Business Exit Planning

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Business Exit Planning

<u>What is Exit Planning ?</u>

A process, system or approach that results in an owner’s transition out of the business

<u>Why Exit Planning ?</u>

At some point, every owner leaves his or her business, and wants to accomplish specific goals in the process

<u>Ingredients of Successful Exit:</u>

- Written Exit Plan
- Experienced Team
- Cash Flow – Cash is King
- Management apart from owner

Business Exit Planning

Size of Marketplace

- 12,000,000+ Family owned businesses
- 7,000,000 established businesses in U.S.

Owners Demographics

- 9,500,000 business owners
- Average age 59
- 60% will leave in next 10 years
- 50% will leave in next 5 years

Exit Planning Steps

Step 1 – Setting Exit Objectives

Step 2 – Determining Value/Price

Step 3 – Preserving, Protecting and Promoting Value

Step 4 – Converting Business Value to Cash Upon Sale to 3P

Step 5 – Transferring the Business to Co-Owners, Employees or Family

Step 6 – Contingency Planning for Business

Step 7 – Wealth Preservation Planning

Step 1: Setting Exit Objectives

When does owner want to transfer ?

Income needed during retirement ?

Who does owner want to transfer to ?

- Family 50%
- Employees 30%
- Co-Owner 15%
- Outside Party 5%

Additional Owner Objectives:

- Shift Wealth to children ?
- Charitable Gifts or Transfers ?
- Reward Employees ?
- Receive full value for business ?
- Take business to next level ?
- Maintain ownership indefinately ?

Advisor Team

Why an Advisor Team ?

- No one professional has all answers
- Diverse skills and talents necessary
- Team approach minimizes time & cost

Advisor Team Members:

- Financial/Insurance Advisor
- Business/Estate Planning Attorney
- CPA/Valuation Specialist
- Business Broker/Investment Banker
- Business Consultant
- Banker/Trust Officer

Step 2: Determining Value/Price

Fair Market Value: the amount a willing buyer will pay a willing seller when neither is under any compulsion to buy or sell Revenue Ruling 59-60

Explaining Low Value

If sale to "insider", valuation not as important as future cash flow. These owners need low value to avoid excessive taxes to maximize cash flow, so need defensible value

Therefore, the value of a business is based upon the perspective of the person valuing it and the reason for the valuation.

Step 2: Determining Value/Price

Who performs the valuation ?

- CPA ($2,000 - $10,000)
- Business appraiser ($5000 - $35,000)
    - CVA/CBA/ABV/ASA
    - Use CPA or appraiser if < $5M
- Business Broker or Investment Banker ($0 - $25,000)
- Use Investment Banker if > $10M
  or Business Broker if $5M - $10M

Some Methods of Valuation:

Going Concern Value

Adjusted Net Asset Value

Capitalization

Step 2: Determining Value/Price

Factors affecting value

- nature and history of business
- economic outlook of industry
- book value of stock
- earning capacity
- goodwill
- diversification of production
- quality of management
- importance of seller to business
- net value of underlying assets
- prospects of creating market for stock

Step 3: Preserving, Protecting & Promoting Value

Benefits to Owner:

- Reduces Income Taxes
- Creates Ability to sell business
- Protects assets from creditors
- Increases value and cash flow
- Motivates & keeps Key Employees

Three Components of Step Three:

- Preserves value from needless taxes
- Protects value from creditors
- Promotes through value drivers

Step 3: Preserving, Protecting & Promoting Value

<u>Preserving Value by Minimizing Taxes:</u>

- Charitable Remainder Trusts
- ESOPs
- Use of Lowest Defensible Value
- A Choice of Entity
- Creation of Multiple Entities

Step 3: Preserving, Protecting & Promoting Value

CRTs (or Guaranteed Income Trusts):

Advantages	Disadvantages
Avoid tax at sale	Irrevocable
Charitable Deduction	Terminates S election
Eliminates FET	Kids do not receive assets

