The highest level of education.

Victor W. Vaccaro, Jr., CPA/ABV, CFF, CDA

Successful Strategies for Ownership Transition

"If you don't know where you're going, you'll end up someplace else."

- Yogi Berra

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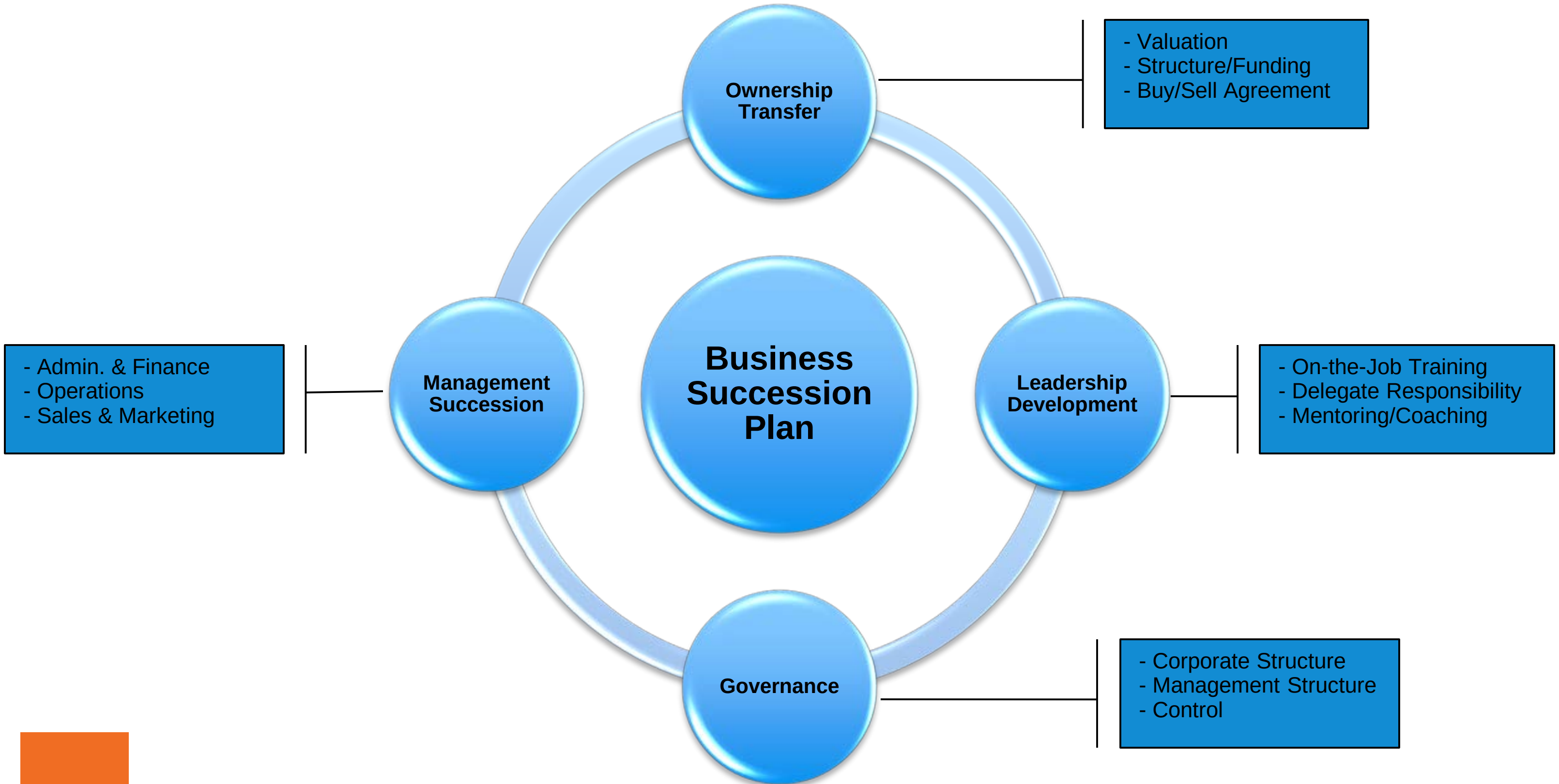
What is a Business Succession Plan?

