LEAVING YOUR BUSINESS IS INEVITABLE

WHITE PAPER

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Michael Wildeveld, CEPA, M&AMI, CM&AP, CM&AA, CBI, CBB
Veld Mergers & Acquisitions
1 Park Plaza, 600
Irvine, CA 92614
Phone: 310-652-8066
www.veldma.com

Introduction

This white paper contains an overview of The BEI Seven Step Exit Planning Process™. We have white papers describing many of the Process's elements in detail. Please contact the advisor who gave you this white paper if you'd like additional information about a specific topic.

Owners begin thinking about the Exit Planning Process when two streams of thought begin to converge. The first stream is a feeling that they want to do something besides go to work every day: either they would like to be someplace else—doing something else—or they simply no longer get the same kick out of doing what they are doing.

The second stream is the general awareness of the following:

- They are close to financial independence.
- They are making significant strides toward reaching financial independence.
- They can achieve financial independence today by selling their businesses.

As these two streams converge, an owner's thoughts flow inevitably toward exiting the business. As these two streams converge for you, will your business be prepared for your departure on your terms? Consider the following fictional account.

Peter Daniels told his advisor that he wanted to leave his food-processing company in five years by selling it for enough cash to maintain a comfortable post-exit lifestyle. A quick review of the company's financials suggested that with a current annual cash flow of $1 million (before Peter's salary of $400,000), the company's estimated value was around $4 million.

When Peter's advisor suggested that they create and implement a step-by-step process to increase value, minimize taxes, protect existing value from loss, and assure that his two key employees stay with the company after his exit, Peter agreed but did nothing more. Peter neither designed nor implemented an Exit Plan.

Five years later, Daniels Food Processing Inc. was essentially unchanged, but Peter's frustration had skyrocketed. An economic downturn had significantly affected business cash flow. Peter had reduced overhead but had done nothing to increase cash flow.

For example, he had neither created and updated business systems (especially any marketing plan) nor restructured his inadequate and under-motivated management team.

Peter was still at least five years away from his exit.

Exit Planning is more than thinking and talking. It is taking the actions necessary to enable you to reach all of your Exit Objectives. These Objectives include leaving your business when you want, to the successor you choose, for the amount of cash you desire.

Further, Exit Planning takes time. The farther in advance you start planning for your exit, the more options you have and the better the outcome is likely to be.

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The Exit Planning Process we describe in this white paper was created over 20 years ago and has been refined by the experience of thousands of owners and their advisors.

While each Exit Plan is as unique as the owner who creates it, properly crafted Exit Plans have several signature characteristics.

- They aim to **increase business value** both in the short and long term.
- They are **put into writing** so that all involved can measure their progress toward the owner's goals.
- They **incorporate accountability** by holding the owner and each advisor to deadlines for completing each task.

Summary of the Seven Steps

If you would like an illustration of the seven-step path from where you are to your successful exit, please ask us for our Exit Plan Road Map.

Before we describe each Step of The BEI Seven Step Exit Planning Process in detail, it will be helpful to summarize the Steps as questions. Think about how you'd answer each one.

Step One: Set Exit Objectives/Goals. Have you determined your primary Exit Objectives in leaving the business, such as the following?

- Your desired departure date?
- The income you need to achieve your financial objectives?
- The person to whom you want to leave the business?

Do you have secondary objectives, such as taking care of certain employees or continuing the family legacy?

Step Two: Quantify Available Resources. Do you know how much your business is worth? Do you know what the business' cash flow is likely to be while and after you leave it? Do you know the amount of income you can expect to receive from your non-business investments after you exit the business?

Step Three: Focus on Business Value. Do you know how to increase the value of your ownership interest? Do you know how to protect the business value you've already created? Do you know which actions are necessary to minimize income taxes not only today but also when you transfer ownership?

Step Four: Sale to Third Party. Do you know how to sell your business to a third party in a way that will maximize your cash *and* minimize your risk and tax liability?

Step Five: Transfer to Insiders (co-owners, family members, or key employees). Do you know how to transfer your business to family members, co-owners, or employees under the following conditions?

