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Planning for a Successful Ownership Transition

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Planning for a Successful Ownership Transition

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Introduction to Ownership Transition Planning

"The future ain't what it used to be."

\- Yogi Berra

The Baby Boomers

- On January 1, 2011 the very first "Baby Boomers" turned age 65
- Beginning on January 1, 2011 and every single day thereafter 10,000 "Baby Boomers" will reach the age of 65 which will continue everyday for the next nineteen (19) years
- Approximately 9% of the "Baby Boomer" generation are business owners
- As a result, approximately 7 million "Baby Boomer" companies in the United States are estimated to be transitioned during this period
- The Exit Planning Institute has projected that over the next 12-15 years, more than 8 million closely-held U.S. companies will be sold

Transition of Family Businesses

- PWC annually conducts its ***Family Business Survey***, which surveys nearly 2,400 family-business owners and managers
- The 2014 survey indicated that only 16% of the businesses surveyed have a succession plan in place; only 25% for respondents age 65 or older
- The survey also indicated that 38% of business owners consider succession planning a key challenge in the next five years
- *http://www.pwc.com/gx/en/pwc-family-business-survey*

Introduction to Transition Planning

- As these statistics indicate, ownership transition is an issue that **MUST** be addressed in every closely-held company
- The lack of a clearly-defined ownership transition plan can:
  - Lead to confusion and disputes among key employees and family members
  - Cause disruptions in business operations
  - Result in the dissolution of value to existing and future owners

The Need for Ownership Transition

- To foster company growth through the admission of new owners
- To poise the business for unexpected opportunities
- To create a market for existing owners upon death, disability, retirement or separation from service
- To add expertise or retain key personnel
- To plan for a business owner's most significant retirement asset

Challenges in Transition Planning

- **Economic Challenges**
  - Devalued or depleted retirement assets from the recession have delayed retirements and have stalled transition planning
  - More stringent lending environment reduces available financial resources to implement ownership transition (i.e. lack of borrowing capacity)
- **Demographic Challenges**
  - 78 million "Baby Boomers" are being replaced by 20% less "Generation Xers"
  - Younger generations are generally more cautious, more life-balanced and have fewer financial resources
  - Demand for talent has exceeded supply

Opportunities in Transition Planning

- Business expansion through mergers and acquisitions
- Attract outside talent from competitors
- Retain existing talent through ownership
- Interest rate environment for companies with borrowing capacity