"An established framework within a business enterprise which provides for the orderly transition of all aspects of the business upon the occurrence of an event or series of events, whether foreseen or unforeseen."

Components of a Business Succession Plan



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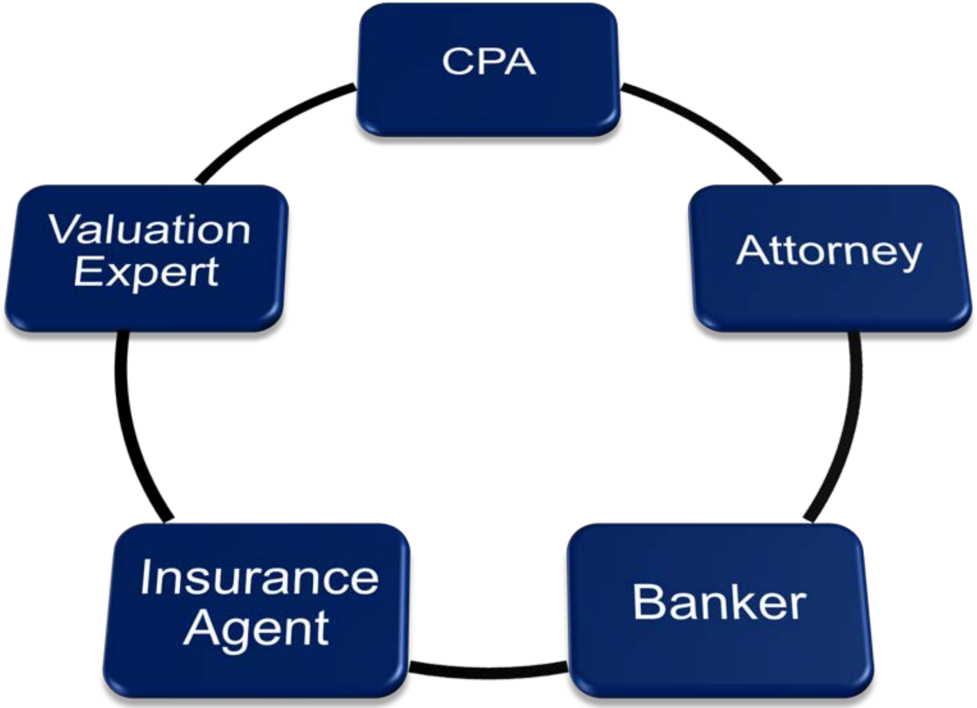
Transition Planning is a Team Sport



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Two (2) Types of Transition Plans

- **Internal** – transition of existing ownership to family members and/or key employees who have or will take an active role in the business
  - Common internal ownership transition strategies include gifts, cross-purchases, redemptions, stock bonuses, deferred compensation and employee stock ownership plans (ESOPs)

- **External** – transition of existing ownership to individuals or entities outside the business enterprise
  - Common external ownership transition strategies include mergers, stock acquisitions, asset acquisitions and liquidations

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Internal Ownership Transition Plans

Pros	Cons
Continuation of the firm	Lack of future owners
Access to a pool of buyers who are in the firm	Candidates for ownership may be more risk adverse
Assurance of a reasonable return	Funding through current operations
Ongoing control until retirement	Possible transfer for less than maximum value
Continuance of salary and benefits	Greater risk post-transition if management not properly transitioned

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Transition Planning Process - Internal

