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# Begin with the End in Mind: Exit Planning for the Private Business Owner

Houston Business and Estate Planning Council

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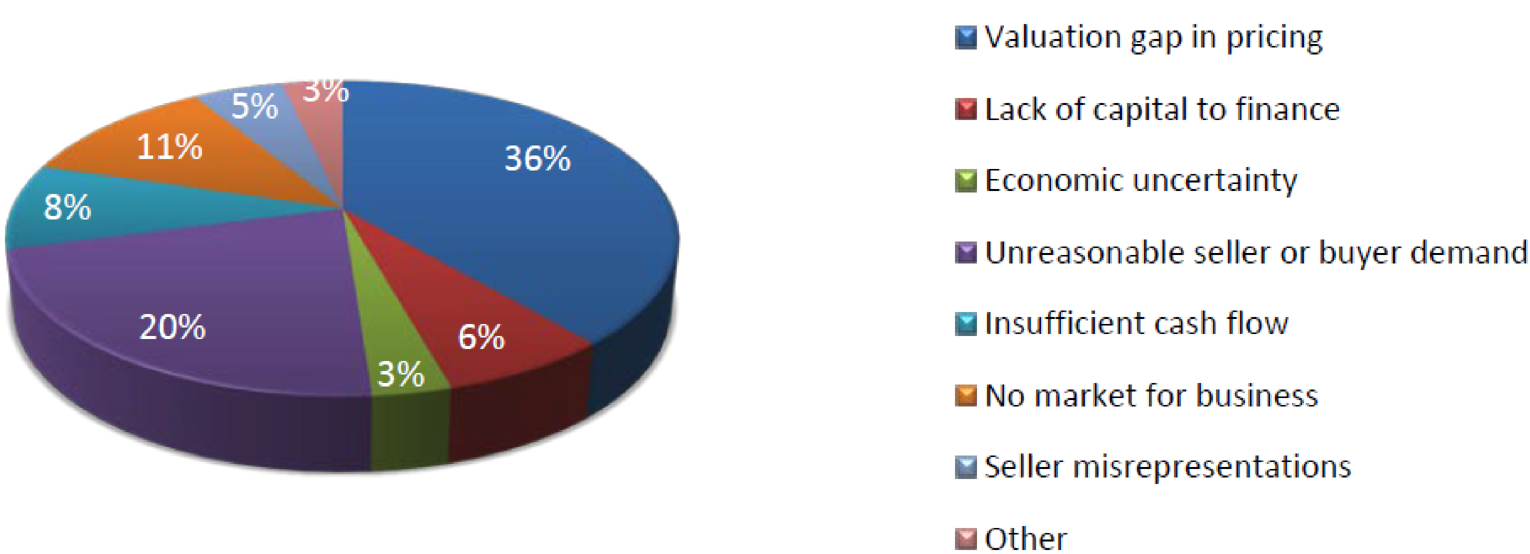
# State of Private Business Owner Readiness

- 12 months after selling, 3 out of 4 business owners surveyed “profoundly regretted” the decision. (Price Waterhouse)
- 70-80% of businesses put on the market don’t sell. (Business Reference Guide, T. West; Pepperdine Graziadio Business School)
- Only 30% of all family-owned businesses survive into the second generation; only 12% survive into the third generation; only 3% operate at the fourth generation and beyond. (Family Firm Institute)

# Why Businesses Transactions Fail

The top three reasons for deals not closing were: valuation gap in pricing (36%), unreasonable seller or buyer demand (20%) and no market for business (11%).

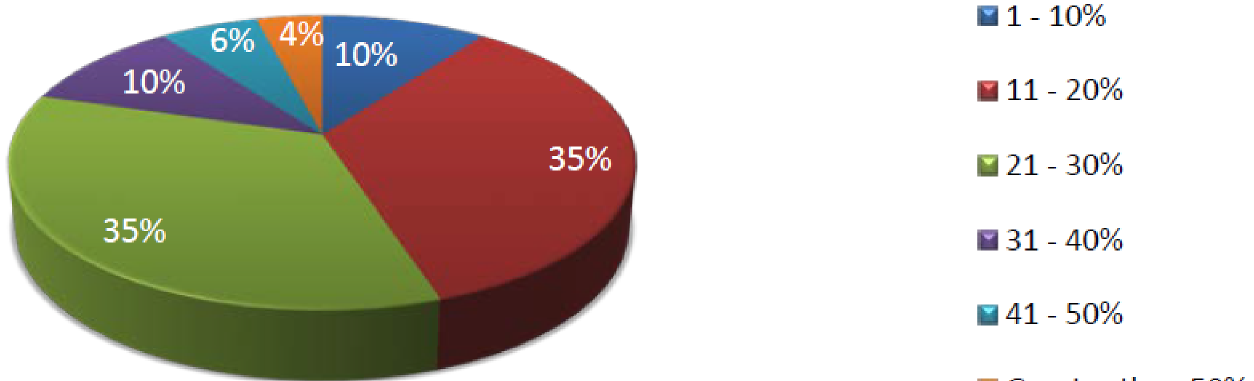
***Figure 40. Reasons for Business Sales Engagements Not Transacting***



# #1 Issue - Owner Value Gap

Of those transactions that didn't close due to a valuation gap in pricing, approximately 69% had a valuation gap in pricing between 11% and 30%. Note: this graph can be confusing. The red segment, for example, means that 35% of valuation gaps were between 11% and 20%.