- Without losing control of the business until you have all of your cash in hand?
- While paying the lowest allowable amount in taxes?

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Step Six: Develop a Contingency Plan for the Business. Have you done what it takes to ensure that the business survives if you do not?

Step Seven: Develop a Contingency Plan for the Owner's Family. Have you provided for your family's financial well-being and continuity should you die or become incapacitated both before *and* after your ownership transfer?

The BEI Seven Step Exit Planning Process

Step One: Set Exit Objectives/Goals

> *When a man does not know which harbor he is heading for, no wind is the right wind. –Seneca*

Seneca's advice is as sound for business owners today as it was centuries ago. Yet, few owners heed that advice or appreciate its implicit warning.

Many owners do not set Exit Objectives precisely because it is too emotionally wrenching to contemplate separating themselves from a business they have created, nurtured, lived with, suffered with, brought to maturity, and in which they have totally immersed themselves.

Your Exit Plan should be based on your goals. It is difficult, if not impossible, for any planning professional to engage you in the Exit Planning Process until you are emotionally prepared to begin planning to leave your business.

Where Do I Start?

The Romans believed "victory loves careful preparation," and we know that preparation starts with setting achievable goals. However, owners who are emotionally ready to face their departures often do not know what to do or where to begin. This is the point at which the need to set clear, simple Exit Objectives is paramount.

From our case study, Peter's problem was not that he was without a goal: He knew he wanted to exit in five years with financial security. He also knew he needed to build business value, and if asked, he probably assumed that the only way to reach that goal was to sell to a third party. However, in failing to create and act on a plan more specific than waiting for a buyer to appear, Peter failed to progress toward his exit.

There are three straightforward Exit Objectives that, once established, allow owners to cut through a lot of muddled thinking that otherwise bars them from moving forward. These Objectives are as follows:

1. Knowing how much longer they want to work in the business before retiring or moving on.
2. Determining the annual after-tax income they want during retirement (in today's dollars).
3. To whom they want to transfer the business:
    - Family?
    - Key employees?
    - Co-owner(s)?
    - Outside third party?
    - Employee stock ownership plan (ESOP)?

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No owner can effectively begin planning (or acting in an efficient and coordinated manner) to leave his or her business without establishing each of these Objectives.

Many owners set other objectives as well, such as the following:

- Maintaining family harmony.
- Providing for one or more employees.
- Transferring wealth to family members.
- Getting maximum value for the business.
- Giving to charity.
- Taking the business to the next level with someone else's money.
- Living a life of significance.

Remember, your objectives direct all subsequent planning efforts and actions. You are the person primarily responsible for this Step, but you do not need to work alone.

Who can help? Owners do not need to reinvent the Exit Planning wheel themselves. We have experience in creating and implementing Exit Plans for owners with varying goals and in a variety of industries.

Step Two: Quantify Available Resources

A universal ownership objective is to secure the income stream that you (the owner) and your family will need to support a future lifestyle.

The following three elements constitute your financial resources:

1. Business value.
2. Non-business sources of income.
3. Projected business cash flow.

A Word About Business Value

> Knowing the value of the business is critical to the planning necessary to successfully exit your business, because for most owners, their businesses are their most valuable asset.

Accomplishing financial goals depends on converting that asset to cash.

Based on owners' knowledge of the current value of their businesses, owners and their advisors can determine the following:

1. Whether an owner's financial objectives can be met at present through a conversion of value to cash.
2. How much the business' value must grow in order to reach the owner's retirement objectives (this is more common than the preceding point).
3. Whether, and how quickly, they make progress.

Step Three: Focus on Business Value

There are three parts to focusing on business value:

1. Increase the value of your business.
2. Protect its existing value.
3. Minimize current tax liability and liability when you transfer ownership.

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Increase Business Value

An inevitable byproduct of a consistently well-run business is consistently increasing value. There are numerous actions an owner can and should take to maximize value. These include the following:

- Maintaining and consistently increasing cash flow.
- Creating and using efficient systems.
- Documenting the sustainability of earnings.
- Motivating and keeping key employees.