Phase 1	**Valuation**	• Establishes the current value of the business • Aids in projecting the value over term of plan • Estimate of "dollars" to be transitioned
Phase 2	**Transition Plan Structure**	• Identify the goals of existing owners, family members & key employees • Develop plan structure that "meshes" these goals • Addresses key elements of timing, funding, affordability & taxes
Phase 3	**Buy/Sell Agreement**	• Incorporates key elements of valuation and transition plan structure • Provides legal substance to transition plan • Eliminates confusion in the event of death, disability, retirement or separation from service of a current or future owner

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External Ownership Transition Plans

Pros	Cons
• Possible transfer for maximum price	• Difficulty in finding right buyer
• Provides for greater liquidity and less risk for existing owners	• Confidentiality
• Shorter time frame	• Post-merger integration can be difficult due to cultural differences
• Add new talent, skills, markets or service offerings	• Loss of control and identity
	• Staff / client retention

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Merger & Acquisition Planning Process

Phase 1
- Pre-Acquisition Review of Existing Business

Phase 2
- Search & Screen Potential Buyers / Targets

Phase 3
- Investigation / Valuation / Due Diligence

Phase 4
- Negotiation & Closing

Phase 5
- Post-Merger Integration

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Obtaining a Proper Valuation

"A nickel ain't worth a dime anymore."

- Yogi Berra

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Valuation of Closely-Held Businesses

- A proper business valuation is both an **art** and a **science**
- The science of business valuation is represented by systematic approaches, quantitative analysis, fact gathering and research about the subject company, the industry in which it operates and other internal and external factors impacting the company's business and ability to generate future cash flow
- The art of business valuation is represented by those who have the depth of experience and expertise in the science of valuation to achieve the best result by weighing the underlying components of value and taking into account all relevant issues at hand

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The Valuation Process

- Purpose, Standard of Value, Premise of Value, Valuation Date, Nature of Subject Interest, Limiting Conditions
- Financial Analysis, Economic Analysis, Industry Analysis, Site Visit
- Benefit Stream
- Risk Analysis – Discount Rate / Capitalization Rate
- Valuation Approaches – Asset, Income, Market
- Asset Approach – Adjusted Net Assets
- Income Approach – Discounted Earnings (Cash Flow) or Capitalization of Earnings (Cash Flow)
- Market Approach – Guideline Public Company Method, Comparable Sales, Rules of Thumb
- Selection of Most Appropriate Approach or Model
- Valuation Discounts / Premiums
- Sanity Checks
- Value

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Levels of Value

Strategic Value of Closely-Held Business Sold to Outsider

Synergistic Value
(Investment Value or Acquisition Value)

Premium 10% - 40%

"Deal Zone" – sales price to outsider

Internal Transfer Price

- No premium for control

- No discount for minority interest

Fair Value of Closely-Held Business
(Stockholder's Value)

25% - 50% Discount

Value for Income, Estate and Gift Tax

-Premium for Control and Discount for Minority Interest

-Marketability Discount

Fair Market Value
(IRS Value)

Valuation Approaches

- Valuations of closely-held businesses fall into any one of three (3) general approaches
  - **Asset Approach** – Value of the business is based solely on the value of the entity's assets net of liabilities, including both tangible and intangible assets
  - **Income Approach** – Most widely used method of valuing a closely-held business where value is the sum of the present values of the expected future economic benefits attributable to the ownership interest
  - **Market Approach** – Value of a closely-held business is determined by reference to the market values of comparable companies who are either publicly-traded or were recently sold in the private marketplace

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Formalizing the Plan

"We're lost, but we're making good time."

- Yogi Berra

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Comprehensive Plan for Ownership Transition

- **<u>All</u>** Company's, no matter what stage they are in, should have a comprehensive, written plan for ownership transition.
- The plan should address all financial aspects of the plan for ownership transition including the method for valuation of stock.
- The Company may also chose to address the transition of Management in this plan or address that separately. However, the plan should specifically address issues of voting control during transition.
- An important part of the plan will be to project the future transfers of ownership for years into the future.
- A cash flow analysis must be performed as a crucial step to ensure that the plan is affordable for the Company and equitable to both the founding owners (sellers) and second-tier owners (purchasers).

