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Succession Planning

BRIAN K. POLLACK, CPA

Topics we will cover

- Growing the financial strength of your business
- Transferable value
- Why strategic/succession planning is important
- Different types of succession plans
- Understanding the due-diligence process in a third-party transaction
- Valuing your business
- Types of sale transactions

“The reward of succession planning is the final test of greatness for the business owner. If it is present in your organization, it will hardly be noticed. If it is not present, it will destroy your company and may cause your family extreme financial loss and hardship.”

Peter Drucker

“Designing and implementing an exit strategy is a business owner’s final and most important project. Many business owners do not realize how much time and energy is needed to create a comprehensive and effective business succession plan.”

Stuart Phoenix, FMI

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5 Keys to Prosperous Growth

1. Vision & Values: Understanding what business you are in and why
2. Perpetuation: Institutionalizing ownership for succession planning and generational growth
3. Balance sheet strength
4. Capacity: Infrastructure-growth relationship
5. Best of Class: Rate, Level, Pace…Are you a mature company?

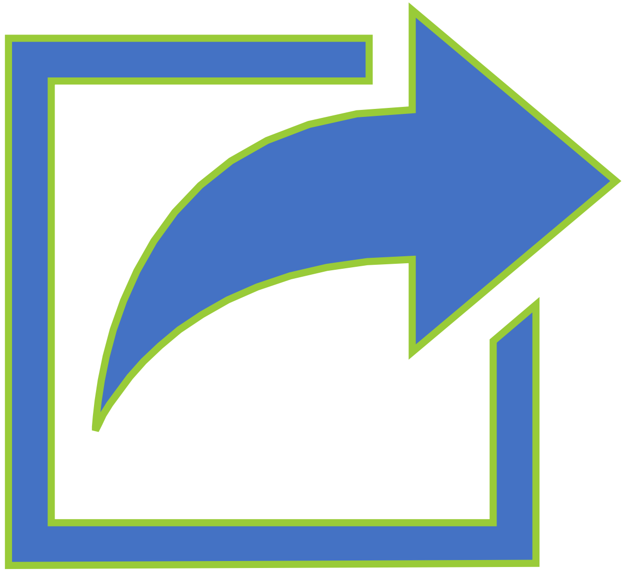
Empowering Staff

Do you have Transferable Value?

"The ability to transfer that business, along with the related profits, to another. If the profits of a business cannot be transferred to another, then the value of the business is most likely in the underlying assets of the business."

David A. Enger, Business Banking Institute

Do you have Goodwill?



Creating Transferable Value

- What are our company's values? Do employees know and live these values?
- What are the capabilities of my personnel? Do I have the right people in the right positions?
- Does the business have capacity or is everyone working 12 hours per day?
- Can the employees fill in for me while I am on vacation or does work come to a halt when I leave the office?

Do you work *in* or work *on* your business?

Are key employees responsible for financial results?

Do they really understand how their decisions, or lack of, can affect the company's financial position?

Fundamentals of Succession Planning

- When does the business owner plan to retire?
- What does the business owner need financially to retire?
- Does the owner want the company to remain private or be sold to a third party?
- If the owner wants the company to remain private, who are the future leaders and when will they become owners?
- To whom and when will control and voting power be given?
- What level of training and development do the business owner's successors need?
- What will be required of the business owner for indemnification purposes?

I want to sell but… to whom?

- Do I sell to family and/or employees?
- Do I sell to an unrelated third party?

Most business owners are surprised that they really only have three choices for ownership transfer:

1. Sell the company,
2. Give the stock away, or
3. Liquidate the assets

Selling the Company: Employees/Family Members

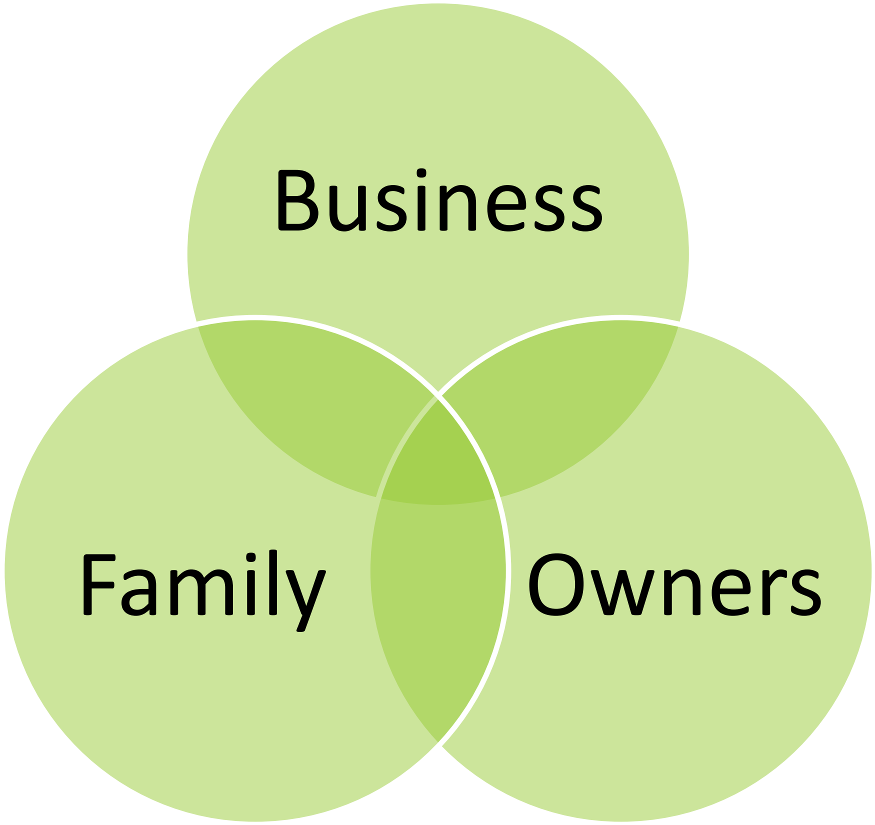
- Surveys indicate that the majority of private businesses end up cashing out by selling their firms to key employees or family.
- The buyers should be individuals who have a direct impact on the firm's day-to-day operations and profitability.
- A substantial portion of the sales proceeds will come from the company.

In most cases, one of the following techniques is used in an internal sale:

1. Direct sale from company
2. Stock redemption from the current owners
3. Employee stock ownership plan (ESOP)
4. Brother/sister companies
    - New company starts while old company winds down and eventually liquidates

Transferring ownership to family

The process of merging the family and business systems is a difficult one that requires a unified commitment and collaborative effort from all family members.



The 25-year Family Business Death Trap

1st Gen | 1st Gen | 1st Gen | 1st Gen | 1st Gen | 1st Gen

2nd Gen | 2nd Gen

3rd Gen

Life expectancy for the typical family-owned business is 24 years, a phenomenon often called the “25-year death trap”.

For every two family businesses that continue into the second generation, four do not.

Of the two that succeed, only one survives into the third generation.

Why?

Transferring ownership to family

- Do you have the patience and temperament to be a good teacher?
- Do you regard teaming up with your adult children as an obligation or an opportunity?
- Are you capable of treating your child as an adult?
- Are you ready to loosen your hold on the business?
- Is your son or daughter really qualified for the job?
- Is your child respected by top non-family management?

Selling the Company:
Outside Unrelated Third Party

- Seller is usually substantially cashed-out at closing, and ongoing financial risk and liability are reduced.
- Business continuity and management succession issues become the new owners' concern.
- The owner is generally required to remain with the company for a transition period.
- A third-party sale is often the best alternative when a buyer can be found. Do you know a "strategic buyer?"

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What should you do if you want to sell your company to an unrelated party?