*Figure 41. Valuation Gap in Pricing for Transactions That Didn't Close*



# Why Plan?

The Urgency of your desire to sell inversely impacts the likelihood of receiving FMV, unless you run your business as if it were for sale

- Prepare for unplanned exit
  - Death
  - Illness/Disability
  - Divorce/Loss of Partner
  - Unsolicited Offers

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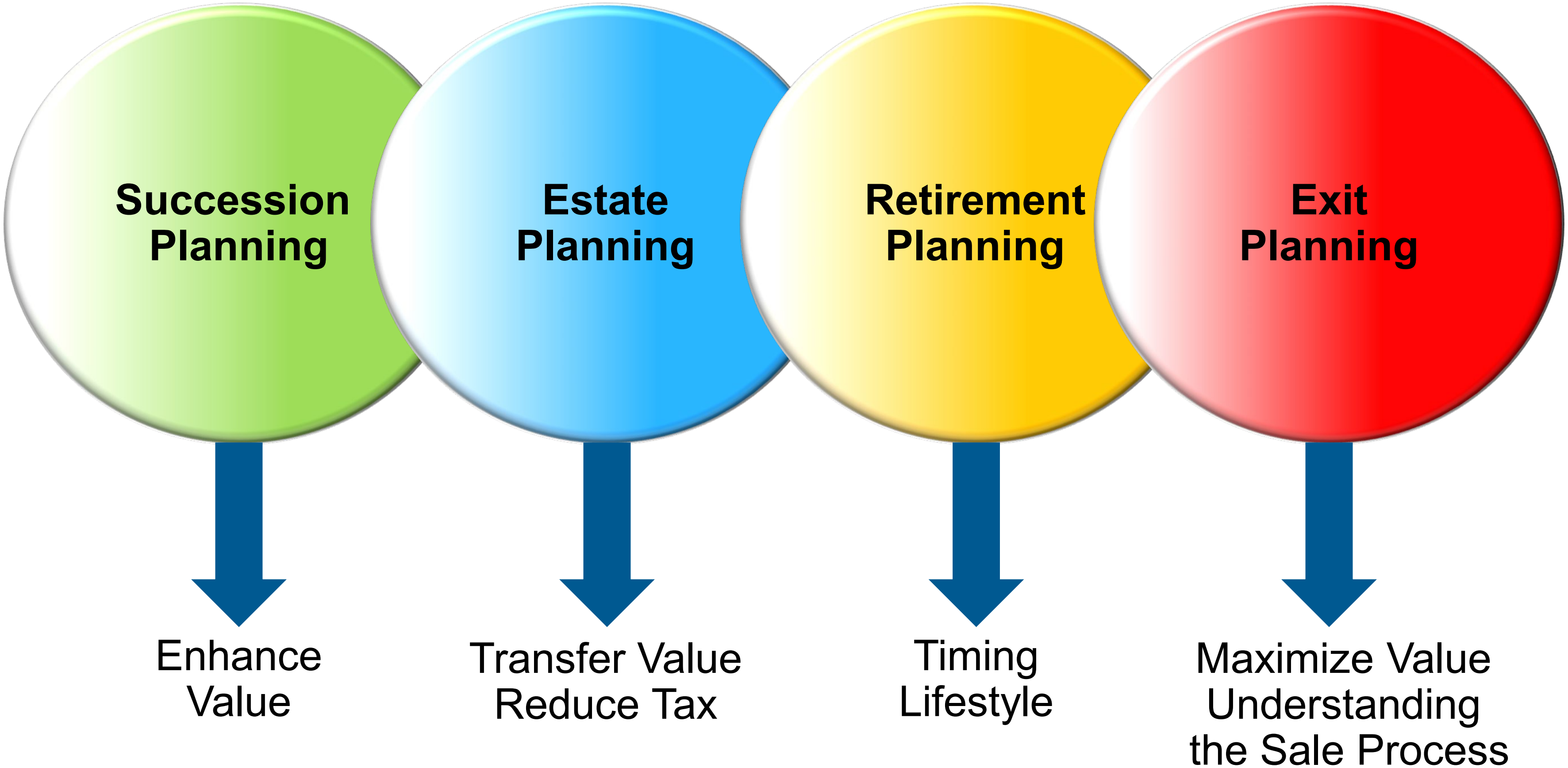
# Facets of Planning: Are You Prepared?



# Getting Started

### Assemble Team

**Core:**
- Attorney(s)
- Wealth advisor
- CPA
- Exit Planning Advisor

**As Needed**
- Investment banker/Valuation advisor
- Insurance professional
- Business coach
- Valuation

### Baseline Value
- Determine current value
- Salability
- Valuation method
- Valuation trends

### Future Value
- Value when you are ready to retire
- Net proceeds for a realistic lifestyle

### Assess Gap
- Understand value drivers
- Implement strategies that enhance value
- Factors that create the difference in multiple and value
- Value creating characteristics

# What are the Advantages of a Succession Plan?

- Avoids inertia
- Provides a roadmap to achieve a successful exit
- Focuses on the **execution** of your strategic plan
- Implements strategies to maximize value
- Develops investment strategy for realistic lifestyle maintenance

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# Key Goals

- Control how and when you exit
- Minimize wealth transfer taxes
- Maximize after-tax value
- Retain control of your situation via exit options
- Increase confidence, reduce stress of family and employees
- Ensure business continuity

# So What is Your Plan?

Do nothing?

- Don’t know how to start
- No advisory team
- Too busy

# Options

- Sell Your Business to Outsiders
- Sell Your Business to Employees
- Transfer Your Business to Family Members

# Option: Sell Your Business to Outsiders

- Prepare for sale
- Retain experienced financial advisor
- Understand value drivers
- Implement strategies that enhance value

# What Do Buyers Want?

- Types of buyers
  - Strategic
  - Financial
  - Owners/Operators

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# Financial Buyers

- Mature stable targets
- Create liquidity in 3 to 5 years
- Strong cash flows and debt capacity

## Strategic Buyers

- Increased revenues
- Diversification
- Increased market share
- Geographic expansion
- Economics of scale
- Synergistic benefits

# Owners/Operators

- Discretionary cash flow
- Leverageable assets
- Seller financing

# Option: Sell Your Business to Employees

- Institutionalize your business
- Make sure new owners can run it
- Fund the transaction
- Post transaction role

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# Option: Transfer Your Business to Family Members

- Develop successors
- Understand family dynamics
- Consider possible tensions
- Role of non-family executives
- Tax implications
- Required ongoing Involvement?

# From Lifestyle Business to Salability

| | Company A Food Packaging | Company B Aerospace |
|---|---|---|
| Revenue | $100,000,000 | $30,000,000 |
| Margin | 6% | 20% |
| EBITDA | $6,000,000 | $6,000,000 |

What factors create the difference in multiple and value?

