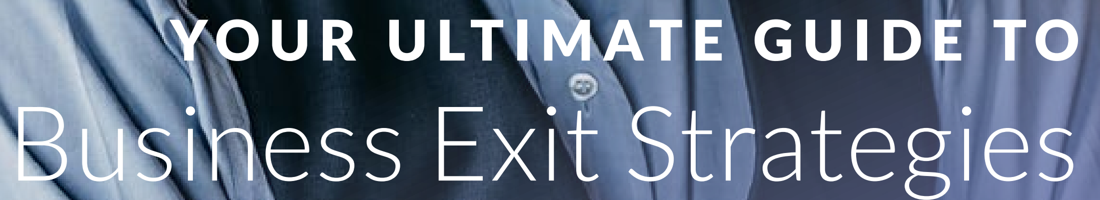

Top Succession Plans for Owners

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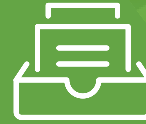

Introduction: What is an Exit Strategy & Why Do You Need One?

What is a business exit strategy?

Most business owners would agree that a company's success or failure, at least in part, depends on the strength of the plan. The same can be said for the transition out of business ownership and the importance of choosing the right succession plan for your company.

Your exit strategy roadmap will likely be unique to your business and your needs. For some, that means winding down a business entirely — but it doesn't have to. There are many options for selling your financial interest and liquidating your investment. Indeed, maybe your original exit strategy was part of your initial business plan, but things have changed.

It's important to recognize that as circumstances change, your business exit strategy may also need to be adjusted. No one lives forever — but knowing you established, cultivated, and grew a business that can outlive your active, sole management should be considered a badge of success as an owner.

Plus, a planned exit is typically better than the alternative — so your first step on this important journey is choosing which roadmap you'll follow.

Why do I need a business succession plan?

Just as every business owner has their own reasons for starting a company, they can have different reasons for leaving. Your reasons can affect your exit strategy, and may include:

- Crisis — this can involve health, family, personal, and even financial crises, or a combination of several
- Economic recession or changes to the marketplace
- An enticing acquisition offer from a competitor or other third party
- On the horizon, a desire for a fulfilling end to a satisfying career
- And more

Planning ahead empowers business owners to take the time and carefully consider all available options, to make a rational decision on how to make a business exit. Before choosing a strategy, it's important to ask yourself what you want and expect from your business exit.

The most successful, and often most rewarding, exit strategies are carefully planned to create a fulfilling exit experience for the business owner and a promising future for the company and its employees.

Before You Decide **On Your Exit Strategy**

What do you want from your company sale?

Before you commit to a planned exit strategy, it's important to reflect on not only your reasons for preparing a succession plan, but also your expectations for the outcome. To get started, consider:

- Do you want an ongoing role in leading, managing, or working for the business?
- What are your liquidity needs?
- Are you aware of the actual market value of your business?
- Who is your source of advice, counsel, and support as you evaluate, choose, and execute your succession plan and exit strategy?

More than half (52%) of small business owners expect to use their business as a main source of funding for their retirement — yet only 20% have a formal succession plan in place.[1] An effective exit strategy helps ensure business owners achieve the following objectives:

- Maximize business value
- Maximize liquidity
- Minimize tax liability
- Help control the transition out of the business
- Help support a good life in retirement
- Feel reassured about handing off the business to qualified leadership
- Create and leave behind a legacy
- Preserve family and business goodwill

Commitment to a successful exit and business transition requires the same level of care, consideration, and attention to detail that goes into building a successful business in the first place.

A Non-Sale Exit Strategy: The "Lifestyle Company" (see also Liquidation, Walkaway)

For some people, the easiest choice is not choosing at all.

Lifestyle company owners pocket profits instead of investing back into the business, wind down the company, and close the business when it no longer turns a profit. Employees are terminated. Assets are sold at market value, debts are paid, and any remainder can be reinvested for retirement, or into the next endeavor.

Risks include:

- Quality and operational issues due to lack of investment
- Damage to reputation and relationships
- Accelerated timeline

Options For **Selling Your Business**

Third Party Sale

Selling a business on the open market is an option that's typically attempted by many small business owners, and some have success. For those without a successor, such as children or employees with an interest in taking over, a third party sale may seem like the obvious option.

