The business owner at this stage has spent significant resources in improving the business. They have been following the plan to achieve their goal. They have created transferrable value. But the unexpected happens before the target date.
- How do you protect the transferable value you are creating?

PHASE VI

- The business owner must consider what happens in the event of an unexpected tragedy or event affects their ability to oversee the business.
- A written contingency plan documents certain aspects of the business in the event the business owner experiences or encounters an unexpected event.
- The business owner's estate planning documents must consider the business succession plan.
- The contingency plan can identify who will vote the ownership interest, who will be appointed to governance, who will be appointed as officers or managers, what key employees should be considered for promotion, what compensation changes should be made, how do we retain the workforce during this unexpected event, what should be considered for sale or transfer of the business
- **Team Member: Benefits Consultant (Disability), Life Insurance Consultant, CPA, Attorney**

RINSE, WASH, REPEAT

- The business owner needs a moment to assess how they are doing toward their goals and objectives.
- Is the business at the optimal state? Does the business owner have the “Freedom of Choice”?
- Review, evaluate, continue, review, evaluate, transition

FREEDOM OF CHOICE



Business is optimal and I choose to continue operating it.

Business is optimal and I choose to implement my exit strategy.

WHAT ARE MY EXIT OPTIONS?

- With an optimal business, the business owner should have multiple options to consider for their exit transaction.
- Understanding the different types of transactions is important in selecting the best acquirer.
- Asset sales are likely for third party transfers unless there are unique industry reasons to consider an equity transaction.
- Equity Sale or Equity Issuance are likely when there is an internal transfer to key employees or family members.
- Is it best to sell off parts and pieces or the entire going concern?



QUESTIONS?

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BUSINESS VALUATION BASICS

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Why Value?

- Focus on valuations for exit
- Different exit strategies affect the type of valuation needed and the approaches taken
- Sale to a third party/private equity
- Sale to existing management
- Sale to family members
- Pass business to family members by gift
- ESOP
- IPO

Why Value? – Other Reasons

- Tax Reasons
 - Estate/Gift Tax
 - Income Tax
- Litigation
 - Divorce
 - Shareholder Disputes
 - Quantification of Damages: Value before vs Value after breach/tort
- Buy-Sell Agreements
- Regulations require: 409(A) Stock Options

Methods of Valuation

- Asset Methods
- Market Methods
- Income Methods

Asset Method

- Subtract liabilities from assets = Net Asset Value (NAV) or Equity Value
- Book value is rarely a good indicator of value
- Adjust all assets and liabilities to fair market value
- May need separate real estate and equipment appraisals
- Are A/R collectible?/is inventory obsolete?
- Asset method does not reflect goodwill of the business
- Ideally avoid this method

Asset Method

- Most applicable to:
 - Investment or holding companies
 - Very small businesses with little or no goodwill
 - Consistently unprofitable companies
 - Asset-intensive businesses
- Often considered as a “floor value” for other types of companies

Market Method

- Most common in sale transactions
- Math is simple for most businesses: A measure of annual cash flow x a multiple
- Approach hides a lot of finance theory
- The idea is that the value of any asset reflects the future cash flows that an owner can expect in the future
- The multiple reflects the risk that the future cash flows will differ and the growth expectations for the company

Cash Flow

- Normally the last 12 months or the most recent year
- Earlier years or future expectations can sometimes be taken into account if significantly different from most recent year
- Quality of financial statements are key
 - Audited/Reviewed Financial Statements = gold standard but expensive
 - Tax returns
 - Internal financial records

Cash Flow Adjustments

- Non-recurring revenues and expenses
 - Cost of law suit
 - One-time bump in revenues due to a customer getting a big contract
- Non-operational expenses
 - Above (or below) market rate expenses e.g. owners salaries; rents
 - Other discretionary expenses – autos, meals, travel, life insurance, deadbeat relatives on payroll etc.
 - Better if recent financial statements are clean; reduces need for explanation
- Add back
 - Non-cash expenses – depreciation
 - Interest expense
 - Tax expense

Common Cash Flow Measures

- EBITDA – defined above
- Sellers Discretionary Earnings = EBITDA plus owner's salary/benefits
- Free Cash Flow – EBITDA/SDE less annual required capex
 - Not as common in small business deals