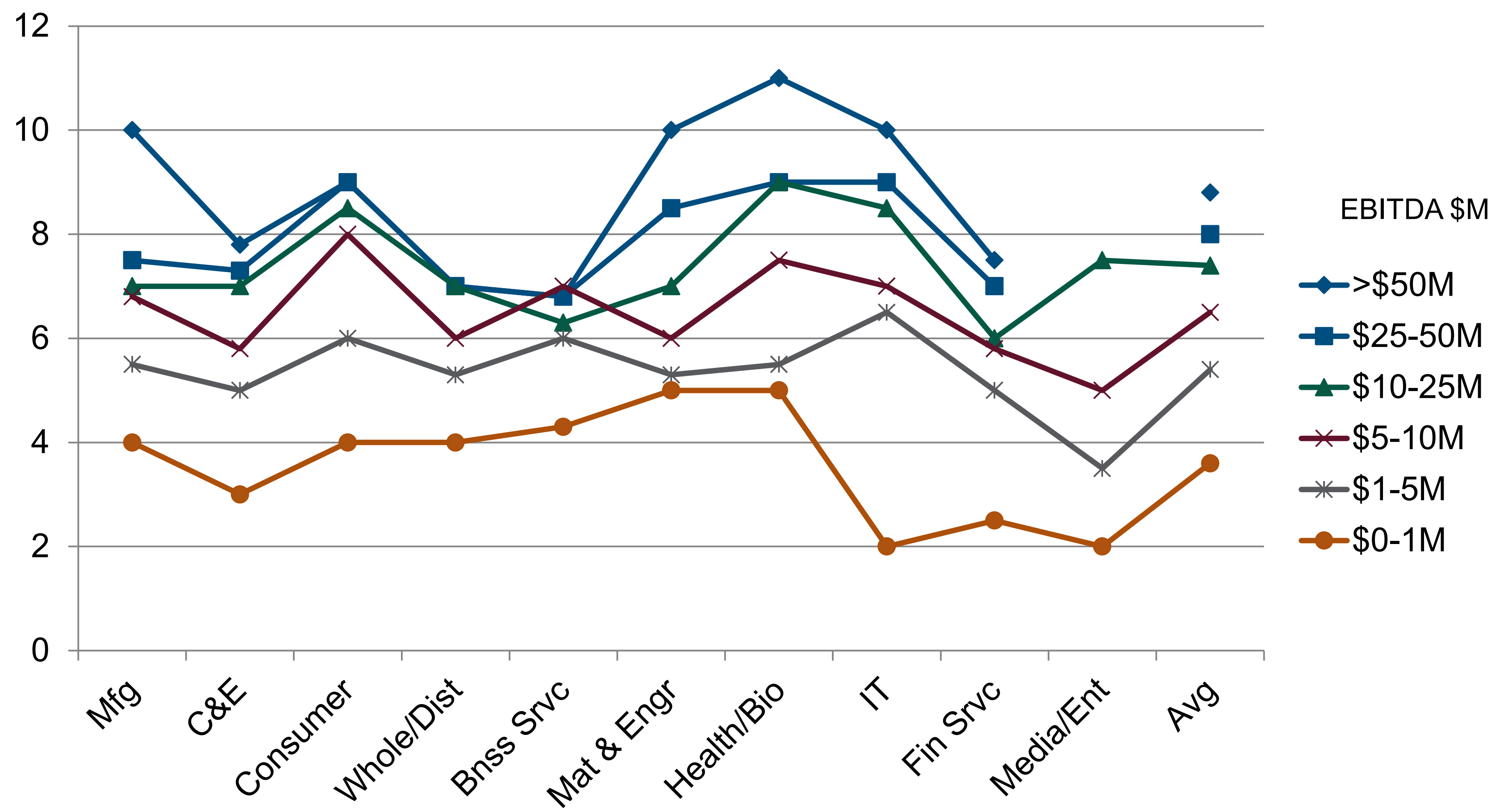
*EBITDA= Earnings Before Interest, Taxes, Depreciation, and Amortization*

# Valuation Method

- Enterprise Value = EBITDA x Multiple

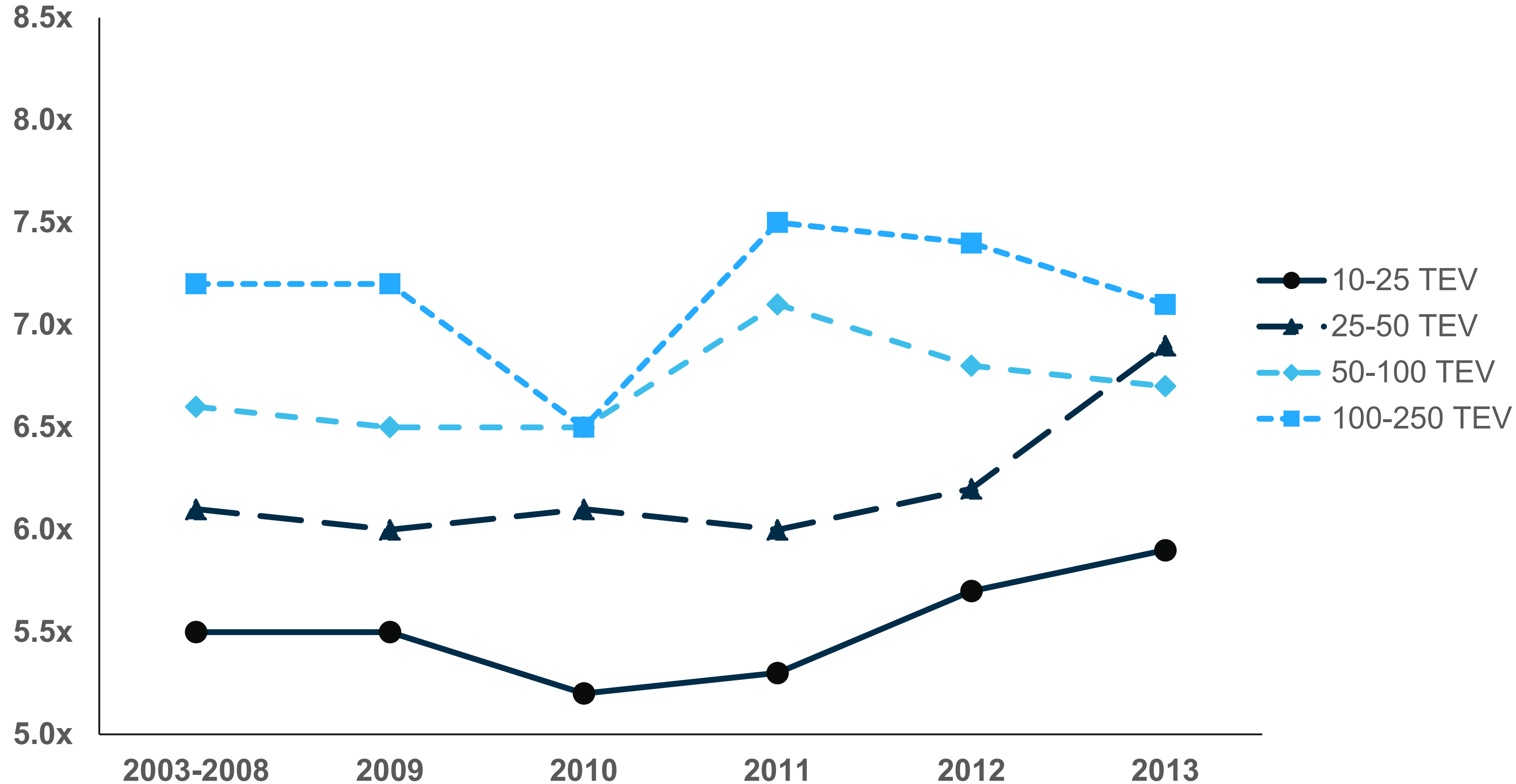
- EBITDA
  - Quantitative
  - Operating cash flow