ESOPs:

Qualified Ret. Plan	Complexity
EEs earn ER stock	Ongoing Cost
Indep. Tee & Advisors	Ongoing Mgmt. a concern
Can avoid tax @ sale	since ESOP is shareholder
Can create ongoing tax savings	
Can use C or S Corp stock	

Step 3: Preserving, Protecting & Promoting Value

<u>Choice of Entity</u>

- C or S Corp
    - advantage of C Corp is more deductions but S Corp better at sale
- FLP
    - discounts, asset protection, sound mgmt., easy gifting to kids
- Family Foundation
    - tax free, family goals over multiple generations, can support community or other charities

Step 3: Preserving, Protecting & Promoting Value

<u>Protecting Value from Creditors</u>

- Entity Protection
- Multiple Entities
- Off Shore Trusts
- Casualty & Liability Insurance

<u>Promoting Value Through Value Drivers</u>

- Improve appearance of facility
- Pay down debt
- Diversify customer base
- Growth strategy
- Operating & Strategic Mgmt. team
- Incentives to EEs ie bonus or Deferred Comp

Step 4: Converting Business Value to Cash Upon Sale to 3P

<u>Benefits to Owner</u>

- Cash
- Less Financial Risk
- No Family Succession Issues
- Speed

<u>4 Phases</u>

- Phase 1
  - Pre Sale Planning & Pricing
    - Sale Objectives
    - Assemble Team
    - Due Diligence

Step 4: Converting Business Value to Cash Upon Sale to 3P

- Phase 2
  - Marketing Business & Finding Buyer
    - Investment Bankers are good at assessing value in given part of country, and at all 4 Phases and have access to Private Equity Funds
- Phase 3
  - Negotiating Sale:
    - Letter of Intent
    - Final Due Diligence
- Phase 4
  - Documentation and Closing
    - Purchase Agreement

Step 5: Transferring the Business to Co-Owners, Employees or Family

Benefits to Owner

- Achieves Exit Objectives of:
  - Selling to Key Employee Group
  - or to children
- Motivates and retains Key Employees
- Planning reduces risk

Can Pre-fund Owner Buy-out

- create Nonqualified Deferred Compensation Plan
  per Step 3 as incentive to Employees
- benefit accrual is the funding vehicle
- option with Key Employee Group to use
  or not for buy out

Step 5: Transferring the Business to Co-Owners, Employees or Family

<u>Alternatives to Outright Sale of Remainder</u>

- Keep Ownership
- Sell over time
  - Installment note
  - Segments of ownership
- ESOP
- Sell to new Key Employee Group
- Sell 100% or 60% to 3P
- Cash out via bank financing

<u>Down payment/Seller Carry</u>

- SBA terms

<u>Can Minimize Income Tax, Maximize Owner Security</u>

Step 5: Transferring the Business to Co-Owners, Employees or Family

Opportunities for Insurance/Financial Planning

- Life Insurance on life of buyer to ensure purchase price
- Life Insurance on life of seller to provide security to family and fund balance of buyout
- Key person Insurance on Key Employees
- Invest client funds outside of business

Step 6: Contingency Planning for Business

Benefits to Owner

- retains ownership and control of company
  if co-owner departs
- can force non-contributing owners to leave business
- provides consistency between lifetime and death
  objectives
- ensures survival of the business for benefit of others
- family receives value of owner’s interest, in cash

Step 6: Contingency Planning for Business

<u>Contingency Planning Issues</u>

- Continuity of Business Ownership
- Company's loss of Financial Resources
- Loss of Key Talent: Owner
- Loss of Employees and Customers

<u>Co-Owned Business Continuity</u>

- Traditional Buy Sell Planning
  - Death
  - Disability
  - Transfer to 3P
  - Termination of Employment
  - Retirement
  - Involuntary Transfer
  - Business Disputes

Step 6: Contingency Planning for Business

<u>Common Buy Sell Problems</u>

- Valuation Not Reviewed
- Failure to cover all transfer events
- No coordination of insurance