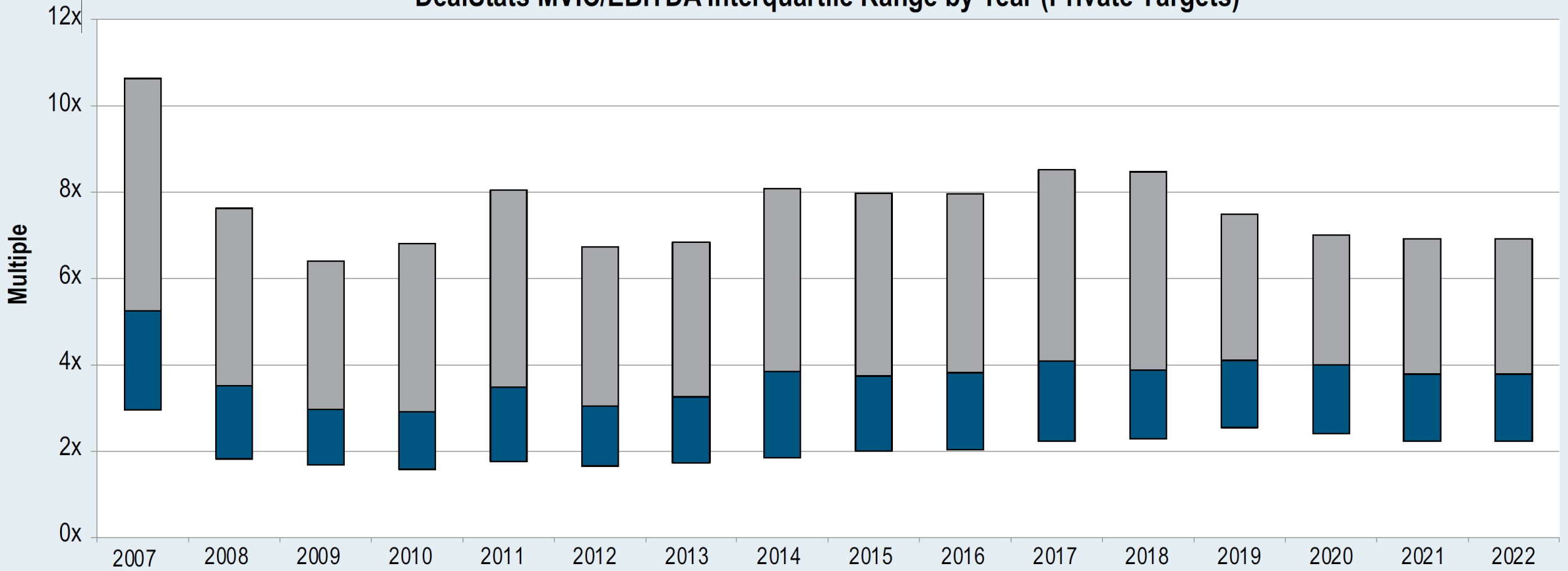
What is Sold – Assuming an Asset Sale

- SDE
 - Fixed assets
 - Goodwill – name/trademark/website/customer records/customer relations
 - Therefore the seller gets benefits of a/r – but responsible for a/p and debt
- EBITDA
 - Debt free/Cash free
 - Fixed assets
 - Goodwill
 - “Normalized level of working capital”
- Value of inventory – depends