- Multiple
  - Qualitative
  - Market derived from comparable companies




Pepperdine Private Capital Markets Report 2018

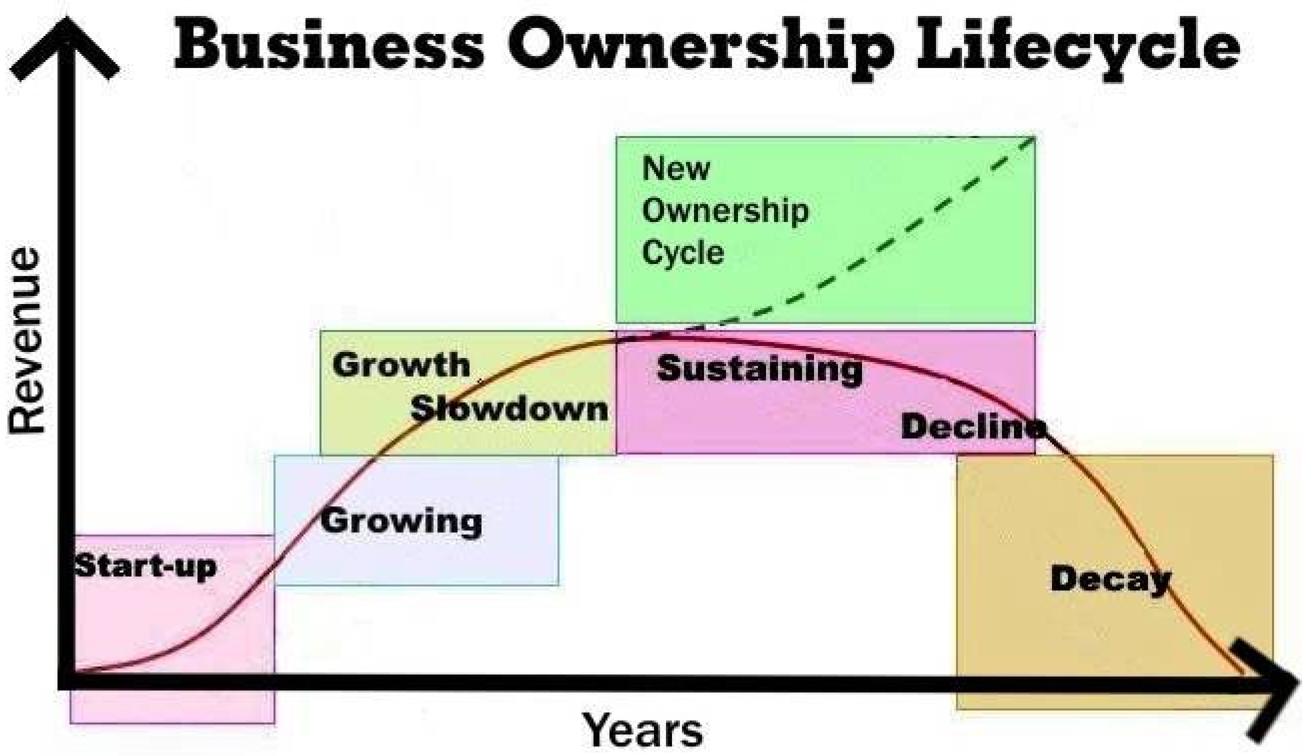
# Historical TEV*/ EBITDA
# By Deal Size