This Step goes to the heart of a successful business and to the essence of your role within the business: to enhance value.

Minimize Risk

A future buyer may not even consider purchasing your company if there's a risk that its value will decrease. Have you taken steps to make sure your key employees stay with a new owner after you exit?

In the earlier case study, one of Peter's pressing issues was the risk that one (or both) of his key employees could leave the company. Peter had neither financial incentives in place to induce key employees to stay nor any restrictions to prevent them from leaving and taking employees, customers, vendors, and other relationships with them. Once Peter got serious about exiting, this was one of the first areas he addressed.

Minimize Tax Liability

There are a number of tax-minimizing techniques owners employ as they work toward their exits. Charitable remainder trusts, ESOPs, defined benefit plans, and lowest defensible value are examples of tools we use to minimize taxes. (We have white papers regarding key-employee incentive plans and other Value Drivers. Please contact us to request them.)

At best, it takes years to reap the benefits from most tax-planning strategies. Assuming both income- and business-tax rates are likely to increase, can you afford to wait to investigate various tax-saving strategies?

Step Four: Sale to a Third Party

There are a variety of ways to market a business for sale, but if your company is worth at least $5 million, one of the best ways to reap top dollar is to have an investment-banking firm orchestrate a competitive (or controlled) auction.

In a competitive auction, multiple qualified buyers come to the negotiating table at the same time, all with the same information and all prepared to make an offer for the company. This process maximizes sellers' leverage and enables them to select the sale price, deal structure, and ongoing operating philosophy that are most attractive.

Key to the success of this process is the ability to bring a large number of qualified buyers to the table at the same time. Of course, competitive auctions don't just happen. They take careful preparation, marketing, and execution.

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If your company is worth less than $5 million, you may be able to retain the services of an investment banker skilled in competitive auctions, but more likely, you will use the services of a business broker and engage in a negotiated sale.

Again, a key to success is using the most capable broker available.

Step Five: Transfer to Insiders (co-owners, family members, or key employees).

Owners who wish to transfer their businesses to family, co-owners, or key employees must do the following:

- Minimize the income-tax consequences of the transfer to both the seller and the buyer.
- Minimize the departing owner's risk of not being paid the entire purchase price by having the owner stay in control until he or she receives every dime of the purchase price.

The reason we emphasize these two conditions is simple: The buyers (children, co-owners, or key employees) have no cash.

Minimize Taxes

The only way you (as the owner/seller) will receive your purchase price is to receive installment and other payments directly from the company over an extended period of time. All of the money you receive will come from the business' future cash flow (i.e., income the business earns after you depart).

> *...it is imperative that your Exit Plan works to minimize the tax consequences to the business and to the buyer in order to preserve a greater part of the company's cash flow for the departing owner.*

Therefore, it is imperative that your Exit Plan works to minimize the tax consequences to the business *and* to the buyer in order to preserve a greater part of the company's cash flow for the departing owner. There are several techniques we can use to accomplish this.

Minimizing ownership value of the business

The lower the price paid for the ownership interest, the fewer dollars are subject to the double-tax whammy. The first whammy is the income tax charged to the buyer (i.e., key employee, co-owner, or family member), and the second whammy is the capital-gains tax assessed against the seller (i.e., the departing owner).

In other words, for the seller to receive money for his or her ownership interest, the company must first earn the cash that the buyer pays tax on when he or she receives it. The buyer then pays that after-tax amount to the seller as partial payment for the ownership interest, and the seller (owner) pays a capital-gains tax upon receiving that money. Hence, there is a double tax on each dollar of cash flow earned by the business that is used to pay for the departing owner's interest in the company.

Create unfunded obligations

The best way to protect the business' cash flow (or "golden goose") from the double tax is to create unfunded obligations to the owner

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from the business long before the actual transfer. These obligations include the following:

- Non-qualified deferred compensation for you (the owner).
- Leasing obligations between you and the business, such as a building or equipment.
- Indemnification fees.
- Licensing and royalty fees.
- Subchapter S dividends.