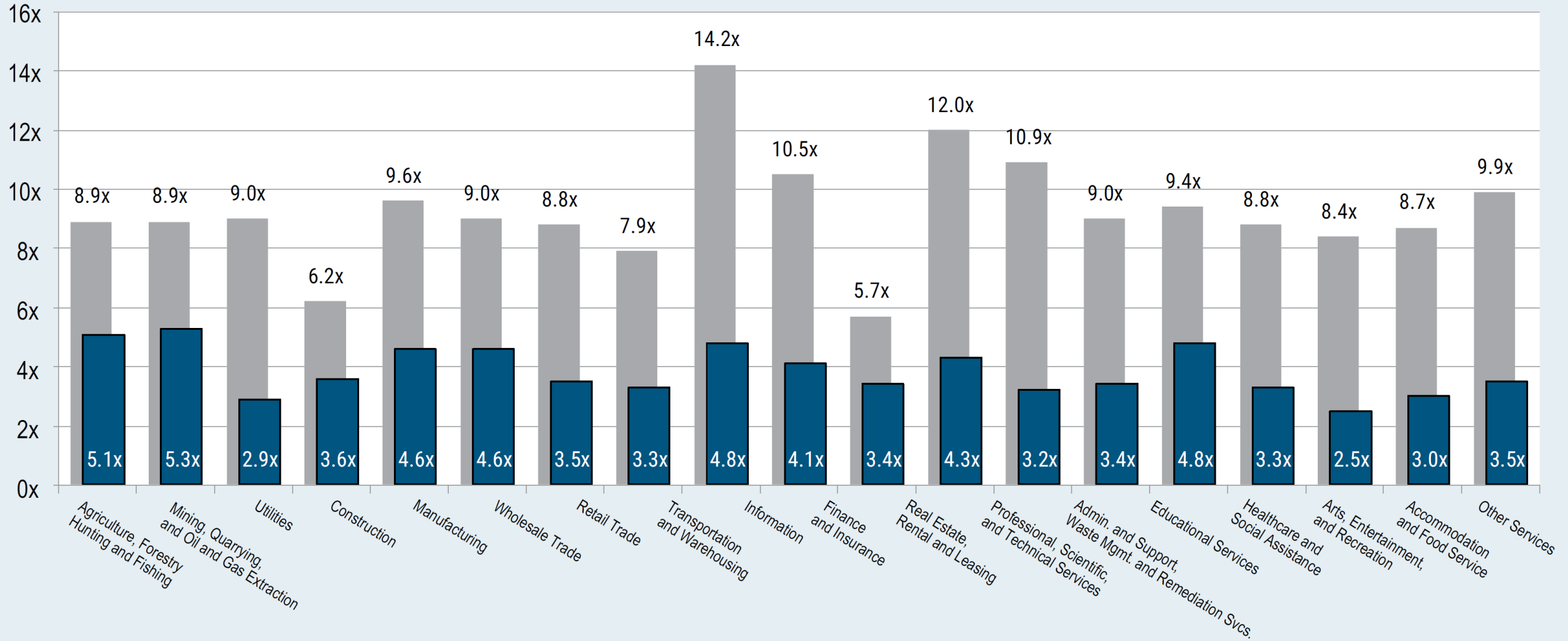
Multiples

- Whatever you can negotiate
- Risk
- Growth opportunities
- Is industry “hot” with private equity rolling up smaller businesses
- Rules of thumb
- Databases of transactions

DealStats MVIC/EBITDA Interquartile Range by Year (Private Targets)



DealStats Median MVIC/EBITDA (Private Targets)



Some Differentiators

- Turnkey operations
 - Reliable management team
 - Management/financial/billing systems
 - Owner mostly redundant
- Recurring revenues
- Diversified customer base
- Long track record
- Strong metrics
- Growth opportunities

Terms of the Deal

- Cash on the barrel
- Payment over time
 - May never see the cash
 - Standing in line after the bank
 - If not paid you theoretically get the business back – but who wants that?
 - But may have to take a note at below market interest to get the deal done
 - Especially with high interest rates
- Earn outs

Market Method Example

Ongoing future cash flow \$100,000

X

Price/Cash flow multiple 5*

Value: \$500,000

- Add cash/excess assets, less interest bearing debt

* Derived from transaction data or public company data

Discounts

- Discount for Lack of Control (DLOC)
- Discount for Lack of Marketability (DLOM)
- Key person discounts – often handled in the multiple