Key #1 – Understanding the Transition Planning Process

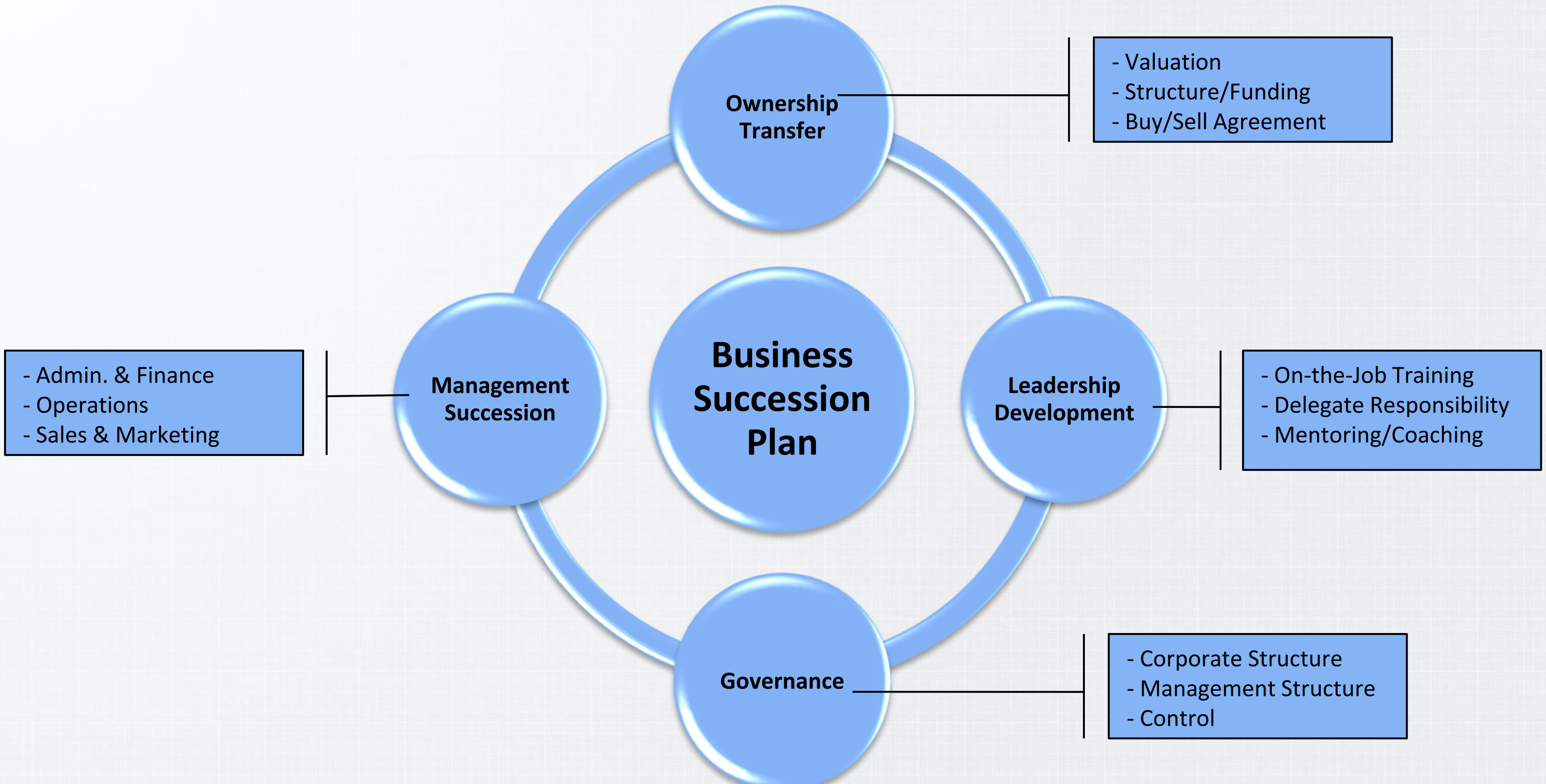
"If you don't know where you're going, you'll end up someplace else."

\- Yogi Berra

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



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 cross-purchases, redemptions, stock bonuses, gifts, 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

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

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

External Transition Plans

- When businesses do not have the necessary ingredients for an internal ownership transition plan, owners must then look to external exit strategies, including the following:
  - Mergers
  - Asset Acquisitions
  - Stock Acquisitions
  - Orderly Liquidations
  - Forced Liquidations

External 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

Merger & Acquisition Planning Process

Phase 1
- Pre-Acquisition Review of Existing Business

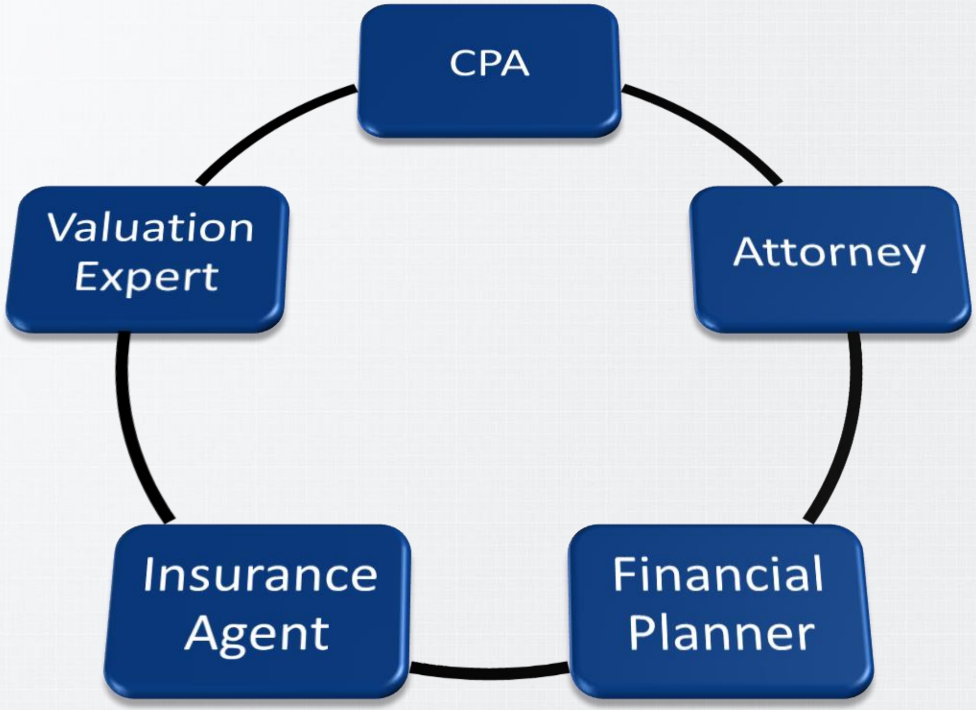
Phase 2
- Search & Screen Potential Buyers / Targets

