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Succession/Exit Planning – Where to begin

When you start having those thoughts about transitioning your business to your children who have been working there for some time, or selling it to an outsider, there are some initial preparations that you should start working on.

Outlined below are some initial suggestions and questions that you should think about.

Selling Inside the Family

- Most business owners will transition their company to one or more children over several years, such as three to five years. During this transition time work on paying down debt and improving profits as much as possible.

- Most parents will gift some stock to their children in order to start the process. You will need to have a valuation of the company prepared by a business valuation firm that knows your industry, such as our firm, Castle Valuation Group, LLC.

- During the transition process, if there are two or more stockholders you should work with a highly qualified corporate attorney who can prepare a buy-sell agreement, or stock redemption agreement, that protects the company and all the stockholders in case of death, divorce, disability, personal bankruptcy and termination.

- During the transition process, make sure that the next generation is involved in every aspect of the business including all financial decisions, and all of your meetings that you have with your banker, accountant, attorney, insurance agent and all other advisors.

- At the beginning of your three to five year transition timeline there are three important advisors that you need to bring together and work for you to develop this important blueprint which covers every aspect of your business transition. You will need a good corporate attorney who can help you with preparing buy-sell agreements, triple net leases, sales contracts, employment contracts and all the legal requirements for transition ownership in your state. You should have an accountant on your team that thoroughly understands your personal income tax bracket and the corporate income tax. Also, if you're transitioning stock to children it will be helpful for the accountant to know the next generation's income level, tax bracket and deductions. To design the most efficient transition plan within the family the accountant needs to know the tax bracket and financial background for not only the company, but also the sellers and the buyers. The third member of the team should be a financial advisor who has been involved in many closely-held business sales. The financial advisor can help you with negotiating the sale of the stock to the next generation, analyze all retirement income options, help the next generation with decisions about the transition, provide management for liquid retirement assets and company sales proceeds, make recommendations on changes to estate planning documents, and discuss overall family finances.

- While your team is working together on developing the blueprint for this transition there are several financial items for you to review. First, check your inventory and make sure that you know what the accurate inventory is. Do you have any obsolete or ex items? Over the next several years should the inventory be slowly increased or decreased? Also, check the accounts receivable and write off any bad debts.

- Clean up the balance sheet and make sure that the assets of the company are close to being correct and the liabilities are also proper. If a loan has been paid off then remove the entry from the liability section. Make sure that the stockholder's equity is close to being accurate.

- Talk with the accountant on your team and make sure that you understand what the cost basis of your stock is. Understanding the cost basis is very important. For example, if you sell your company for $500,000 and your cost basis is $200,000 then you will probably have capital gains of $300,000. Your accountant will work with you during the transition period to improve your cost basis and continue to analyze different ways to minimize capital gains and maximize your retirement assets and protect your net worth. The financial advisor that you choose to work with should also be involved with all of these business financial discussions. Castle Wealth Advisors, LLC helps over a hundred business owners with these financial decisions every year.

- Try to find a business and personal financial advisor that is a fee only, fiduciary, and independent just like the attorney and accountant that you have chosen for your team. The design of your financial blueprint is very important and your team needs to work for you and be paid by you.

Selling to Key Employees

- About 20% of all business owners will sell to one or more key employees because their children have chosen other careers. Sometimes key employees are the best choice for selling your company.

- As I mentioned above, during the three to five year transition period start cleaning up your balance sheet and your profit and loss statements. The key employees will need the best looking financial statements that you can provide in order for them to arrange financing from a local bank, or an SBA lending bank such as the National Coop Bank in Washington, DC or Wells Fargo Bank.

- You need the same three business advisors for this type of transaction as I mentioned above. The attorney, the accountant, and the financial advisor that you chose will help you put together a blueprint to transition the business to your hand-picked key employees. If you have questions about how key employees could purchase your company, please contact Castle Wealth Advisors, LLC.

- When selling to key employees there are many ways to design the sales contract. Sometimes consulting contracts, or non-compete agreements, are considered. Sometimes the owner would sell 20% to 25% of the stock to the key employees by using a promissory note and the SBA lending bank would normally finance about 80% of the sale.

- As mentioned above, make sure that the one or two senior employees are completely familiar with every aspect of the business including all the financial statements and tax returns. During the transition timeline try to include your key employees in all meetings held with banks, attorneys, accountants, insurance agents and all vendors.

- Larger employers with at least 50 to 75 employees may consider an employee stock ownership plan (ESOP). These types of plans do not work for everyone, but it should be considered by your advisory team if you have a larger business.

- Sometimes if all of the employees want to be involved in the ownership then a worker cooperative could be put together by the employees to buy out the owner. This type of worker coop should be considered by your advisory team.

<u>Selling to an Outside Buyer</u>

- Usually, about 30% to 40% of business owners will sell to another company in their industry.

- If there is real estate involved, the buyers will either want to purchase the real estate or make sure that there is an existing triple net lease that they can assume. All of the lease terms should be based on market conditions for your city or market area.

- During the due diligence process the buyers will want to see the last two or three years tax returns and business financial statements. This is why cleaning up all of these documents during the last three to five years is so important.

- These types of buyers are going to be looking at the assets to be purchased. The seller will normally keep some of the assets such as cash in the corporate checking account, patronage stock from their purchasing coop, if there is any, and personal vehicles. All other assets that the sellers want to keep will need to be outlined in writing.

- The buyer will also be looking at the gross sales, the gross margin, and the total adjusted EBITDA that they will have to work with. Purchasing assets is important, but for most buyers the amount of usable cash flow is more important than the assets. This is why increasing your gross margin and reducing expenses the last three to five years is so important.

- The purchase price for the company is usually the number one item that is talked about. The number two item is a discussion about all of your well-trained employees. Make sure that all of the managers and department specialists have the best up-to-date training. Having well-trained employees that are good with customers makes a company more valuable.

- In the last 12 to 24 months make sure that the facility that you are located in is updated, modern and clean.

- There are many ways to negotiate the sale of your business to someone within your industry. During the last three years before you sell the company make sure that your advisory team reviews several options with you.

- If you have a C corporation the terms for selling your company may be different than if you have an S corporation, or an LLC.

- Make sure that your advisory team is prepared to answer all of the normal due diligence questions that a buyer may ask.

- Try to spend at least two to three hours with your advisory team every year during the last three years before you sell the company. Talk about any new tax laws, the economy, potential buyers, or new selling options that they may come up with for you. If you have business or personal financial questions, Castle Wealth Advisors, LLC is ready to help.