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Owner Exit Options

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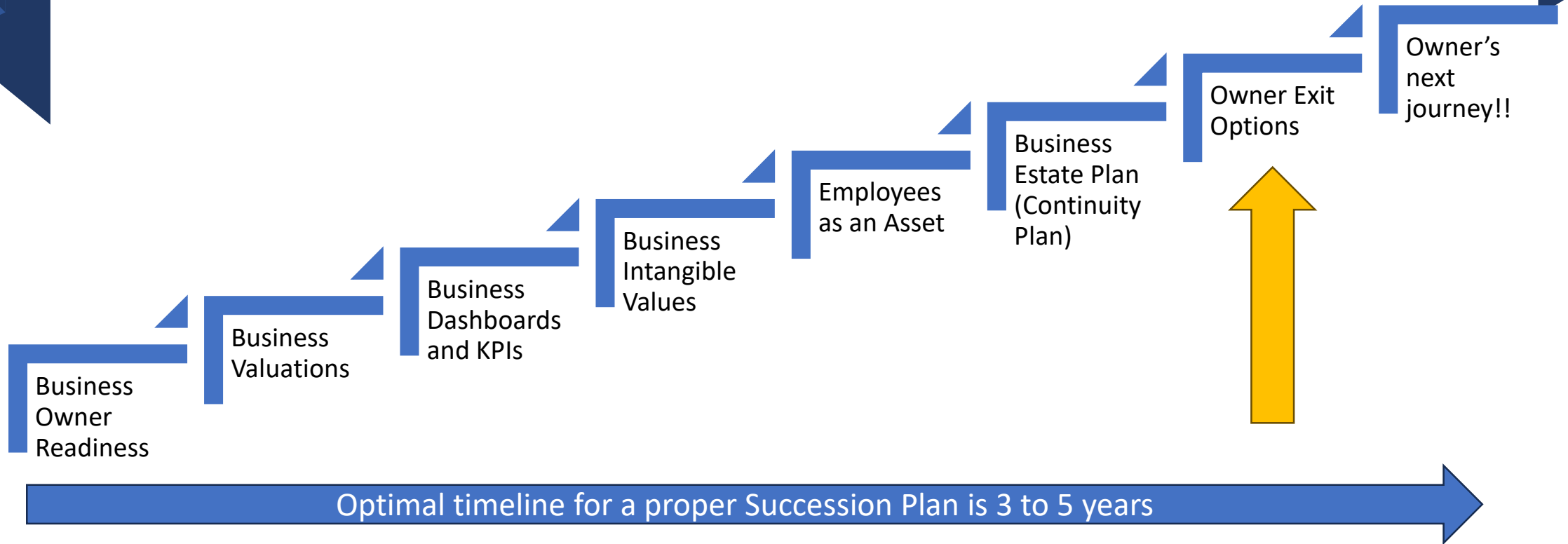


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Owner Exit Options

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Business Succession Planning – The Journey



Owner Exit Options – Owner Assessment

- The business owner must assess what they are looking for in succeeding from the business.
 - Is it the highest price they can get for the business?
 - Is it purely the most upfront liquid funds?
 - Is it leaving a legacy business they know will continue for future generations?
 - Is it considering their stakeholders – customers and employees?
 - Is it rewarding the loyal employees that helped build the business?

Owner Exit Options – Owner Assessment

- Depending on the answer to those questions, it will give the owner direction in choosing their business exit.
 - Highest Price = sale to a third party buyer either a strategic buyer or financial buyer
 - Upfront Liquid \$ = this can be either a third party buyer or internal transfer with SBA financing.
 - Leaving a legacy = internal family transfer will not produce the highest price or highest liquid funds. The question here is whether it is a sale or gift?
 - Stakeholders = this is likely accomplished with an internal sale. External buyers may have a different business approach that may result in disruption for stakeholders.
 - Loyal Employees = internal management transfer will not produce the highest price; however, with SBA funding it may produce the liquidity sought.

Owner Exit Options – Buyer Type

- With the decision on what the business owner wants in the succession of the business, the business owner can begin to identify the type of buyer.
 - Third Party
 - Strategic – competitor
 - Financial – PE group
 - Internal
 - Family – children or other family members that are working in the business
 - Employees – long time management buyout.
 - Liquidation and dissolution of the Company

Owner Exit Options – Types of Transfers

- The succession or exit from the business can happen in several different ways. Depending on the buyer type, the type of transfer may be:
 - Asset Sale – sale of substantially all of the assets of the business. Transaction between the Company and buyer.
 - Equity Sale – sale of the owner equity in the company. Transaction between the business owner and buyer.
 - Equity Issuance – issuing equity to family or employees. Transaction between the Company and family or employee.
 - Gifts – transfer to family or employees for no consideration. Transaction between business owner and recipient.
- Each type of transfer comes with pros and cons to both the seller and buyer.