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Comprehensive Plan for Ownership Transition

- The ownership transition plan should evaluate and determine the methods to be utilized for the transfer of stock and value, including cross-purchases, redemptions, installments sales, deferred compensation, and employee stock ownership plans (ESOPs).
- An effective plan must include a buy-sell agreement among the shareholders.
- The ownership transition plan should be updated as necessary – Firms that have already gone through ownership transition or have ongoing sales could also benefit from updating or preparing a plan!

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Questions for Business Owners

When business owners approach retirement, common questions they may ask themselves are:

- **Who** should be admitted as new owners?
- **What** percentage ownership should I sell?
- **When** should I retire?
- **Where** will the funds come from to purchase my ownership interest?
- **Why** should I sell my interest and relinquish control of the company?
- **How** should the sale be structured?

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Establishing a Plan to Answer These Questions

- Long-term strategic ownership transition plans are designed to answer these questions and provide for a framework for ownership transition which addresses both foreseen and unforeseen events

- Commonly referred to as **Events of Transfer**, these include the retirement, death, disability or separation from service (voluntary or involuntary) of a shareholder

- As each company is unique, so to is each ownership transition plan – there is no “standard” ownership transition plan

Best Practices

- Start transition planning early
- Work to prepare the next generation
- Communicate a clear vision to family, key employees, fellow owners and other members of transition "team"
- Develop a written plan
- Incorporate your succession plan as part of your overall business/strategic plan as well as your corporate culture
- Anticipate and address conflict

Victor W. Vaccaro, Jr.

CPA/ABV, CFF, CDA, Partner

Email: vvaccaro@dmcpas.com

Web: www.dmcpas.com and
www.dmconsulting.com

Address:

Financial Plaza
221 S. Warren Street
Syracuse, NY 13202-2687

Phone: 315-472-9127

Scan to add Vic Vaccaro to your contacts.

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Hinman, Howard & Kattell LLP

ATTORNEYS

Jon J. Sarra, Esq.
Chair, Estates, Trusts, and Wealth Planning

Estate and Succession Planning for the Business Owner

Disclaimers

- This presentation is not intended to be legal advice. It is for information only.
- This may be considered attorney advertising. You should not rely on it as legal advice.
- Please contact an attorney to discuss your specific situation.

What is a Business Succession Plan?

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Internal Transfer:

- Focus of discussion today.
- Ownership transition to family members and/or Key employees.
- During lifetime or death?
- Gift or purchase for consideration, or both?
- How will it be funded?

The Basics:

- **Will or Revocable Trust**
- **The Alternative (not great)**
  - Intestate Succession
    - Spouse and Children – Spouse inherits first “$50K plus ½ of balance.”
  - Right of election
    - 1/3 of Estate

Estate Tax:

- Both Federal and New York State Tax has become friendly to the business owner.
- Planning between spouses still important.
- The $14,000 myth.

Digging Deeper:

- Terms of a <u>written</u> agreement among owners will govern and supersede the terms of a Will or Revocable Trust.
  - Operating Agreement, Bylaws, By-sell, etc., will dictate who can be equity owner and have voting rights.
- If conflict, heirs may only inherit economic rights as assignee.

Considerations:

- How much ownership will each family member receive;
- Will Family members not involved in the business receive an ownership interest; if not, will they receive other assets to “equalize” transfers among family members;
- Will the ownership include voting rights or be limited to a non-voting equity interest;
- Are there any legal restrictions on transfer, such a shareholder or LLC operating agreement;
- Will some or all ownership be transferred during life, and if so, by gift, sale, redemption or some combination;

- What is the value of the business interest and are any valuation discounts available;
- If some or all ownership is to be sold or redeemed, how will this be paid and will there be any security for any future payment;
- How will the ownership interest be structured, either outright or in trust;
- What are the income tax consequences of any sale;
- What are the gift, estate and GST tax consequences to the transferor on any gratuitous transfers and income tax consequences to the transferee in the future;

- Are there sufficient liquid assets to pay any taxes; if not, will the business qualify for any extension of time to pay estate tax;
- To the extent any transfer will occur at death, will life insurance be used to fund some or all of the payment due the business owner or any estate taxes; and
- Is the Business properly structured or is any restructuring necessary.
- What documents or agreements are necessary to execute any transfer or which govern the relationship of multiple owners, e.g., Shareholder or LLC Operating Agreement.