Phase 3
- Investigation / Valuation / Due Diligence

Phase 4
- Negotiation & Closing

Phase 5
- Post-Merger Integration

Transition Planning is a Team Sport



Key #2 – Obtaining a Proper Valuation

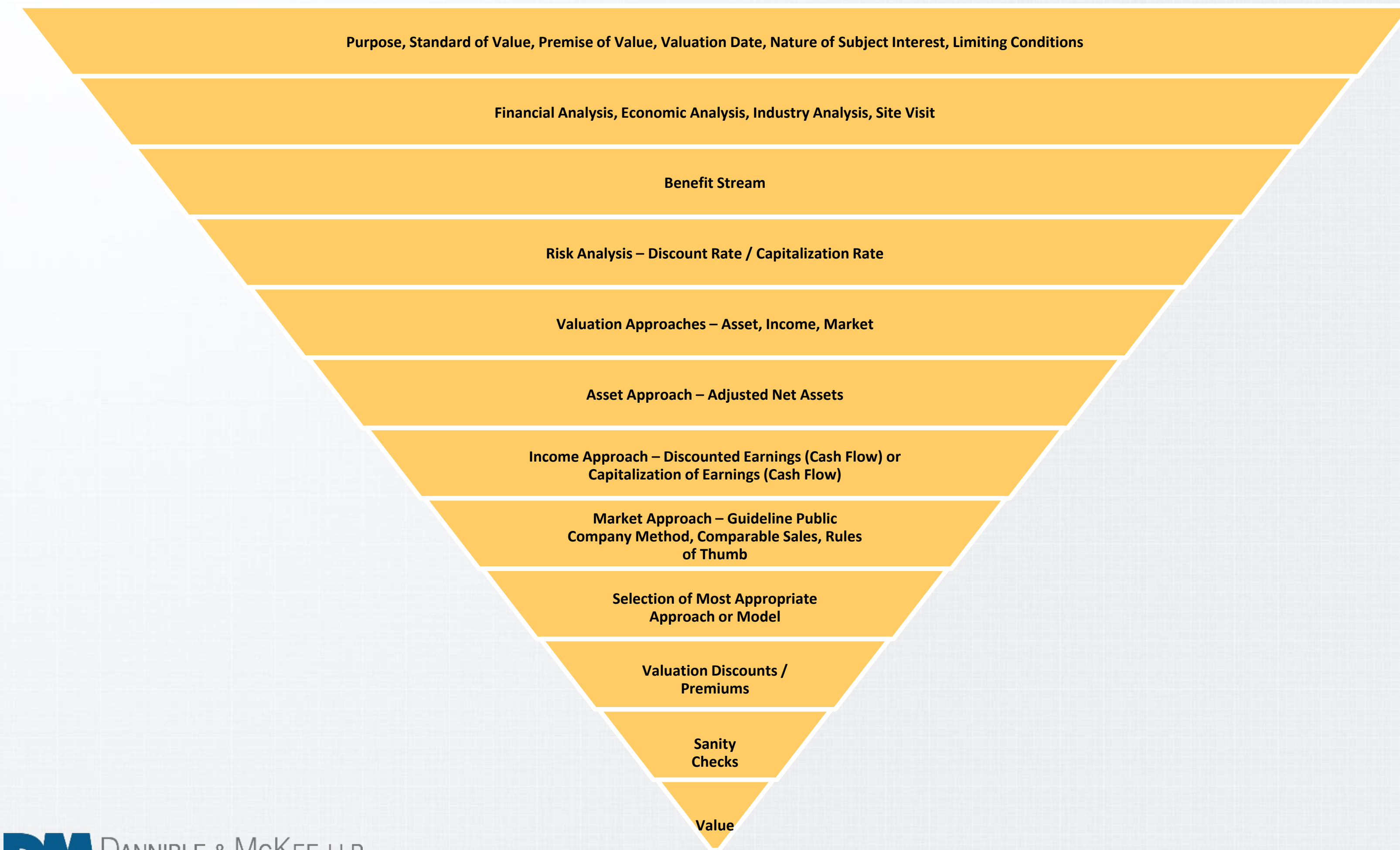
"A nickel ain't worth a dime anymore."