*TEV = Total Enterprise Value = Company Equity + Debt – Cash

Source: GF Data Resources

# Business Lifecycle



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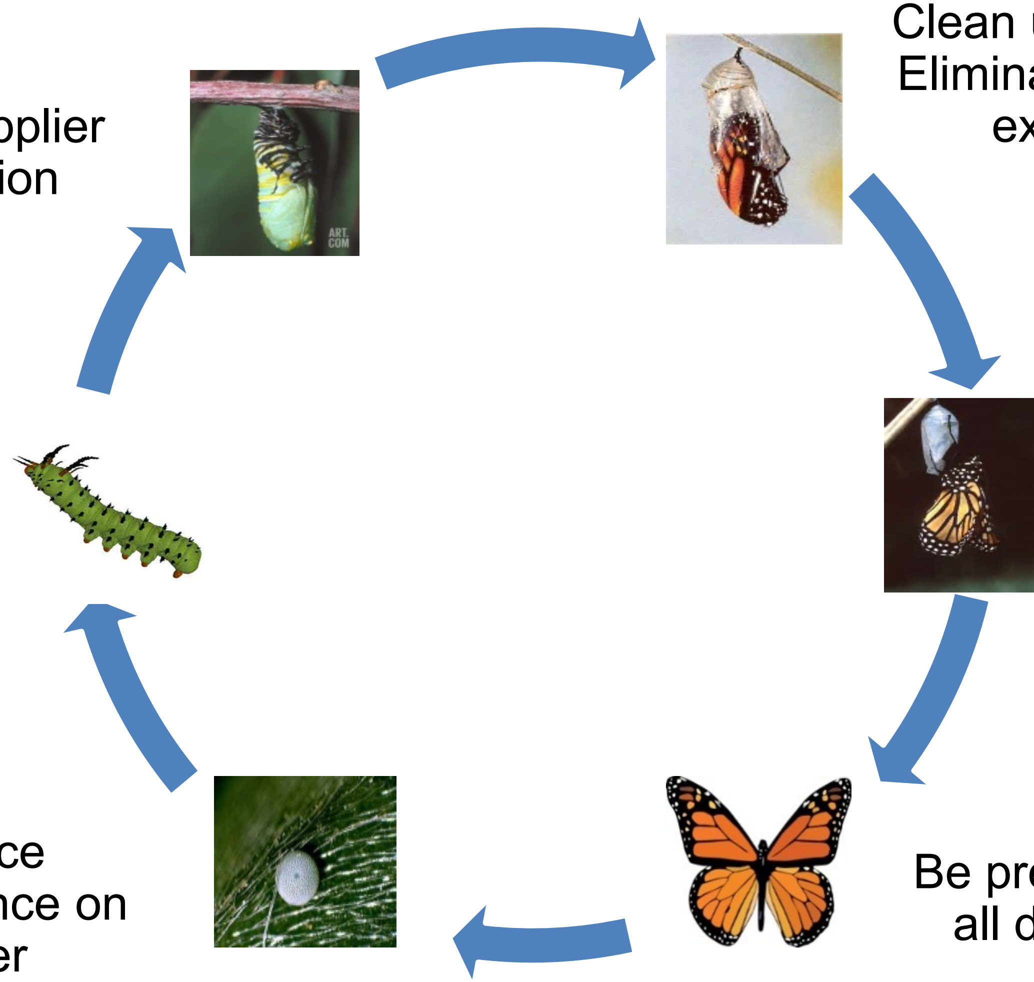
# Implementation



Reduce customer/supplier concentration

Clean up financials
Eliminate personal expenses

Create annuity income differentiation to entry barriers

Be prepared with all documents

Reduce dependence on owner

Focus on growth, profitability, and scalability

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# Drivers of Value

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| Company A | Qualitative | Company B |
|---|---|---|
| **None** | Product Development Program | **Robust** |
| **None** | Market Development Program | **Robust** |
| **Owner Dictates** | Corporate Culture | **Owner Cultivates** |
| **Inconsistent** | Processes | **Finely Tuned** |
| **None** | Lean Initiatives | **Fully Implemented** |
| **At Risk** | Environmental | **Industry Leader** |
| **Owner Dictates** | Corporate Culture | **Owner Cultivates** |
| **Inconsistent** | Processes | **Finely Tuned** |
| **None** | Lean Initiatives | **Fully Implemented** |
| **At Risk** | Environmental | **Industry Leader** |
| **Haphazard** | Training | **Regular and Formal** |

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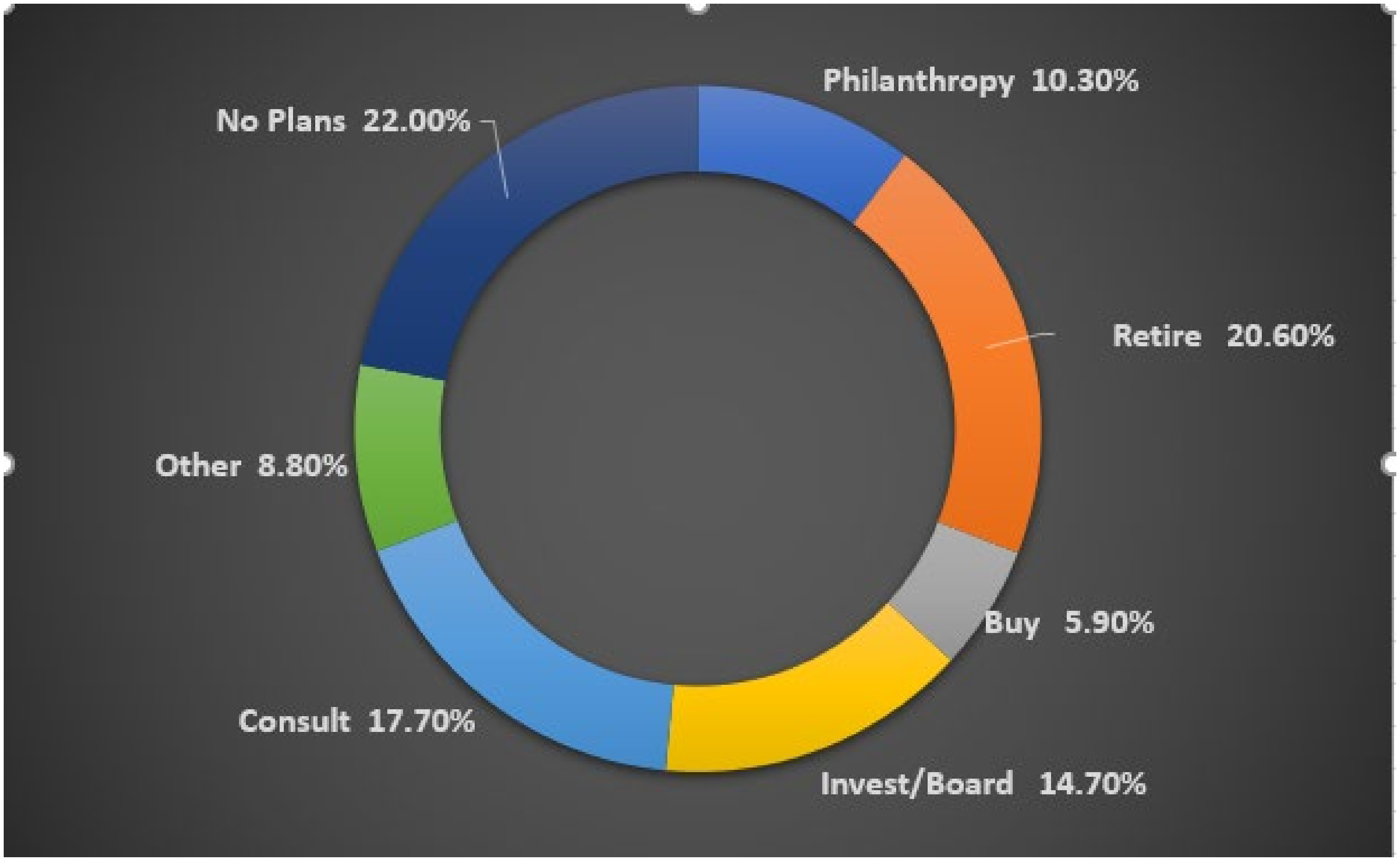
# From Lifestyle Business to Salability (revisited)