That said, the open market can be challenging, especially as many baby boomers are in the transition to retirement. In addition, a third party sale can be complicated and require a comprehensive and holistic exit plan that includes stay-behind agreements for key management or other employees, shareholder rights agreements for investors, tax strategies, inventory valuation, market assessments, and much more.

Another complication to outside third party sales is timing. It can take years to find a buyer who is willing and able to meet a seller's expectations for pricing — and that's just the beginning of a sale process that can be complicated by financing, timelines, multiple parties' interests, and more. The majority of businesses that attempt to sell this way don't succeed.

30 to 40%

of businesses that put themselves up for sale actually execute a final sale.[2]

Initial Public Offering (IPO)

In an IPO, an owner sells stocks in the business to the public for the first time. IPOs get a lot of attention, but that doesn't mean they're a good fit for every business. The IPO is typically a strategy reserved for larger businesses that can validate their attractiveness to institutional investors with very detailed and involved accounting processes.

Going public subjects your company to significant regulatory requirements for reporting and transparency under the Sarbanes-Oxley Act, and it also means that you no longer serve only your company vision; in a sense, investors become your new boss.

The regulatory demands and growth required to justify an IPO are not for every business, so if an IPO is on your list of possibilities, dig deep to make sure you understand the requirements, not just at the time of the IPO, but over the life of the business thereafter:

- Business owner's shares may be subject to a lock-up period after the IPO
- Earn-out period could be several years
- Market conditions and appetite for IPOs can influence stock price
- Significant investment into marketing and public relations may be needed well in advance of an IPO
- Preparations for selling the company may leave little time or energy to manage the business
- May require corporate reorganization
- High transaction costs

Mergers & Acquisitions

Mergers and acquisitions are often referred to together, as though they're interchangeable. In fact, they are quite different.

A merger is the combining of two or more businesses into a single entity. Often in a merger, you remain a part of the business, though in some cases, management succession plans may enable you to execute the merger and exit the company.

There are different types of mergers:

- Horizontal (a company in the same industry)
- Vertical (a company in the same supply chain)
- Conglomerate (companies may have little or nothing in common)
- Market extension (same products/services in different markets)
- Product extension (complementary products)

A merger can lead to a considerable loss of control over the company, and may not really be an effective strategy for a controlled exit.

In an acquisition, an outside company, which can range from a competitor to an investor, buys the company outright. The owner negotiates the sale and walks away. Liquidity is the main benefit of an acquisition, and in the case of a strategic acquisition, the company could be purchased for a much higher price than any other buyer may offer.

But for business owners who want to control their exit and participate in the company's ongoing growth and development, it's important to keep in mind that acquisition may exclude them from a future with the business they worked hard to cultivate and nurture. The same goes for employees — the acquiring business, after the sale, can do what it wants.

Mergers and acquisitions also have a failure rate of 70-90%, with a lot of the difficulty experienced in balancing buyout price and company vision.[3] When operational models and business cultures aren't well matched, the outcome can be dire for a business.

Is Your Company a Good Prospect for a Buyer?

- Increasing revenue and profit
- Potential for future growth
- Clean financials
- Stable management
- Good employee retention
- Reputation for quality
- Marketing and sales performance
- Low risk to buyers
- Operational systems and processes are in place, documented, and followed

Friendly buyout: Selling to family, friends, employees, etc.

The sale of a business to, for example, a child or children of the owner, is not uncommon. But it's also not without risk, including risks to long-term personal relationships.

Combining money and friendship can be fraught. Complications can arise over price, financing, timelines, and much more. In the interest of protecting feelings and relationships, the buyer can risk undervaluing the company.

Circumstances can also change over the course of the sale, and while you may think your plan includes staying on as a leadership employee, there's always the risk that it may not work out. In the worst-case scenario that family members purchase the company and manage it into failure, resentments can last a lifetime.

Management buyout:

Some successful buyouts involve selling to the next generation of company management. Ideally, that means carefully planning for succession, preparing leaders for what's to come in their roles after taking the helm to make sure employees experience a smooth transition to new ownership,

It also may take time to work collaboratively through a financing agreement with management team buyers. Often, the seller finances the sale and the buyer(s) make payments over time. This can be a win-win, since the business owner typically stands to make more money than they would if winding down and selling off assets — and purchasing employees can earn their way into ownership over time. But for a seller who wants to quickly liquidate their position, the longer financing terms may not be an attractive option.