Reduce risk by maintaining control

The best way to minimize a departing owner's risk of not receiving the full purchase price is to keep that owner in control until he or she receives every dollar. To accomplish this, your Exit Plan might include one or more of the following techniques:

- Securing personal guarantees from the buyer, including business and personal assets.
- Holding a controlling interest in your company until financial security is assured. One technique is to use a two-phase process in which the insiders purchase a minority interest in the business.
- Remaining involved in the company until you are satisfied that the cash flow will continue without you.

Transferring a business to children, co-owners, or key employees is a high-risk venture. The owner's ace in the hole is usually the option to sell to an outside party if the insiders/buyers are unable to fulfill their obligations.

Step Six: Develop a Contingency Plan for the Business

One of the benefits of developing an overall exit strategy is that you quickly appreciate how contingency planning is an integral part of it. Taking prudent measures so that your business survives if you don't is a natural part of the Exit Planning Process.

In an ideal situation, business-continuity needs upon the death or incapacitation of an owner can be met by a business-continuity agreement with a co-owner. However, most businesses are solely owned.

If sole owners do nothing else, they have a duty to their families and businesses to create written plans that answer the following questions:

- In my absence, who can be given the responsibility to continue and supervise the following:
  - Business operations?
  - Financial decisions?
  - Internal administration?
- How will these people be compensated for their time and, most importantly, their commitment to continue working until the company is transferred or liquidated?
- What should happen to the business upon my death or permanent incapacitation?

When owners make the decision to begin transferring their businesses, the last thing they are likely to consider is the need for adequate planning to protect the business if they should suddenly die or become incapacitated. Yet, this is precisely the point at which the business is

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most vulnerable: It has peaked in value, but the event creating liquidity (i.e., the sale of the business) is likely years away.

The remedy is usually straightforward: adequate legal documentation in the form of a buy-sell agreement or a stay-bonus program that includes adequate funding for important employees.

Step Seven: Develop a Contingency Plan for the Owner's Family

With this final Step, your Exit Planning Process comes full circle.

Review your financial objectives established in Step One: If you don't survive until your business exit, which financial resources will your family need and where will they come from? Which actions can you take to minimize or avoid estate taxes?

> *Unlike some of your lifetime objectives (e.g., financial security), Estate Planning Objectives and business-continuity objectives are relatively easy to meet upon your death or incapacitation.*

As a business owner, your Estate Plan is another part of your overall Exit Plan. Unlike some of your lifetime objectives (e.g., financial security), Estate Planning Objectives and business-continuity objectives are relatively easy to meet upon your death or incapacitation. To acquire the liquidity sufficient to meet your financial objectives, consider the purchase of life insurance and disability insurance. You may be surprised by how easy it is to meet after-death objectives using insurance.

Once owners complete the first two Steps of the Process (Setting Objectives and Quantifying Available Resources), they often jump to this final Step (preparation of appropriate Estate Planning documents and funding financial needs using insurance) so they can minimize the financial impact their death would have on their families and their companies' ability to survive.

Conclusion

All of the techniques that produce operational business success (learning from mistakes; developing business strategies based on experience, and trial and error; and conducting business efficiently and effectively) do not guarantee a successful business exit.

Sadly, the valuable experience owners develop over the course of their business lives does not equip them to leave their businesses successfully. Experience, learning, and trial and error all require time, a luxury most business owners do not enjoy as they approach the end of their ownership lives.

All this planning sounds complex and time consuming, but it does not have to be. We can help create a written and comprehensive Exit Plan that gets you the money you need, achieves all of your other objectives in a time- and cost-efficient manner, and meets the following criteria:

- Based on your Objectives.
- Includes all Seven Steps summarized in this white paper.

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- Holds you (the owner) and all advisors accountable.
- Provides a means of measuring your progress toward a successful exit.
- Imposes deadlines to ensure that you and your advisors act in a timely manner.

Armed with a written Exit Plan, a team of skilled and experienced advisors, and with (ideally) several years before you exit, you can optimize your ability to leave your business in style. If you would like more information about how we can facilitate an Exit Planning Process tailored to meet your specific objectives, please give us a call.

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