| | Company A<br>Food Packaging | Company B<br>Aerospace |
|---|---|---|
| Revenue | $100,000,000 | $30,000,000 |
| Margin | 6% | 20% |
| EBITDA | $6,000,000 | $6,000,000 |
| **Enterprise value** | **$25,000,000** | **$70,000,000** |
| **Multiple (EV / EBITDA)** | **4.2x** | **11.7x** |

What factors create the difference in multiple and value?

# What do you plan to do post-transition?



# It's Never Too Early to Start Planning…

- Start working ***on*** your business, not ***in*** your business
- If you have the time, it's probably too late
- Don't let life's events do your planning for you

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# How to recognize common mistakes and start conversations with business Owners

# Starting the Conversation with Owners

1. Who is your likely successor?
2. When do you think you'll want to leave your business?
3. How much planning have you done?
4. Tell me what's important to you when you think about leaving your business.
5. How much money will you need from your business to keep up your lifestyle after your exit?
6. What have you done to protect your family's wealth?
7. What plans do you have in place if something happens to you?
8. If you don't solve your Exit Planning concerns, what kinds of difficulties would you face in the future?

# What Strengthens and Increases Value in My Business?

| Internal Factors | Weak | Neutral | Strong |
|---|---|---|---|
| 1. Sales (size, growth, potential) | | | |
| 2. Gross margin (%, growth) | | | |
| 3. EBITDA ($, %, growth) | | | |
| 4. Predictable earnings | | | |
| 5. Balance sheet value/asset | | | |
| 6. Scalable growth engine | | | |
| 7. “Got to have” factor | | | |
| 8. Market attractiveness present and future | | | |
| 9. Geographic strength | | | |
| 10. Distribution strength | | | |
| 11. Product innovation | | | |
| 12. Technical capabilities | | | |
| 13. Systems and info strength | | | |
| 14. Predictable customer base | | | |
| 15. Barriers to entry | | | |
| 16. Management team, not including me | | | |
| 17. My personal expertise | | | |
| 18. Strategic fit to a buyer | | | |
| 19. Legal structure | | | |
| 20. Brand awareness/strength | | | |
| 21. Other | | | |
| | | | |

# What Factors Multiply My Business' Value?

| Factor | Multiple |
|---|---|
| **Quality of earnings**<br>Can be projected for 3 years with high certainty. | |
| **Diversified customer / product base**<br>No more than 10% of my sales in any one customer. | |
| **Manageable strategic drivers**<br>It is clear what drives the profit of the company and what management can do to enhance those drivers. | |
| **Great, motivated CEO**<br>A CEO and the team that can double the bottom line without me. | |
| **Accurate, timely management systems**<br>Critical forward looking metrics are measured and communicated. | |
| **"Must have" company status**<br>Buyers understand the strength and uniqueness of my business model and they "must have" my company to fill their strategic need. | |
| **Scalability**<br>There is a clear path for return on additional invested capital. | |
| **Business discipline and governance**<br>Business disciplines are in place and aligned for planning, managing, measuring and accountability to increase the value of the business. | |
| **Believable, compelling story of the future**<br>Market attractiveness, synergies with buyer, predictable customer growth, great leader with a proven history, etc. | |

# How Strong is my Current Situation Today?

| Factor | Weak | Neutral | Strong |
|---|---|---|---|
| **ENERGY:** My health and energy are strong enough to grow this business long term. | | | |
| **ENGAGEMENT:** I am fully engaged emotionally in this business. | | | |
| **SKILLS:** My business and personal skills are deep enough to manage this business as it grows. | | | |
| **ALIGNMENT:** My partners/family and I are well aligned on how to grow the business and what risks to take. | | | |
| **FAMILY or PARTNERS:** The relationships work well. | | | |
| **RISK:** When I look at the future, the payoff from opportunities in the market place significantly outweigh the risks of chasing them. | | | |
| **VALUE:** I have a good chance of creating the value I want in my business within the next 3-5 years. | | | |
| **SYSTEMS:** I have the management systems and information that will guide the company to a high valuation. | | | |
| **TEAM:** I have a high level of trust in my management team. | | | |
| **SECURITY:** The company is generating the income I want and the balance sheet is strong. | | | |
| **MEANING:** I find my work enjoyable and meaningful. | | | |
| **FREEDOM:** I am able to work reasonable hours and have enough time for my family and "my time." | | | |

# PLANNING FOR THE UNEXPECTED

# Business Continuation

| | | | |
|---|---|---|---|
| Who has the skills to manage the business during a difficult ownership transition following a business continuity event? | What are the specific areas of management that must be addressed in order to preserve the value of the business? | What are the specific expectations that the transition management individual/team must meet? | How will their management performance be measured and quantified? |
| Who will determine whether performance is adequate? | Is it necessary for the transition management to delegate any responsibilities during the transition period? | At what point will the transition management support be complete? | What is an appropriate reward for successful continuity of management? |
| What are the expected concerns of employees following a continuity event? | Who will communicate transition plans to employees? | What message should be conveyed to employees in order to reduce anxiety? | Realistically, will some reduction in employee base be necessary? |

# Fundamentals of Buy-Sell Agreements

- A buy-sell agreement is a legally binding contract—whether simple or complex—that dictates the terms of a future sale of a business interest, ensuring continuity of ownership and management. It specifies the triggering circumstances (retirement, death, disability), the buyer(s), and how the business will be valued.
- A buy-sell agreement ensures stability in business transition and prevents heirs from having to run or sell the business after an owner dies. With a buyer in place, a life insurance policy assures that funds will be available when needed.
- A buy-sell agreement ensures an orderly transition and alleviates conflicts over the value of a business. Heirs get needed cash, and surviving owners are assured that the heirs or a stranger cannot insert themselves into the business