Bottom Line:

- Term Approach with Trusted Tax, Legal and Banking Advisors.

Jon J. Sarra

Assistant Managing Partner

700 Security Mutual Building

80 Exchange Street

Binghamton, NY13901

Phone: 607-231-6788

Fax: 607-723-6605

Email: jsarra@hhk.com

HH&K

Hinman, Howard & Kattell LLP

ATTORNEYS

SBA Solutions

KeyBank Business Banking

Presented by:

Chet Schultz
SBA Lending Specialist
Key's Central New York Business Banking Team

Date:

October 17, 2017

KeyBank SBA Lending

Small Business Administration (SBA) Lending Programs

- **Rankings**
  - #1 SBA 7(a) Lender in dollars in CNY - SBA FY 2017
  - #9 SBA 7(a) Lender Nationally in dollars - SBA FY 2017
  - 43% jump in 7(a) loan volume from 2016 levels - SBA FY 2017
  - Largest increase among the nation's top 20 SBA lenders – SBA FY 2016
  - Consistent Top 20 SBA Lender in both 7(a) and 504

- **SBA Preferred Lender**
  - Allows Key to make certain loans without prior approval from the SBA
  - Privilege extended to a limited number of banks in the United States
  - SBA requests can be done "in-house" saving our client's time

- **KeyBank Dedicated SBA Team**
  - Key has invested heavily in all areas of national SBA lending platform
  - Dedicated SBA processing from origination to closing
    - SBA RMs, SBA Service Officers, SBA Underwriting, SBA Closing

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KeyBank

Strategic Solutions

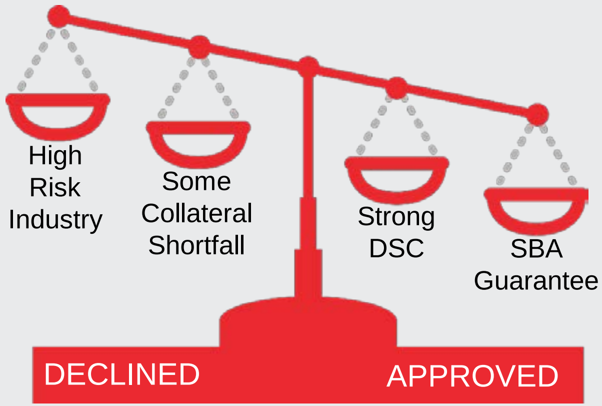
Small Business Administration (SBA) Lending Programs

Why are SBA guaranteed loans a good solution for small business?

The SBA guarantee program enables KeyBank to provide financing to small businesses by guaranteeing major portions of the SBA loan. SBA loans are designed to meet the specific needs of small business owners when funding is otherwise unavailable on reasonable terms.

Here are some risks that SBA Programs can mitigate:

1. Collateral Shortfalls
2. Lower Equity Injections
3. High Risk Industries
4. Business Experience



KeyBank

Strategic Solutions

Small Business Administration (SBA) Lending Programs

How will an SBA loan meet your needs?

SBA guaranteed loan programs are set up to handle a full range of small business needs for most industries. SBA loans may be used to:

- Finance business acquisition and change of ownership
- Construct new commercial buildings (60% min. OOCR)
- Purchase existing commercial real estate (51% min. OOCR)
- Expand or modernize facilities
- Purchase machinery, equipment, fixtures, leasehold improvements, inventory
- Finance increased receivables and augment working capital
- Finance Start-Up Business (on a limited basis).