- Yogi Berra

Valuation of Closely-Held Businesses

- A proper business valuation is <u>both</u> 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 <u>all relevant issues at hand</u>

The Valuation Process



Valuation Designations

- **American Institute of Certified Public Accountants (AICPA)**
  - ABV – Accredited in Business Valuation
- **National Association of Certified Valuators and Analysts (NACVA)**
  - CVA – Certified Valuation Analyst
  - AVA – Accredited Valuation Analyst
- **American Society of Appraisers (ASA)**
  - AM – Accredited Member
  - ASA – Accredited Senior Appraiser
  - FASA – Fellow of the American Society of Appraisers
- **Institute of Business Appraisers (IBA)**
  - CBA – Certified Business Appraiser
  - MCBA – Master Certified Business Appraiser
  - AIBA – Accredited by the Institute of Business Appraisers
  - BVAL – Business Valuator Accredited for Litigation
  - ABAR – Accredited in Business Appraisal Review

Purpose of the Valuation

- Valuations for closely-held businesses are conducted for a variety of strategic, legal, tax and financial reporting purposes, including the following:

- Internal Ownership Transition
- Estate, Gift & Income Tax
- Employee Stock Ownership Plans
- Financial Reporting
- Allocation of Purchase Price
- Buy/Sell Agreements
- Reorganizations and Bankruptcies
- Business Planning
- Mergers & Acquisitions
- Litigation & Ownership Disputes
- Dissenters' Rights Cases
- Shareholder Oppression Cases
- Goodwill Impairment
- Family Limited Partnerships
- Recapitalizations
- Stock Option Plans

Standards of Value

- The proper **Standard of Value** for valuing a closely-held business is an assumption or set of assumptions regarding the specific characteristics of the buyer and seller (either hypothetical or actual) in a given set of circumstances surrounding a particular transaction (or assumed transaction)
- There are three (3) principal **Standards of Value** for valuing a closely-held businesses:
  - **Fair Market Value (IRS Value)**
  - **Fair Value (Stockholder's Value)**
  - **Investment / Strategic Value (Merger/Acquisition)**

Fair Market Value

- IRS Revenue Ruling 59-60 defines **Fair Market Value** as:

  "the price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts. Court decisions frequently state in addition that the hypothetical buyer and seller are assumed to be able, as well as willing, to trade and to be well informed about the property and concerning the market for such property."

Fair Market Value

- **Fair Market Value** standard is the most recognized and accepted standards used in all tax situations (estate, gift, income tax, purchase price allocations, etc.)
- Key elements of the **Fair Market Value** standard are that the parties to the transaction are "hypothetical," the transaction is at "arm's-length" and that the buyer and seller are able and willing
- **Fair Market Value** will contain a premium for control and a discount for minority interest
- Because a fair market is based on a hypothetical buyer and a hypothetical seller, this value can be affected by an actual buyer or seller's unique motivations

Fair Value

- **Fair Value** is defined by the *Uniform Business Corporation Act* as "the value of the shares immediately before the effectuation of the corporate action to which the dissenter objects, excluding any appreciation or depreciation in anticipation of the corporate action" (stockholder's value)

- The **Fair Value** standard possesses some characteristics of **Fair Market Value** in that there is commonly a willing buyer but not a willing seller. However, the parties are typically known and the buyer may be more knowledgeable than the seller

- Many valuation experts consider **Fair Value** to be **Fair Market Value** without discounts for minority interest or lack of marketability

Investment Value

- **Investment Value** is the value to a particular investor, which reflects the particular and specific attributes of that investor
- In contrast to **Fair Market Value**, the **Investment Value** standard identifies a particular buyer or seller and the attributes that buyer or seller brings to the transaction
- Also commonly referred to as **Synergistic Value** because of synergies between the buyer and seller (geographic location, specific product or service offerings, know-how, customer base, competition, etc.)
- The **Investment Value** standard is typically used in merger/acquisition transactions

Investment 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)

Elements of Value – Revenue Ruling 59-60

- IRS Revenue Ruling 59-60 introduced eight (8) factors that must be considered in determining the fair market value of a closely-held business
    - The nature of the business and history of the enterprise since its inception
    - The economic outlook in general and the condition and outlook of the specific industry in particular
    - The book value of the stock and financial condition of the business (**Asset Approach**)
    - The earning capacity of the business (**Income Approach**)