ESOP: Employee Stock Ownership Plan

An ESOP is another way a company owner can sell, and establish employee ownership of all or part of a company — by setting up an ESOP trust, which becomes the legal entity that holds shares of company stock on employees' behalf. The company contributes funds to the trust (or the trust borrows funds), and the trust uses those funds to purchase some or all of the company's shares, depending on the percentage of financial interest the seller wants to liquidate.

The result of this purchase is liquidity to the seller, with significant tax savings. The portion of a company owned by an S corporation ESOP is not subject to federal or state income taxation, as the ESOP shareholder is a tax-exempt entity. So, if a business owner sells 100% of an S corporation to an ESOP, that company is not subject to federal or state income taxes. The unique tax advantages of an ESOP can help the company maintain healthy cash flow, which may help support a successful transition of ownership.

While the seller is no longer 100% owner, they may choose to continue working and enact a longer-term exit strategy that allows continuity of leadership and an orderly, planned succession for management. Because there's no disruption to business, employees and customers alike experience a secure, smooth transition and continuity of company culture. In addition, the ESOP is also an attractive qualified retirement benefit plan.

Setting up an ESOP company can be complex, and is subject to specific regulations. So it's not a DIY plan — it requires specialized advisors, a designated fiduciary trustee, and third party management for the long term, so it's important to partner with a team that understands ERISA regulatory requirements and the legal and business complexities you may encounter. But an ESOP also provides a predictable timeline for the sale, immediate liquidity, and mechanisms to provide assurance that you'll get a fair price for your company.

Learn more about the potential business, tax, and retirement advantages an ESOP could deliver to your succession plan in Key Benefits of Incorporating an ESOP in Your Business Exit Strategy.

What **Comes Next?**

As you evaluate your options for selling your business and planning your exit strategy, it's important to also evaluate the company. Consider whether you're a fit for various options based on the following variables:

- Business size and structure
- In-depth and accurate financials
- Economic and market conditions
- Profitability and prospects for growth and future success
- Entrepreneurial employees, friends, family members
- Competitors
- Time horizon for your exit

It's also worth taking the time to reflect on your goals, and consider the importance of factors in your business sale decision. To start, here are a few questions to ask yourself:

? How quickly do I need to liquidate my financial interest?

? How important is controlling my own exit?

? How comfortable am I handing off the company to an outside third party? To a competitor?

? How would I use an opportunity to put a management succession plan in place?

? How important is leaving behind a healthy, thriving company culture for my employees?

? How interested am I in potential tax savings on the sale?

Mistakes to Avoid

1. While you don't want to jump into a sale you're not ready for, procrastinating won't help, either. Opportunity costs are real, and your mindset can impact the price you're willing to accept, so even if your horizon is longer, it makes sense to start planning sooner, not later, so you don't allow yourself to feel overwhelmed or out of control in the process.

2. Failing to plan can also have an impact on the performance of the company after the sale.

3. Skimming over the details. Due diligence is the foundation of success for all parties involved.

4. Don't forget due diligence when it comes to your consultant or advisory team. It's essential to know that the partner you choose is an expert with a successful record in the type of transition you choose.

What Now?

It's important to remember that you don't need to decide today — but in order to continue moving your exit strategy and succession plan forward, you do need to pursue a decision.

That means going deeper to evaluate and prioritize your top options, and to get advice from qualified experts not only to understand how to move forward, but to validate your planning and ensure that, whatever path toward selling your company you pursue, you do it in a way that's fully compliant with regulatory requirements, and that best benefits you, your business, and your employees over the long term.

SOURCES
[1]SunTrust, Building a Template for Transition, no date.
[2]Investment Bank, Only 30 to 40% of Businesses Actually Ever Sell.
[3]Harvard Business Review, The Big Idea: The New M&A Playbook, 2011.

Contact Us

You can investigate many of the potential benefits of selling your business by creating an ESOP company when you download our ebook, **Key Benefits of Incorporating an ESOP in Your Business Exit Strategy**. The ebook goes into deeper detail explaining the tax advantages, quick path to liquidity, and many more benefits an ESOP can deliver to you, your company, and your community. Just click the link to learn more.

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