Before the Transaction

Consider business advisors that specialize in company transitions (M & A)

- Do you hire a business broker or investment banker? They serve as the quarterback of the transaction and coordinate all the players, including the owner(s).
  - Allows the owner to stay focused on the day-to-day business operations.
  - Do <u>not</u> sign any contract or exclusivity until reviewed and approved by counsel.
- Attorney/Legal team who specializes in M & A transactions
- Accounting professionals who understand the financial and tax ramifications of M & A transactions
- Financial investment advisor
- Estate attorney

Preparing your company for possible sale

- Have a clear understanding of your options
  - Refer back regularly. They may, and will, change over time.
  - Implement a strong active governance team.
- Highly consider getting a "legal audit"
  - Do you have all your business entity documents and are they up to date? Including:
    - Corporate/Partnership structure
    - Buy-sell agreements
    - Employment contracts
    - Tax elections
    - Stock ledgers
    - Corporate minutes
    - JV arrangements
- Any ongoing or potential litigation issues
- Review current governance. Consider creating an advisory board.
- Identify and reduce business risk
- Get understanding of unfunded obligations

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Preparing your company for possible sale

- Review your internal accounting and financial systems and make changes accordingly.
  - Having a strong controller or CFO is critical during the due diligence process. ***This can make or break a transaction.***
  - "Consider" upgrading to an audit, if not already
  - Get rid of the skeletons
  - Need to be able to produce accurate GAAP monthly financials on a timely basis
- Size does matter in a sale
  - Higher enterprise value the larger you are.
    - More desirable with a VC buyer
    - Improved overall controls, procedures and policies
    - Better depth and knowledge of people and technology
    - All of this leads to greater "transferrable value"

Understanding Transaction Terms

Understanding some critical terms in a transaction:

- SPA, APA or MIPA?
  - Stock Purchase Agreement, Asset Purchase Agreement, Member Interest Purchase Agreement
- EBIT - Earnings Before Interest and Taxes
- EBITDA – Earnings Before Interest, Taxes, Depreciation and Amortization
- Normalized EBIT or EBITDA
- Multiple
- LOI (Letter of Intent)
- Trailing 12's
- Cash free/Debt Free
- Debt (do not underestimate what this <u>may</u> mean)
- 1202 Stock
- Anti-churning rules
- Working Capital
  - Contract definition
  - Working Capital Target
  - Closing Working Capital
  - Final Working Capital (60 to 90 days after sale)
- Q of E (Quality of Earnings)
- Earn-Outs/contingencies
- Escrows
- Collars or buckets
- Reps and warranties
- Data room
- Due diligence (legal, financial, operational)
- "F" reorganizations

Calculating Modified EBITDA

Net income		1,000,000
Add back:		
	Interest	25,000
	Taxes	50,000
	Amortization	10,000
	Depreciation	150,000
		235,000
EBITDA		1,235,000
Normalization		
	Rent	35,000
	Officer comp	150,000
	Office fringes	15,000
	Donations	50,000
	Other	50,000
		300,000
Modified EBITDA		1,535,000

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$$V = \frac{B}{R}$$

$$\text{Value} = \frac{\text{Benefit}}{\text{Risk}}$$

Valuing the Business

	Example 1	Example 2	Example 3
Modified EBITDA	$ 1,535,000	$ 1,535,000	$ 1,535,000
Multiple	4	5	6
	6,140,000	7,675,000	9,210,000
Add Cash	1,250,000	1,250,000	1,250,000
Less "Debt"	(350,000)	(350,000)	(350,000)
Plus(minus) Working Capital adjustment	-	-	-
Expected cash flow from transaction	$ 7,040,000	$ 8,575,000	$ 10,110,000

What is better: stock sale or asset sale?

Generally, buyers prefer to purchase the assets of an existing business while sellers normally prefer to sell the stock.

Why?

Comparing asset and stock purchases: Buyer's perspective

FACTORS FAVORING ASSET PURCHASES:

1. Buyer is protected from unknown or contingent liabilities
2. Allows the buyer to purchase only the assets desired
3. Buyer can allocate the purchase price to the assets acquired
4. An asset purchase allows the buyer to avoid minority shareholder problems that could arise with a stock purchase.

FACTORS FAVORING STOCK PURCHASE:

1. Valuable contract rights (leases, contracts, franchises, etc.) will usually be unaffected by a stock purchase.
2. Subject to some limitations, but may be able to utilize tax attributes such as net operating loss carryovers
3. Generally, can retain favorable employee collective bargaining agreements or insurance ratings
4. Buyer retains the seller's corporate name
5. Stock sale will avoid disputes between the buyer and seller over the allocation of the asset purchase price to specific assets.