Elements of Value – Revenue Ruling 59-60 (*Cont.)*

- The dividend-paying capacity of the business
- Whether or not the enterprise has any goodwill or intangible value
- Sales of the stock and the size of the block of stock to be valued
- The market price of stocks engaged in the same or similar line of business having their stocks actively traded in a free or open market (**Market Approach**)

Valuation Approaches

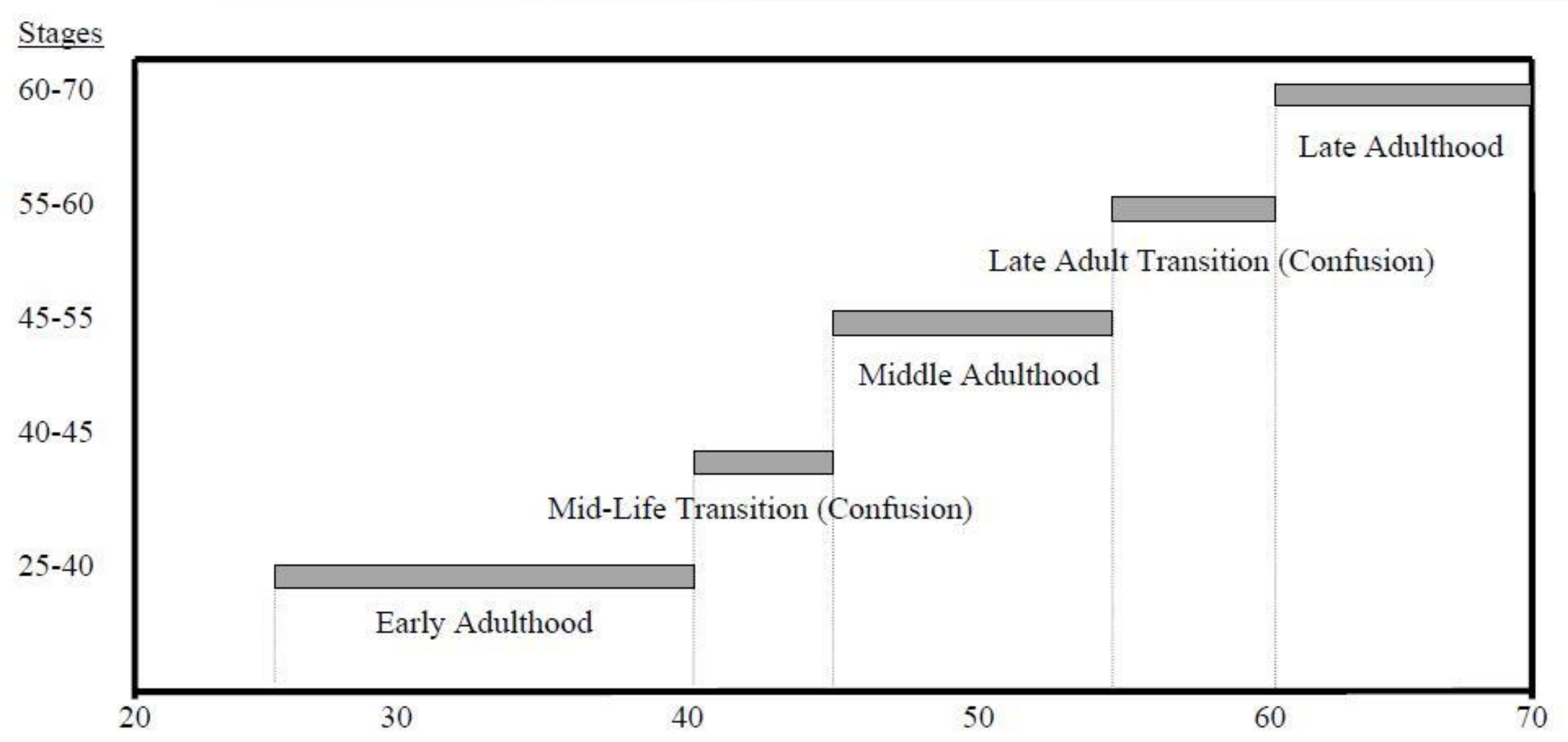
- Valuations of closely-held businesses fall into any one of three (3) general approaches
  - **Asset Approach** – Value of the business is based solely on the value of the entity's assets net of liabilities, including both tangible and intangible assets
  - **Income Approach** – Most widely used method 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

