What Are Your Business Succession Options? Here Are 5 Strategies To Consider

Business owners regularly meet challenges when building a great and valuable enterprise. Such an endeavor can take two lifetimes to achieve but ironically as retirement time approaches, these same individuals often face new, perplexing challenges. How does one choose the best “retirement path” for themselves and their family? Fortunately, there are many available business-succession choices/plans to account for such issues.

Choice #1: Keep the Business Within the Family

There are two options within this choice.

Method A: Hire a professional management team
It may be advisable to build a professional management team including a board of directors and strategic plan outlining formal responsibilities and to maintain accountability.

Case study: One client established a management company to oversee the operation of the family businesses. It was “linked” through a management-fee agreement owned by a trust. This structure provides the owner’s spouse, children, and grandchildren with indefinite ownership of the entity. The first business “moved” into this structure had $1 million in profits. Although this structure is not available to all it features low barriers to entry.

Method B: Pass the business to the “adult-kids”
While this is a common approach, it often does not go as smoothly as planned. Communication is often neglected. Parents would often rather avoid conflict and subsequently postpone succession planning or provide incomplete, vague or inefficient plans. While the concept of what is “fair” can be relative in the eyes of individual adult-children as well as parents, heirs often will honor their parents’ wishes when a formal plan is in place. Unsurprisingly, the sooner one starts often the better the results when it comes to addressing such challenges as:

Structuring a business transfer
This often comes down to resolving “value-versus-control” issues. There are many ways to discount the share value of a company before passing it to children or to a trust for their benefit timing, however, is critical.

Case studies are hypothetical examples for illustrative and educational purposes only and should not be interpreted as a recommendation or advice.

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Re-capitalizing company stock
Consider creating separate voting and non-voting stock share classes. With this technique, an owner can gift or sell the discounted, non-voting shares to heirs or to a trust for their benefit while removing the value of appreciated stock from the estate and maintaining control.

Equalization
What is advisable when one child is active in the business and others are not? Perhaps one has helped build the business and the others did not. There are plenty of choices available to account for such differences while keeping family harmony but here again planning and communication are critical.

Managing different financial personalities
Individuals have unique relationships with money – including those raised in the same household. Which course should one take when one child is a spender, displays risky behavior or has a troubled spouse or child and the other is financially and personally responsible? What about providing for those who are indifferent towards money and business? There are many ways to meet these goals while efficiently "sourcing money" for heirs to use to purchase the business. Whichever approach is selected cash flow and taxes need to be taken into consideration. This often takes a professional and objective team to determine a sound approach and put it into action. Such an approach may not obtain the highest price for your business but can provide continuous cash flow to offset any discounts.

Choice #2: Transfer the Business to a Key Employee(s)

There is much to consider with this approach but the single biggest factor is time. Many business owners regularly postpone planning. Such inaction often results in eliminating this choice. While few 50-somethings can commit to a long-term, buy-out obligation as they frequently do not have the necessary capital, talented individuals will not wait indefinitely.

Before exploring this approach you first need to establish the value of the enterprise and your financial objectives. This leads to how to best structure the buyout focusing on the financials and how key employees would access capital. Include a realistic timeline and tax implications to see if this path is viable. While employees will need after-tax money to make the purchase, you (the seller) will have to pay tax on any gain. However, alternative paths to achieve the same end could include:

- Salary Continuation Plans
- Deferred Compensation Plans
- Qualified Retirement Plans (such as Defined Benefit or Cash Balance Plans)

Modeling with these paths will help determine if the assumptions, desired cash flows and tax strategies can be achieved. While this path does not always provide the highest price for the business it is often higher than a family-transition and can also be used when transitioning to a family member.

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Choice #3: Utilize Employee Stock Ownership Plans (ESOPs)

Not so common and very complex, ESOP's can be a great way to transition a business to your key employees — some of whom could be family members. The design flexibility an ESOP can provide can make them a very attractive path for nearly every situation as the seller and buyer can enjoy tax benefits. However, the price received will usually be based on the appraised value, which is often not the highest value. ESOPs can also be expensive and complicated to establish and maintain. With an ESOP you can:

- Sell some of your company now and some later.
- The plan can be structured so you remain in control.
- Often the owner stays involved for some period after the initial sale.
- Depending on the structure, an owner can "exchange" their shares for US stocks and bonds without recognizing tax at the time of the exchange.
- Normally the plan is structured to allow for deductible monthly payments by the business on behalf of the employee-owners to pay the seller.
- Employee ownership can provide increased loyalty, camaraderie and productivity.

Choice #4: Selling to or Partnering with a Private-Equity (PE) Company

This is frequently a popular choice because the price is normally much higher than a sale to family or key employees or by establishing an ESOP. This approach takes time and attention from you and your team so starting early can have great benefits. While the anticipated "big payday" often interests business owners, what may happen after the check clears must be addressed, including:

- Should you sell all or a portion of your company? (PE companies may take a minority position, allowing you to take some equity out of your business and maintain control.)
- Should you withhold part of the financing and/or a portion of the sale price in the new company in anticipation of a second sale? This is typically easy to model. It generally provides great cash flow and favorable tax planning but there are risks.
- How will the actual offer be structured including working capital and escrow requirements? This can require intense financing skills and a strong team at the negotiating table.
- How are earnings or EBITDA (Earnings before Interest, Taxes, Depreciation and Amortization) defined, i.e., who will negotiate the fine print? For each dollar in additional earnings there is normally a great multiple to be enjoyed.
- Is there a realistic "end game" or timeline for the new team to hold your company until the next sale or add-on?
- What will your new or modified role be? What about new roles for your children, spouse? Are each of you aligned with the new vision i.e., model or will there be friction in the forecast?

Choice #5: Sell to or Partner with a Strategic Competitor

This choice typically provides the highest price for a business. Why? Strategic partners normally have considered acquiring your company, are familiar with it and willing to pay a premium for it. In addition, often the seller can remain involved at a level of his/her own choosing. The considerations with a strategic partner can overlap with those of a PE deal. And while the pace to complete such as deal is usually more time-consuming there often is greater clarity on the company's future.

While there are volumes written on these five choices and many variations of each, the first steps to take in this transition include:

- Determine the net-of-tax amount needed to produce your desired income? What is the best tax plan to maximize your post-sale assets? How will these proceeds be integrated into your other plans/investments?
- Complete your estate plan well in advance of a sale and determine the post-sale value. Should you establish a trust for your spouse or children? Is there a special-needs individual? Should you establish a family foundation?
- Should gifts be completed in advance of going to the market? What would the value of the business be for those gifts and should you explore discounting techniques?
- Are your financials and legal structure clean and prepared for due diligence?
- Have you built your team? Do your current advisors have complementary skills and experience in structuring a deal of this magnitude?
- Should you hire an investment banker and what would their value and cost be?

While there is a lot of risk in business, one we believe is rarely discussed is "succession risk." If you have a succession plan but it has not been updated or even examined for some time, it may be a good idea to dust it off and see if it is still relevant. If not, we hope the few steps we've outlined above can help you understand and profit from the available choices.

Please contact HUB Retirement and Wealth Management if interested in taking your first steps to preparing for this transition.