MAPPING A TRANSITION PLAN

How a Houston CPA Firm Can Help Navigate

REYNOLDS
AND ASSOCIATES

INTRODUCTION

A popular quote that many business leaders can relate to is: “Work on your business, not in your business.” It’s a phrase that owners specifically appreciate as it helps them stay focused on leading as opposed to doing.

One component of working on your business includes business transition planning. Specifically, identifying potential partners or buyers of your business can help to guide your long-term personal planning and goal development.

There are so many important factors to consider, and we created this guide to provide some basic expectations and subtle guidance and recommendations to help business owners who are ready to map out their own business transition plan.

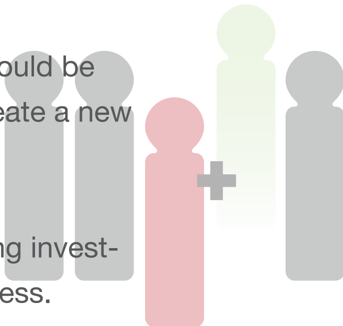
FOUR COMMON SCENARIOS

When it comes to ownership transition plans, no two situations are exactly the same. While this is not an all-encompassing list, we have worked with numerous companies over the years, and have identified four common scenarios:

1

OWNER STAYS INVOLVED, AND TAKES ON A STRATEGIC PARTNER

The owner has grown the company as far as they can or desire, and could be looking for an infusion of capital to expand into additional markets, create a new product line, or expand and improve the management team.

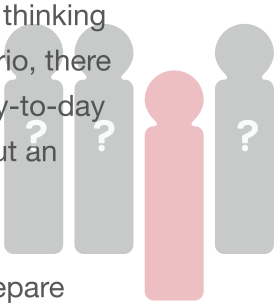


Additionally, the owner(s) are ready to reap some return on their existing investment, and still have an interest in staying involved in running the business.

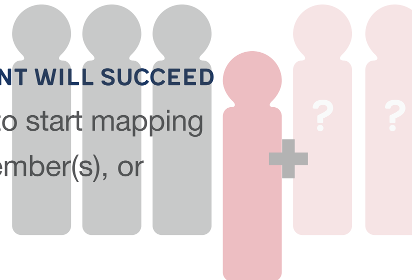
2

OWNER PREPARING FOR RETIREMENT, NO OBVIOUS PERSON TO SUCCEED

The owner is approaching their desired retirement age and wants to start thinking about what they’re going to do with the company. However, in this scenario, there are no family members or experienced employees who are part of the day-to-day operations that seem like obvious people the owner could approach about an ownership transition.



The owner is seeking guidance about what they should do to begin to prepare themselves to be attractive to an outside investor or buyer.



3

OWNER PREPARING FOR RETIREMENT, FAMILY OR SENIOR MANAGEMENT WILL SUCCEED

The owner is approaching their desired retirement age and wants to start mapping out a transition plan to family member(s), senior management member(s), or possibly a combination.

FAMILY MEMBER(S)

From our experience, in this case there is typically very little communication that has taken place between the owner and the family member(s) so there are expectations that have to be set.

Often, the owner's child(ren) think the parent is simply passing the business to him/her/them, but from the parent's perspective, they expect to get some financial benefit from what they have invested/put into the business.

SENIOR MANAGEMENT MEMBER(S)

This can be an easier transition, but the challenge is finding competent and willing senior management member(s) who are financial able to purchase the company.

TIP: MINIMIZING TENSION

HAVING A TRUSTED THIRD PARTY INVOLVED WHO CAN AID IN THE DISCUSSION BETWEEN FAMILY MEMBERS AND / OR SENIOR MANAGEMENT MEMBERS WHO ARE ACTIVELY INVOLVED IN THE CURRENT BUSINESS TYPICALLY ADDS A LOT OF VALUE AND MINIMIZES EMOTIONS AND POTENTIAL FOR HUGE MISUNDERSTANDINGS AND TENSION IN THOSE RELATIONSHIPS.

In either situation, there are multiple solutions, including gifting, owner financing, buyer sourced financing, or even debt created for the company to transition ownership can be discussed.

4

OWNER DISSOLVES THE COMPANY

This scenario is the most rare. After spending years building up value, most owners seek to capitalize on their hard work and realize a financial gain.