Key #3 – Understanding the Sociology Behind Ownership Transition

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

- Yogi Berra

Life Cycle of the Business Owner



Life Cycle of the Business Owner

Business Life Cycle	Age	Business Decisions	Personal Life
Early Adulthood	25-40	• Interest in growing, expanding the business • Increase capital for expansion • Level or reduce retained earnings • Higher risk tolerance • Higher debt tolerance • Low interest in personal retirement planning	• Initiation (burdens of childhood) • Need for personal gratification • "Novice" adult, husband, father • Changing relationships with parents • Full energy, capability, & potential • Contradictions & illusions
Mid-Life Transition (Confusion)	40-45	• May make strategic business decisions more difficult	• May seek mentor relationship • Time for major life choices (if not already made) • The "invisible" son? • Ultimatum vs. the "laid-back" heir
Middle Adulthood	45-55	• Build on foundations established in early adulthood • Expansion programs in place • More sensitivity to key employees • Need for management team and organizational structure • Credit lines established	• Mental and physical changes: "aging" • Increased likelihood of illness • Importance of internal messages • Senior leadership & authority
Late Adult Transition (Confusion)	55-60	• Keeping all options open • Propensity to do nothing	• Compare accomplishments to dreams • Confusion of purpose
Late Adulthood	60-70	• Increased interest in retirement planning • Less interest in expanding the business • More interest in retained earnings • Greater cash flow • Lower risk tolerance • Lower debt tolerance	• Must reduce heavy responsibilities of middle adulthood • Moving out of center stage can be traumatic • Part of "grandparent" generation • Give up authority or become tyrannical ruler • Possibility of creativity, wise elder with youthful vitality

Bridging the Generation Gap

	Traditionalists	Baby Boomers	Generation X	Millennials
Year Born	1900-1944	1945-1964	1965-1980	1981-2004
Workforce	13%	48%	33%	6%
Personal Chacteristics	• Loyal • Conservative • Self-sacrificing • Disciplined • Less technologically oriented	• Idealistic • Question authority • Personal gratification	• Skeptical • Independent • Distrust of institutions • Instant gratification • Entrepreneurial	• Positive • Cooperative • Respect for authority • Multitasking • Highly motivated
Work styles	• Strong work ethic	• High personl expectations • Democratic workplace	• Willing to transfer jobs and companies • Balance personal life and work	• Seek immediate feedback • Like to be asked for input • Like teamwork
Management styles	• Top down	• Consensus management • Micromanage	• Based on competence	• Inclusive
Motivators	• Quiet feedback • Value their experience	• Perks • Titles • Value their importance • Value their uniqueness	• More control of time • Individual recognition • Challenge and flexibility	• Value hard working coworkers • Appreciated concrete, specific recognition
Communications	• Positive, direct approach	• Direct orders • Strong need for "process"	• Want to be heard	• Direct
Lifestyle	• Work hard • Save money	• Work hard, play hard, spend money	• Work hard if it doesn't interfere with personal life • Save money	• Save money

Generation Y – The Millennials

- A 2017 study of the millennial generation conducted by Qualtrics produced many notable findings:
  - In the past five years, millennials have had, on average, 2.29 jobs, representing a job change every 26 months
  - 82% of millennials report that their job is an important part of their life – a higher rate than their parents reported
  - 43% of millennials say the #1 reason to bail on their job is to be more fulfilled
  - In fact, job satisfaction (21%) ranked higher than compensation (17%) for what's most important to them about work
- *http://www.qualtrics.com/millenials*

Goal Setting & Communication

- Establishing clearly-defined goals is often a challenge for both the selling generation and buying generation alike
- For the selling generation in the "late adult transition" phase in the life cycle, this leads to the "propensity to do nothing" which can frustrate the buying generation
- For the buying generation (including Millennials), goals are usually established for them and absent a "blueprint for ownership" the perception is a lack of interest in ownership
- The most effective way to break down these barriers is COMMUNICATION!

Goal Setting & Communication

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?

Why Become an Owner?