Owner Exit Options – Asset Sale

- Asset Sale – For the seller this is the least attractive as the transaction is more complex than an equity transfer. For the buyer, it is the most attractive as they may allocate their purchase price to the various assets allowing for expenses, depreciation and amortization on the assets purchased.
 - This is most common for a third party transaction.
 - **Exception: The company has difficult assets to transfer or has contracts that are difficult to transfer.**
 - The company has a taxable event and depending on the type of entity may result in double taxation (C corporation) or pass through taxation of the gains on the sale (S Corporation or Partnership)

Owner Exit Options – Asset Sale

- If the Company is taxed as a C Corporation, the corporation will have taxable income at the corporate tax rate. In addition, if the corporation liquidates and transfers the remaining assets to the business owners, the owners will have a taxable capital gain. Effective tax rate could be at least 41%.
- If the Company is taxed as a S Corporation or partnership, the taxable gain from the Company will be reported by the shareholders, members or partners. Effective tax rate would be a minimum 20%.

Owner Exit Options – Equity Sale

- Equity Sale –
 - For the seller this is the most attractive as the transaction is fairly simple. The business owner is the only taxpayer in this type of transaction with a single level of tax. The business owner reports the sale as a capital gain transaction.
 - For the buyer, it is the least attractive as their purchase price is locked up in the basis of the equity and not the underlying assets of the Company. Also, the buyer steps in the shoes of the seller as owner of the existing Company. If there are claims or tax issues which predate the closing, the Buyer is ultimately liable.
 - This is most common on an internal transfer. It is possible with third party transaction and management buyouts if the Company assets are difficult to transfer or the Company contracts are difficult to assign.

Owner Exit Options – Equity Issuance

- Equity Issuance –
 - Providing equity to future intended buyers is a simple way to begin the succession process.
 - The Company will issue equity to the family member or employee.
 - This will give the business owner an opportunity to see (at a small scale) whether the family member or employee will be a good owner.
 - This is most common on an internal transfer.
 - If this approach is used, the business owner should consider voting versus non-voting equity.
 - Equity and management agreements are a must.
 - Restrictive Agreements are a must.

Owner Exit Options - Gifts

- Gifts – The business owner is not dependent on the sale of the company for their retirement. For the seller, the transaction is relatively simple with the transfer of the equity interest.
- For the recipient, they receive the equity interest and their basis in the equity interest is the basis the transferor had in the equity. There is no step up in basis (unlike from an inheritance).
 - This is an option for legacy transition to family.

Owner Exit Options - Gifts

- The business owner has a few considerations on how the gift is made.
 - The business owner can make an outright gift directly to the transferee. The equity interest is owned and controlled by the recipient. The equity is exposed to the creditors of the recipient.
 - Alternatively, the business owner may gift the shares to an irrevocable trust for the transferee. The business owner can structure the trust for the transferee and beneficiary as the business owner wants. While the equity is owned in the trust, it is beyond the reach of the transferee's creditors.
 - S Corporations require special drafting of the irrevocable trust.

Owner Exit Options – Deal Terms are King!

- The business owner needs to assess all the deal terms to decide which transaction is best not simply the purchase price.
- A high purchase price with Seller financing may be less attractive than an all cash transaction. A transaction that requires a period of transition as part of the purchase price may be less attractive than an all cash transaction with no continued commitments from the Seller.
- The business owner needs to understand the risks associated with the transaction terms.

Owner Exit Options – Deal Terms are King!

- When the business owner transitions, we want to eliminate as much future business risk from his consideration.
- Seller financing and earn outs shifts risk from the buyer to the seller.
- Seller financing and earn outs are a means for the buyer to lower their ultimate purchase price post transaction.
- A transition period is an opening for the buyer to claim that the Seller breached that term of the transaction and should not be entitled to full purchase price consideration.

Owner Exit Options – Seller Financing

- Typically, seller financing is required with an internal sale – family or employees.
- Seller should ask for other collateral (not simply the ownership in the Company).
- **Tax Consideration:** If there is an asset sale and the Seller intends on closing the business, IRC 453(h) requires the Seller to adopt a liquidation plan before the transaction for the note transfer to the business owner to be in receipt of payment for stock.

Owner Exit Options – Third Party Sales

- Third Party Sales are for the most part complete at closing. There may be deferred payments such as earn outs or possibly a Seller promissory note. The terms once negotiated are final and there is less planning leading up to the negotiations.
 - Business owner should be focused on business optimization leading up to the negotiations.
- **Tax Consideration:** If the Seller is an S Corporation and the third party is not an eligible shareholder, an F Reorganization under IRC 368(a)(1)(F) may be a consideration to facilitate an equity sale transaction. See Rev Rul 2008-18 and IRR 1.368-2(m) for guidance.