Comparing asset and stock purchases: Seller's perspective

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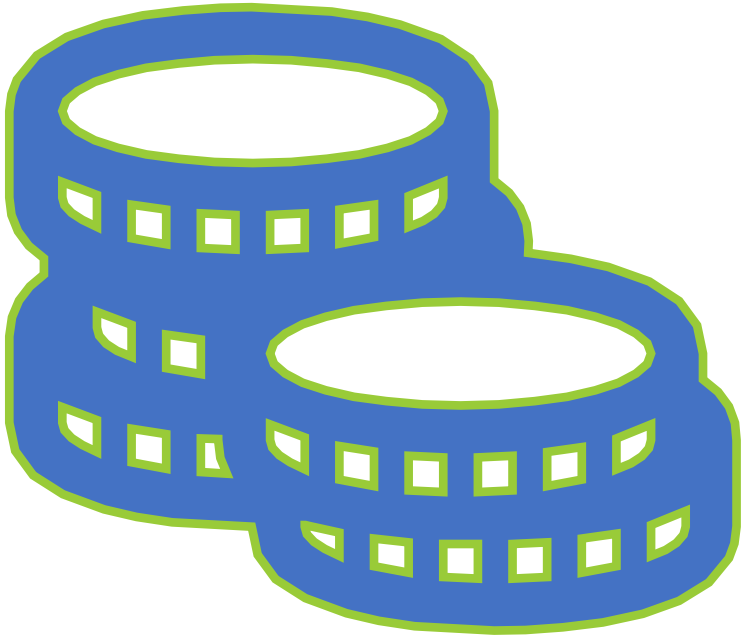
FACTORS FAVORING STOCK PURCHASES:

1. Shareholders generally realize capital gain when they sell stock. Maximum tax rate for long-term gain is currently 20%
2. Shareholders can avoid the "double tax" that can result in an asset sale followed by a corporate liquidation (C corporation issue)
3. If the transaction involves an S corporation, a sale of stock can avoid seller problems caused by "inside/outside basis differences."

FACTORS FAVORING ASSET PURCHASES:

1. The seller is a corporation that can use any unused NOL's or capital loss carry forwards that can offset any corporate-level gain

How do I get paid for selling my company?



- Cash
- Cash and note from buyer
- Cash and note from company (if redemption)
- Earn-out provisions
- Deferred compensation/pension
- Covenant not to compete
- Gifting (give it away)
- Combination

Brian Pollack, CPA
Lanigan, Ryan, Malcolm & Doyle, P.C.
301.258.8900
bpollack@lrmd-cpa.com
www.lrmd-cpa.com

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MAXIMIZING THE VALUE OF YOUR BUSINESS: *Succession Planning*

Andrew L. Schwartz, Esq.
301-838-3327 direct
aschwartz@steinsperling.com

1101 Wootton Parkway, Suite 700
Rockville, Maryland 20852
www.steinsperling.com

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April 27, 2021

What Type of Exit Are We Planning for?

- Sale to a third party
- Transition to employees or management
- Transition to family members
- Close the doors

Internal Succession

- Attracting New Talent
- Cultivating Existing Talent
- Incentivizing and Keeping Talent

Establish a Development Plan

- Skills, traits and values
  - To succeed and contribute to long-term success
  - To be considered for future ownership
  - Criteria must be objective and measureable
    - Experience level
    - Tenure with the company

Key Employees

- Develop:
  - Identify skills and traits needed to contribute to goals of the business
  - Teach, develop, measure progress, provide feedback
- Incentivize:
  - Bonus Plans
  - Phantom Equity
  - Stock Options
  - Profits Interest
  - Equity

Stock Options

- Gives employee the right to buy a certain number of shares at a fixed price in the future
- Grant price is today’s fair market value
- *Non-Qualified Options:* Company gets a deduction and employee is taxed upon exercise on the difference between the exercise price and then-value. Can do single agreements.
- *Incentive stock options:* No deduction for the company and no tax consequence to the employee upon exercise. Employee has to hold for the latter of 1 year before sale and 2 years from grant to obtain capital gains treatment. Must have plan document.