# Why Is It Needed?

- A buy-sell agreement helps ensure that a business will continue after an owner dies.
- When the buy-out is fully funded with life insurance, the agreement provides:
  - Financing and the mechanism to ensure that control of the business remains with the surviving owners
  - Assurance that heirs will receive immediate cash for their inherited interest

# Three Main Types of Buy-Sell Agreements:

- **Cross-purchase agreement**— each owner buys part of the interest. Each owner buys insurance on every other owner to fund the purchase.
- **Entity-purchase agreement**—the business itself buys the interest. The business buys insurance on each owner to fund the purchase.
- **One-way agreement**—an individual (usually a key employee) agrees to buy a sole-owner business. The buyer typically purchases life insurance on the owner to fund the purchase

# What Is a Cross-Purchase Buy-Sell Agreement?

- A buy-sell agreement provides that, if one of the business owners dies, the remaining owners will purchase the deceased owner's interest. Equally important, it obligates the deceased owner's heirs to sell the interest to the other owners.
- A cross-purchase type of buy-sell agreement provides that each surviving owner purchase a portion of the deceased owner's interest. This is in contrast to the entity buy-sell agreement, where the business entity purchases the deceased owner's interest.

# How Does a Cross Purchase Buy-Sell Agreement Work?

- To provide funding, each owner buys a life insurance policy covering the life of every other owner. Each person owns and is the beneficiary of each individual policy.
- Assume a partnership valued at $750,000 is owned by three equal partners—Risley, Radford and Wisman. With a cross-purchase agreement, each partner buys policies on the lives of the other two in the amount of $125,000 each, so that each partner is insured for a total of $250,000.
- If Wisman dies, the death benefits on the two policies insuring his life—one owned by Risley and one by Radford—are paid to the two surviving partners as beneficiaries of the policies. Together, the surviving partners have a total of $250,000 to purchase Wisman's business interest from his heirs.

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# What About Taxes?

- Premiums paid by individual owners are not tax-deductible. If, on the other hand, a corporation pays the premiums, they are deductible when payments are treated as compensation to the shareholder-employee on whose behalf premiums are paid.
- Premium payments treated as dividends to shareholders are not deductible by the corporation.
- Either way, premiums paid by a corporation are treated as income to the shareholder-employee and taxed as such.
- Life insurance death benefits, however, are generally received federal income tax-free.

# Other Benefits

- With a cross-purchase buy-sell agreement in place, surviving owners are assured of having the funds to buy out a deceased owner's heirs and maintain control of the business.
- While all the terms of the sale are decided in advance, the agreement should provide a mechanism (a periodic stock revaluation clause, for example) so that heirs receive a fair price for the deceased's interest.
- Surviving owners receive an increase in basis that can reduce the capital gains tax on a future sale of the business interest.
- Finally, a properly drawn buy-sell agreement can fix the value of the business interest for federal estate tax purposes.

# What Are the Potential Downsides?

- A cross-purchase arrangement can be cumbersome when there are many owners, since multiple life insurance policies are required. In addition, when there is a wide age disparity among the owners, younger owners bear a greater premium burden to insure older owners. Finally, because the policies in a cross-purchase agreement are individually owned, cash values accumulating in the policies are not available to the business.
- Both the benefits and the drawbacks should be considered in determining what type of agreement to put in place. It is important to note that, with any properly drawn and fully funded agreement, owners of small businesses know that they are establishing a fair price for their interest. They can further rest assured that willing buyers with the financial ability to purchase the business interest will be there when needed.

# Cross-Purchase Buy-Sell Agreement Process

1. The owners execute a buy-sell agreement in which they agree to buy—and commit their estates to sell—the business interest for an agreed-upon price.
2. To fund the agreement, each owner buys a life insurance policy on every other owner.
3. When an owner dies, the family/estate receives the deceased owner's share of the business.
4. The surviving owners use the insurance proceeds to purchase the deceased owner's business interest from the estate under the terms of the agreement.

# What is an Entity Purchase Buy-Sell Agreement?

- To provide funding for the buyout, the business purchases life insurance on each owner, with the business entity as the owner and beneficiary of each policy. The business must give notice that it intends to insure the owner-employees and must also secure each owner-employee's written consent.
- The amount of insurance approximates the agreed-upon purchase price for each owner's interest. The agreement stipulates either a specific purchase price or a formula for determining the purchase price. Life insurance proceeds provide the funds to buy the deceased owner's interest.
- Although premiums paid for the insurance are not tax deductible, death benefits are generally excluded from federal income tax when the notice and consent requirements have been met. Redemptions that meet certain requirements can avoid being taxed as dividend distributions.

# When to use an Entity Agreement?

- An entity buy-sell agreement is preferable when there are many owners, since this arrangement requires that the business purchase only one policy on each owner. A cross-purchase agreement requires that every owner buy a policy on every other owner.
- An entity agreement may also be preferred when there is a wide age disparity among the owners, since younger owners would bear a greater premium burden to insure older owners under a cross-purchase agreement.
- If the business wants access to policy cash values, the business must own the policy. This is not possible in a cross-purchase agreement, where individuals are the policy owners.

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# What Are the Benefits of an Entity Buy-Sell?

- With an entity buy-sell agreement adequately funded with life insurance, the business is assured the funds are available to buy out a deceased owner. The surviving business owners maintain control of the business and the deceased owner's estate will be provided needed liquidity for expenses and taxes. All the terms of the sale—the purchase price, when the purchase will occur and funding arrangements—are decided in advance. In addition, a properly drawn agreement can fix the value of the business interest for federal estate tax purposes.
- When written agreements are made in advance and adequate funding is in place, the benefits are substantial. By setting a fair price for the business interest and establishing a willing seller and a willing buyer with the needed liquidity to make the purchase, owners can be confident of a seamless transfer when the time comes.

# Entity Buy-Sell Agreement Process

1. Each business owner is party to a buy-sell agreement with the business.
2. The business gives notice that it intends to insure the owners' lives and obtains their written consent. The business pays the premiums. The premiums are not deductible by the business
3. When an owner dies, the business (as beneficiary) receives the death benefit from the policy insuring the deceased owner's life.
4. The business uses the life insurance proceeds to purchase the business interest from the deceased owner's estate.