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Strategic Solutions

Small Business Administration (SBA) Lending Programs

Loan Types:

1. **Construction Loan** – Interest only until project completion & permanent financing.
2. **SBA 504 Loan** - Real Estate & Equipment Loans (50% Key, 30%-40% SBA, 10%-20% Client Equity)
3. **SBA 7(a) Loan** – 10 year term for Acquisitions (Asset or Stock Purchase) Up to 25 year term for real estate; 10 year term for equipment; 7 year term for working capital.
4. **Cap Lines** – Working Capital needs up to $1,000,000.
5. **International Trade** – Financing needs related to international trade business.
6. **Export Express** – Enables client to enter into a new export, or expand into an existing export market.

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SBA 7(a) Program

Small Business Administration (SBA) Lending Programs

As a preferred lender KeyBank is able to offer a streamlined application process to the 7(a) benefits below:

7(a) Benefits

- **Longer terms** - As long as seven years for working capital, 10 to 15 years for equipment, and up to 25 years for real estate, 10 years for acquisitions. SBA Express lines of credit have a term of seven years
- **Interest rates** - Variable-rate loans typically 1.5% - 4.75% over the prime rate, as stated in The Wall Street Journal
- **Flexible repayment options** - Monthly installments of principal and interest; no balloon payments; three year pre-payment penalties on loans with a maturity greater than 15 years.
- **Lower Equity Injections** – As low as 10%
- **Minimal costs** - Loan packaging fee of $250 to $2,000 which is fully refundable for applications that do not meet SBA requirements; SBA guarantee fee (based on the amount of the guaranteed portion of the SBA loan) which can be financed into the loan amount; no points.

*In 2017 all guaranty fees waived on all loans $150,000 or less

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SBA 7(a)

$1,400,000 7(a) Asset Acquisition Loan

Sources	
KeyBank SBA Loan	$1,308,000
SBA Express Line of Credit	$100,000
Seller Carry Note	$200,000
Equity Injection	$187,000
Total	**$1,795,000**

Uses	
Bus. Acq.	$1,400,000
Line of Credit	$100,000
Inventory	$150,000
Working Capital Permanent	$100,000
SBA GTY Fee	$34,000
Soft Costs	$11,000
Total	**$1,795,000**

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SBA Loan Review Guidelines

Small Business Administration (SBA) Lending Programs

Debt Service Coverage (3 year historical):

- Minimum 1.15:1

Leverage:

- Maximum 3:1 (total liabilities to tangible net worth)

Liquidity:

- Minimum 1.5:1
- Equivalent to the Current Ratio (Current Assets divided by Current Liabilities)

Collateral Coverage:

- Real Estate (Commercial): 80% of FMV
- Equipment – New: 80% purchase price. Used: 50% NBV, or 75% of purchase price, or 75% of liquidation value
- 0.3:1 minimum collateral, if business assets do not fully secure (1:1), pledged personal assets may be required.

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Guarantor Strength: (continued)

- Aggregate personal debt service cannot exceed 40% of gross income.
- Minimum Guarantor(s) Credit Bureau Score 670.

Documentation:

- All loan documents relating to the KeyBank Loan must be in a form and substance acceptable to the Bank's counsel. Closing costs to be paid by borrower; costs may include, but not be limited to: the cost of appraisal, environmental survey (Phase 1, should it be required a Phase 2), legal fees, title insurance, documentation, search and recording fees, etc.

***Meeting these requirements does not constitute a commitment to lend on KeyBank's part, nor does not meeting these requirements constitute a declined application. These are simply some of the credit granting guidelines KeyBank utilizes to evaluate a credit request. For more specific information on a credit request, please submit a fully completed credit package to KeyBank.

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KeyBank

Your Key Team

KeyBank

Chet Schultz
Vice President
SBA Lending – CNY
Mobile: 607-743-0521
Office: 607-772-5410

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Questions

Questions

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