- Participate in establishing future direction for the company
- Professional growth
- Opportunity to choose projects to pursue
- Increased involvement in marketing activities
- Ambition and recognition
- Involvement in decision-making
- Access to financial and operational information
- Additional income including bonuses based on performance
- Growth in value of investment

Considerations for New Owners

- Are goals and vision compatible with those of the company
- Why are they being offered ownership
- How do they fit into the company's long-term succession plan
- What will there role be in the management of the company and how will current management change over time
- Are there potential liabilities that they will assume as an owner
- How much is the firm worth and how is the value determined
- What if the firm is not profitable in the future
- Will they make more money!
- What will happen if they decline the offer of ownership

Strategic Ownership Transition Plans

- 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

Key #4 – Evaluating Available Transition Vehicles & Funding Mechanisms

"When you come to a fork in the road, take it."

- Yogi Berra

Ownership Transition Vehicles

- Vehicles used to transfer equity ownership or synthetic equity to the next generation include:
  - Stock Issuances
  - Cross-Purchase Transactions
  - Stock Redemptions
  - Stock Bonuses
  - Stock Options, Phantom Stock & Stock Appreciation Rights (SARs)
  - Recapitalizations
  - Gifts

Funding Mechanisms

- Funding mechanisms to provide capital to effectively transfer equity ownership include:
  - Insurance
  - Installment Sales
  - Qualified Retirement Plans
  - Employee Stock Ownership Plans (ESOPs)
  - Nonqualified Deferred Compensation

Transition Vehicles & Funding Mechanisms

- The use of any of the above transition vehicles and funding mechanisms is driven by:
  - The goals of the parties in ownership transition (particularly the sellers)
  - The retirement horizon of the selling generation
  - The degree of control to be retained
  - The size of the company
  - The pool of potential buyers
  - A host of other financial and non-financial considerations

Transition Vehicles & Funding Mechanisms

- A proper plan is one that will "mesh" the goals of the selling generation and the buying generation and address the key concerns of :
  - Timing
  - Affordability
  - Tax-efficiency and
  - Cash flow

Key #5 – Formalizing the Plan

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

- Yogi Berra

The Buy-Sell Agreement

- A mandatory step in the plan for ownership transition is the adoption of a comprehensive agreement among the owners that is often referred to as a buy-sell agreement

- For companies with existing agreements in place, the agreement should be reviewed to ensure the company's ownership transition planning objectives are being met and the agreement is current with respect to the current economic and tax environment

- A buy-sell agreement is a contract providing for the sale of an owner's ownership interest in the company upon the occurrence of a specified event (**Event of Transfer**)

The Buy-Sell Agreement

- **Events of Transfer** include the retirement, death, disability or separation from service (voluntary or involuntary) of an owner

- Other **Events of Transfer** can include bankruptcy, divorce, conviction of a crime (especially a felony), loss of professional license or accreditation, loss of residency status, etc.

The Buy-Sell Agreement

A buy-sell agreement should be a "self-executing" agreement that will accomplish all of the following objectives:

- To provide for the orderly transfer of ownership interest upon the death, retirement or disability of an owner
- To create a market at a fair price for the interest of owners who desire to transition their ownership in the fcompany for expansion or in contemplation of retirement
- To fix the value for sale and/or purchase and the related payment terms
- To reasonably assure the continuance of the business and reduce the risk of dissolution and loss of value

The Buy-Sell Agreement

A buy-sell agreement should be a "self-executing" agreement that will accomplish all of the following objectives:

- To provide for the orderly transfer of ownership interest upon the death, retirement or disability of an owner
- To create a market at a fair price for the interest of owners who desire to transition their ownership in the firm for expansion or in contemplation of retirement
- To fix the value for sale and/or purchase and the related payment terms
- To reasonably assure the continuance of the business and reduce the risk of dissolution and loss of value

The Buy-Sell Agreement – Required Elements

- Restrictions on transfer
- An "offering process" for shares available as a result of an **Event of Transfer** or shares issued to new owners and the corporate governance providing control over the transfer of the shares
- The payment terms for the shares and the funding of the resulting cross-purchase or redemption obligations with insurance policies and/or installment sale agreements
- A covenant not-to-compete

The Buy-Sell Agreement – Other Elements

- Provision for a gradual reduction of stock ownership when approaching retirement
- Maintaining voting control by generation
- “Drag-along come-along” provisions in the event of an outside sale
- Spousal consent
- Non-solicitation and confidentiality

Corporate Governance

- An often-forgotten element to ownership transition planning is corporate governance
- By expanding the ownership pool, questions arise as to how decisions are made and by whom
- Although retention of control is a key consideration for the selling generation, the ability to participate in management and decision-making on the part of the buying generation is critical to ensure a smooth transition