# What is a One-Way Buy-Sell Agreement?

- The sole owner of a business faces a unique dilemma—there are no co-owners to buy the business when the owner dies, retires or decides to leave the business. Without a competent successor who agrees to purchase the business when the time comes, the owner stands to lose all the value that has been built up through years of hard work and wise decisions.
- There are other problems, too. The owner or surviving family members lose a source of income. Faithful, long-term employees suddenly find themselves without a job. Vendors, banks and other creditors may become wary, refusing to extend additional credit or wanting to be paid off. Receivables may be difficult to collect.
- Too many sole-owner businesses, no matter how successful, do not outlast their founders because they do not have succession plans in place.

# Identify a Buyer

- Fortunately, there may be an answer. If the owner can identify a buyer (ideally, a valued employee), a special version of the buy-sell agreement used in partnerships and multi-shareholder corporations can be adapted for a sole-owner business.
- This is called a one-way buy-sell agreement because only one party—the non-owner—is obligated to purchase the interest in the event of the owner's death.

# How The One-Way Buy-Sell Works

- Under a one-way buy-sell agreement, the sole owner commits to sell, and the purchaser commits to buy, the business interest upon the occurrence of a specified event (such as the owner's death or retirement).
- The purchase price is based on either a fixed method for determining the value or on a fixed value that is recalculated from time to time.
- The agreement usually provides that the buyer will not assume the business liabilities. The sole owner's executor may use cash from the purchase to pay off the liabilities, as well as other estate costs and taxes.
- The balance is distributed under the terms of the owner's will to the estate beneficiaries, or perhaps to a trust for their benefit

# Funding with Life Insurance

- The buyer purchases a life insurance policy on the owner's life in an amount equal to the purchase obligation under the agreement. The agreement may require the buyer to maintain the policy by paying the premiums when due.
- As the policy's owner and beneficiary, the buyer is obligated to notify the owner before exercising any policy rights that might affect the policy value. Similarly, the agreement may prevent the owner from disposing of key business assets or assigning them as collateral without the buyer's consent.
- The buyer often has a "right of first refusal" on any lifetime disposition of the business by the owner. This means that the owner must first offer the business to the buyer before selling it to a third party during the owner's life, including at retirement. Only after the buyer declines the option can the owner pursue a third-party sale. While this clearly restricts the owner's freedom, it also ensures that the buyer will not pay insurance premiums in vain.

# An Installment Sale

- The buyer can make the purchase in installments, providing the installment sale is structured to comply with the Internal Revenue Code’s installment sale rules.
- This could be particularly useful in the case of a lifetime purchase, when only the policy’s cash value—not the full death benefit—is available to the buyer.
- A one-way buy-sell agreement is an effective way to resolve a myriad of problems that can otherwise affect a one-owner business.
- The key is to find a willing buyer to complete the agreement—ideally, someone already employed by or familiar with the business.

# One-Way Buy-Sell Agreement Process

1. The owner of a business enters into a buy-sell agreement with a non-owner under which the owner agrees to sell, and the non-owner agrees to buy, the business upon the owner's death (and possibly other triggering events) at a price specified in the agreement
2. The non-owner purchases life insurance on the owner.
3. When the owner dies, the non-owner receives the death proceeds. The non-owner uses the proceeds to purchase the business as specified under the agreement

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Alex has been engaged in providing valuation opinions, transaction services and financial advice for middle market private and small capitalization public companies since 1972. He has provided opinions for corporate and estate planning; estate-, gift-, and income-tax requirements; fairness opinions; mergers and acquisitions; and employee stock ownership trusts, among others. He has advised boards of directors and trustees regarding mergers and acquisitions, reorganizations and recapitalizations.

Alex is a founding principal of HFBE Inc. which was incorporated in 1991. On September 1, 2012 HFBE merged with Stout Risius Ross, Inc. forming a national firm with nine offices and 250 employees. Prior to forming HFBE, Alex was employed by a national valuation firm and the corporate finance departments of highly regarded Texas investment banking firms. Alex graduated from New York University with a Bachelor of Science and a Master of Business Administration He is a Chartered Financial. He has written articles related to valuation and merger and acquisitions and spoken to many legal, accounting and business groups.

**Published Articles**

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Andrew T. Gardener is the founder and President of Tanglewood Legacy Advisors, LLC. Established in 2003, the firm is known as the "Family CFO."

Andrew is a past Chairman of the Financial Planning Association of Houston and a past President of the Houston Business and Estate Planning Council. He has also served as Treasurer of the Houston Public Media Foundation, on the Holocaust Museum of Houston Foundation and as an advisor to the University of Houston Board of Visitors.

Quoted in Zig Ziglar's Over the Top, Andrew is acknowledged for his visionary and planning abilities. He has also been quoted in many other publications, including The Wall Street Journal, Bloomberg, U.S News and World Report, the Houston Chronicle, the Houston Business Journal, and Financial Planning.

Andrew is a graduate of Emory University and completed the Certified Financial Planning Program at the Bauer College of Business from the University of Houston. He teaches financial literacy classes for the Women's Resource Center of Houston. Most recently, Andrew completed an executive education program at the Mendoza College of Business at the University of Notre Dame.

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Certified Merger & Acquisition Advisor

Kevin helps business owners during times of meaningful transition; be that pivoting for scale, preparing for an outside sale or developing internal succession.

While Kevin's clients span all walks of life, he specializes in using his background in mergers and acquisitions to help private business owners develop and implement growth and exit strategies from their privately held businesses. Business transitions are complex, and as an engineer turned entrepreneur, he understands the emotional and financial commitment required to build a business; and is focused on ensuring owners are prepared for a successful transition when opportunity or desire sets in. He enjoys working closely with their team of advisors during the planning process, helping to bring forward the complex and inseparable relationship between an entrepreneur's life, business, and finances.

Kevin is a Computer Engineering graduate of Texas A&M University. His passion for numbers and working with people led him to obtain his MBA from McCombs School of Business, which eased his career transition to corporate finance for a Fortune 100 Company. There he worked in corporate strategy roles and as a financial analyst on the buy side of mergers and acquisitions. He is a CEPA, Certified Exit Planning Advisor, and CM&AA, Certified Merger and Acquisition Advisor, and a Certified Financial Planner™. He is a frequent speaker to business owners, helping them understand how to architect and monetize business value.