<u>Opportunities for Advisors</u>

- Prepare and fund Buy Sell Agreement based on revised value and financial exit objective
- Prepare and fund Stay Bonus Agreement
- Fund Business Capital Needs

Step 6: Contingency Planning for Business

<u>Options If no co-owner</u>

1. Continue the business
    - Transfer within family
    - sale to employees –can sign buy sell agreement agreeing to buy balance of stock
    - sale to 3P – company could guarantee employees salary/bonus for 18 months funded by life insurance.
2. Liquidate

Step 7: Wealth Preservation Planning

Benefits to Owners

- Coordinates business succession wishes with estate plan
- In effect, estate planning becomes part of business planning
- Reduces estate taxes while ensuring business interest is controlled by designated family members
- Estate Planning is periodically reviewed as part of annual planning meeting

Step 7: Wealth Preservation Planning

<u>Pre Sale</u>

- Lifetime Transfer to all children
  - Why now ?
    - Valuation
    - Availability of discounting
    - Children needs

<u>Post Sale</u>

- Changing Needs/Objectives
  - Charitable
  - Revision of estate plan
  - original family needs met by bus. transfer
- estate tax considerations

Step 7: Wealth Preservation Planning

Opportunities for Advisors

- Estate Planning design and implementation
- Fund estate tax liability per valuation or sale proceeds
- fund estate “equalization” objective with insurance

Role of Insurance/Financial Advisor

"I'd like to leave/sell my business. Can you help me?" How you answer this question determines whether you will represent your client and his or her company in the future ?

Step 1: Setting the Objectives

1. Explain to the owners the need to quantify exit objectives
2. Perform a financial needs analysis
3. Review and offer advice regarding personal investment strategy aligned with the exit plan.

Opportunity:

1. Become an investment advisor for owner and generate advisory fee income

Role of Insurance/Financial Advisor

Step 2: Determining Value/Price

1. Explain valuation objectives to owner
2. Using available software, perform valuation and provide valuation range to owner.

Opportunity

1. Develop advisory team relationship with owner's CPA or other advisor
2. Create preliminary exit plan for fee

Role of Insurance/Financial Advisor

Step 3: Preserving, Protecting and Promoting Value

1. Educate owner about key employee retention/motivation techniques

Opportunity

1. Fund Key Person Insurance through non qualified deferred comp plan
2. Design and implement retirement plan
3. Fund non qualified employee benefits

Role of Insurance/Financial Advisor

Step 4: Converting Business Value to Cash – Sale to 3P

1. Introduce owner to appropriate transaction advisor (investment banker or business broker)
2. Determine whether owner’s financial needs/exit objective can be met by expected net sale proceeds.

Opportunity

1. Invest sale proceeds
2. receive finder’s fee from transaction advisor

Role of Insurance/Financial Advisor

Step 5: Transferring the Business to Co-Owners, Employees or Family

1. Review owner's financial exit objectives – specifically the interplay of valuation techniques with overall exit planning design

Opportunity

1. Provide key person insurance to buyer
2. Provide seller insurance funding in event of seller's or buyer's death

Role of Insurance/Financial Advisor

Step 6: Contingency Planning

1. Review exiting buy-sell for consistency with exit plan. Suggest modifications
2. Sole owners – explain need for continuity and stay bonus plan
3. co-owners – discuss need for business continuity planning
4. coordinate continuity planning with estate planning

Opportunity

1. provide funding in case of owner’s death or disabilty

Role of Insurance/Financial Advisor

Step 7: Wealth Preservation Planning

1. Review exiting estate plan to ensure consistency with exit objectives
2. Make modifications to and fund exit plan as determined above
3. In light of realistic business value, fund for payment of estate taxes.

Opportunity

1. provide insurance funding to meet owner’s estate tax needs
2. provide insurance funding necessary to meet owner’s financial objective in case of premature death.

Questions