Owner Exit Options – Internal Transfers

- An internal transfer requires much more consideration and planning to structure the transaction. Whether the transfer is to family or employees, there are several considerations before structuring the transaction.
- First, whether this is going to be a full transition or whether this will be a multi-year transition?
 - If it is a full transition, then the transaction is very similar to a third-party sale (asset sale or equity sale); however, the purchase price will likely be less and seller financing may play a larger role in the transaction.
 - If it is a multi year transition, then the equity sale or equity issuance transaction will likely be the structure.

Owner Exit Options – Internal Transfers

- If this is a full transition whether an asset transaction or equity transaction
 - Is the business owner willing to finance the transaction or should the parties consider a leveraged buyout such as SBA financing.
- If this is a multi-year transition stock transaction,
 - Should we recapitalize the company with voting and non-voting shares. There are plenty of non-tax reasons why non-voting shares should be issued to family and employees. Namely, not all people make good owners. This will minimize their say and impact on decision making.
 - In addition, non-voting shares may play a factor in valuing the shares being issued or gifted.

Owner Exit Options – Internal Transfers

- If this is a multi-year transition stock transaction,
 - What are the terms of the buy back of the shares issued or gifted to the family member or employee? If things do not work out as planned, we need an Agreement in place to repurchase the equity. This terms should be negotiated at the beginning.
 - Is their undistributed profits and excess cash left in the company? If the company is going to issue or the owner is going to gift shares, they need to consider whether to make distributions before bringing in new owners.
 - Is there an affiliated entity that owns real estate leased to the operating entity? If so, execute a long- term lease between the operating entity and the affiliated entity before bringing on new owners.

Owner Exit Options – Internal Transfers

- If this is a multi-year transition stock transaction,
 - How will additional ownership be granted to the internal parties – family or members?
 - Will the company issue stock bonuses as compensation, will the business owner sell a block of shares, or will the business owner gift shares?
 - Another approach is for the company to redeem the business owner's shares. Each time the business owner's shares are redeemed, the ownership interest for all other owners increases. Eventually, the internal parties become the sole owner through redemption.
 - This may be very attractive if the company is an S Corporation.

Owner Exit Options – Internal Transfers

- Redemptions – IRC 302(b) provides tests to see if the redemption will be treated as a sale or an exchange or as a dividend treatment.
 - Complete termination of interest. Watch out for attribution rules and constructive ownership which would negate the complete termination.
 - Substantial Disproportionate Distribution. Requires after the redemption to own less than 50% of the total combined voting power AND after the redemption the voting stock has to be less than 80% of the voting stock before the redemption.
 - Redemption not Equivalent to Dividends. A meaningful reduction of the shareholder's proportionate interest in the corporation.
 - Partial Liquidation. The corporation has made a distribution in partial liquidation.

Owner Exit Options – Internal Transfers

- Redemptions – If the S Corporation qualifies for one of the IRC 302(b) tests for treatment as a sale or an exchange, business owner will receive capital gain treatment.
- If the redemption fails to qualify as a sale or exchange, it will be treated as an IRC 301 distribution while using IRC 1368 ordering rules for distributions:
 - The distribution is nontaxable to the extent of the AAA balance (company wide);
 - Taxable dividend for any E&P the S Corporation may have;
 - Tax free reduction in remaining shareholder stock basis; and
 - Capital gain treatment.

Owner Exit Options – Liquidation and Dissolution

- Liquidation and dissolution of the Company is an exit option. Although not a good option as the business owner will not realize the fruits of their labor.
- If the Company has no transferrable value other than the hard assets (heavy equipment, real estate), the simplest exit is to simply sell off the assets in separate transaction to liquidate the Company.

Personal Service Transition

- The business owner should be prepared to answer the following questions in a transition from a personal service entity:
 - How long will you be available to assist in the transition?
 - Do employees have non-competes in place?
 - Will you sign a non-compete?
 - What is the client interaction like? In person, electronic, etc.
 - What is your client demographics for individual clients and years in operation for entity clients?
 - Is your equipment up to date and software licenses current?
 - Do you have a client that represents a large concentration of your revenue?
 - What is your revenue allocation among services?
 - What are your fee rates for services?



QUESTIONS?