Restricted Equity Plans

- Grant or buy-in
- May be subject to vesting
- Value of equity and methods of payment
- Voting or non-voting
- Participate in management or not
- On termination of employment, stock is typically repurchased

Employee Stock Ownership Plans

- Employee benefit plan
- Trust is created to purchase departing owner's equity
- Trust usually borrows to fund the purchase price
- Employees have an interest in the Trust and are bought out on departure
- Expensive to administer

Restrictive Covenants

- Confidentiality
- Non-Competition
- Restrictions regarding Clients, Workers, Vendors

Exits No One Wants to Plan for

- Death
- Disability
- Departure
- Dispute

Contingency Planning for Majority Owners

- What happens if majority owner dies or becomes disabled?
- “Hit by the Bus” Plan
  - Revocable Trust
  - Owner as Trustee
  - Substitute Trustee acts as Board to operate, sell, liquidate

"Hit by a Bus" Considerations

- Family's financial security
- Existing talent within the business
- Maintaining the value of the business

Creating a “Hit by a Bus” Plan

- Purchase and/or sale of your interests
- Revocable Trust with successor Board of Trustees
  - Identify people with diverse expertise
  - Set time period to sell or liquidate interests
  - Allow time extensions with beneficiaries’ consent

Creating a "Hit by a Bus" Plan

- Company/key employees to purchase certain ownership interests
  - Agreements should address management, ownership, dispute resolution, transferability of ownership and other issues
- Maintain flexibility to anticipate change with time
- Long-term development

Transferring Ownership

The Next Generation

Obstacles

- Losing control
- Parting with the asset, reducing personal cash flow
- Facing mortality, “closing chapter”
- Dealing with unpopular family decisions
- Avoiding friction with family members “vested” in the ownership of the business

Practical and Business Concerns

- Long-term viability
- Family members
  - Qualifications, capability, willingness of those who WILL be involved
  - Protection or consideration for those who WON'T be involved or have special needs
- Dispute resolution

The Ownership Agreement

- Must reflect decisions made as part of the transition plan
- Must spell out:
  - Governance and management
  - Restrictions on transferability of ownership interests
  - Employment
  - Management compensation
  - Dispute resolution
  - Other issues commonly addressed

External Transaction

Readying a business for sale to a third party

Initial Planning

- Planning + Preparation = Success
- Identify your inner circle
  - Trusted advisors
    - Attorney, CPA, wealth advisor, banker, broker, mentor, spouse
  - Meet and confer
    - Set up formal meetings
    - Write an agenda, set goals
  - Clean up your house
    - Financials, ownership, employee, customer

Essential Information

- Financial statements
- Tax returns
- Key customer contracts
- Employee agreements
- Non compete
- Leases
- IP
- Accts receivable aging
- Accts payable
- Industry information
- Organization chart

Know the Value of the Business

- Be aware of what the business is worth
  - What does it generate to the owner?
    - Base
    - Perks
  - Do the books reflect accurately?
  - How well is the business structured?
    - Profitability
    - Management
    - Products and pipeline

Know the Industry

- Expanding or contracting?
- Are business sales taking place?
  - What
  - Terms
- What outside forces are risk factors?
  - Government regulation
  - Competition
  - New products
  - Reduction in demand

Consider Strategic Exits

- Who are potential buyers?
  - Private equity/public market
  - Consolidators/Roll Ups
  - Competitors
  - Employees
  - Other owners (consolidation of ownership)

How to Find Them

- Network
  - Industry networking
    - Be present
    - Consider joint venturing (to test the waters)
    - Friendly competitors
  - Trusted advisors
  - Brokers

Now That You Are Ready

- Prepare before you market
  - Have team in place
  - Non-disclosure agreement
  - Outline your wish list
    - Not just price
    - Structure(s) – Lots of options
      - All cash, all stock, mixture
      - Earn out
      - Asset sale, stock sale
      - Equity infusion

Be Prepared for Word to Spread

- Impact on Employees
- Impact on Customers
- Impact on Competitors

Contract Process

- Devil in the Details
  - Representations and Warranties
    - Exhibits
  - Indemnification
  - Escrow
  - Adjustments
  - Consents

Timing

- Transaction timing: Marketing through closing
  - Due diligence
  - Study period
  - Consents
  - Closing
- Intrusion in your business cycle?
  - Impact on pre-closing performance