Corporate Governance

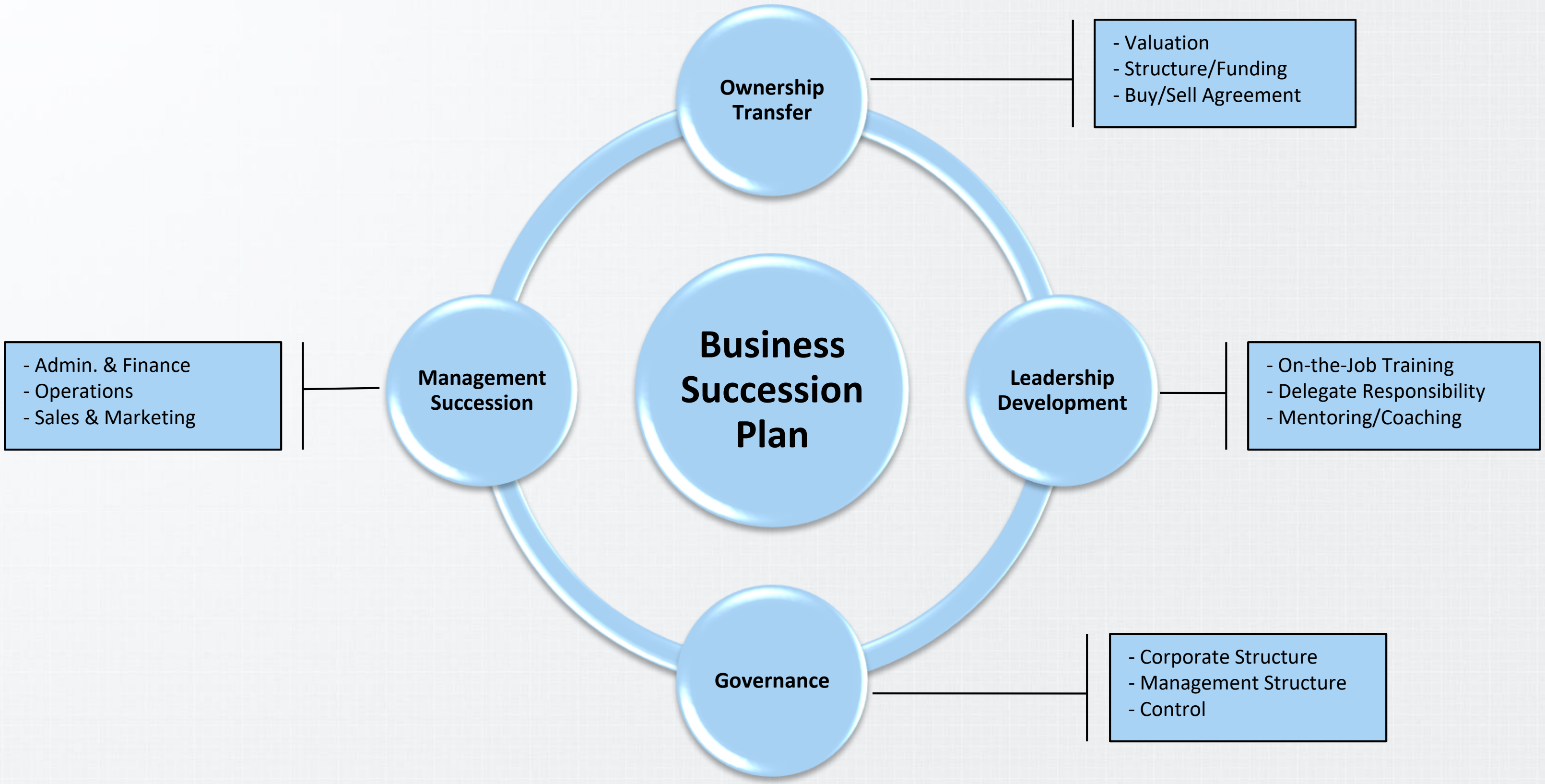
- Corporate governance can take different forms including a Board of Directors, Executive Committee, Management Committee, etc.
- Whatever the structure, the company's governance will play an active role in major decisions affecting the company, including carrying out the company's buy/sell agreement
- Corporate governance needs to be incorporated in other corporate documents outside the buy/sell agreement (corporate bylaws, personnel manual, operations manual, etc.)

Best Practices in Ownership Transition Planning

"It ain't over 'til it's over."

- Yogi Berra

Best Practices



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

Questions

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