But, in some cases, the business owner decides to wind the company down and dissolve all assets.

TIP: SETTING EXPECTATIONS

BEFORE YOU START, IT'S CRITICAL THAT THE OWNER(S) HAS SET SOME EXPECTATIONS ABOUT THE TRANSITION PROCESS. IN AN OWNER'S DREAM SCENARIO, YOU CREATE AND GROW A BUSINESS, DECIDE TO EXIT, AND THEN CASH OUT WHEN YOU ARE READY TO RETIRE AND/OR MOVE ONTO ANOTHER VENTURE. SOUNDS SIMPLE, RIGHT?

THE REALITY IS THAT EVERY OWNER, REGARDLESS OF THE CIRCUMSTANCES, WILL FACE CHALLENGES THROUGHOUT THE TRANSITION PROCESS. NOT BEING ABLE TO IDENTIFY THE PROPER BUYER, NOT GETTING THE DESIRED PURCHASE PRICE, THE PROCESS TAKING MUCH LONGER THAN EXPECTED, HAVING TO START/RE-START NEGOTIATIONS, AND MISUNDERSTANDINGS AND MISCOMMUNICATIONS ABOUT INTENTIONS ARE EXTREMELY COMMON.

HAVING AN EXPERIENCED PROFESSIONAL LEADING THE PROCESS CAN ADD A LOT OF VALUE, AND HELP CREATE SMOOTH TRANSACTION.

BUSINESS TRANSITION PROCESS

As mentioned at the beginning, no two situations are exactly the same. But in the spirit of setting expectations, here is an outline of the overall business transition process.

INDEPENDENT VALUATION

SCENARIO ASSESSMENT

QUALIFYING POTENTIAL BUYERS

NEGOTIATIONS

CLOSING

Tip: Get financial statements in order prior to conducting the independent valuation. It's like staging a house for sale.

Tip: Begin setting expectations and preparing potential buyers.

Tip: Have patience and have your thresholds and potential scenarios documented for easy reference.

Tip: Start no later than three years out from your desired exit.

TIMELINE

0 YEARS

1-2 YEARS

2-3 YEARS

Tip: Develop reports (market analysis, key metrics) that the potential buyer would find valuable.

STEP 1: INDEPENDENT VALUATION

The owner should hire a firm to do an independent valuation, which is designed to help set a marker for the owner (typically some multiple of EBITA, based on an industry standard for the business. If there are valuable assets such as patents or trademarks, separate valuation will be necessary to arrive at an estimated value for the enterprise .

TIP: QUALITY IN, QUALITY OUT

A POTENTIAL BUYER WILL LIKELY EMPLOY A DUE DILIGENCE TEAM TO COMPLETE THEIR OWN VALUATION STARTING THE EXAMINATION OF THE FINANCIAL STATEMENTS THAT THE SELLERS CPA FIRM PREPARED HISTORICALLY. THE MORE CURRENT AND COMPLETE THOSE STATEMENTS ARE MORE CONFIDENT THE BUYER WILL HAVE WITH THE FINANCIAL STATUS OF THE SELLER AND THE FASTER THE BUYER REVIEW PROCESS CAN BE ACCOMPLISHED.

STEP 2: SCENARIO ASSESSMENT

The CPA firm will create various transition models for the owner to review, including the income tax effects under the different scenarios. There will be pros and cons for each scenario, and an experienced team of professionals (CPA, attorney, etc.) can help to set appropriate expectations for each model.

It's critical for the owner(s) to really take time to think through their personal goals, and evaluate best-case and worst-case scenarios. This is another area where an experienced professional with a strong grasp of the owner's goals and personal financial standing will not only help in the assessment of the pros and cons for each scenario, but also in giving specific recommendations about the thresholds that make the most sense for the owner(s).

EXAMPLES OF THINGS FOR THE OWNER(S) TO THINK ABOUT:

- Will you be able to buy that retirement property that you want and have the financial resources to carry that property?
- What standard of living will you be able to maintain after the sale?
- Will there be enough to cover health care and potential long term assisted care living expenses?
- Will this sale leave me with an estate/financial legacy that I can leave to my children?
- What level of "gifting" or owner financing should you consider?
- What is a maximum and minimum valuation price (net of income taxes) you would consider?
- Assuming a sale, how should the owner invest the net proceeds to accomplish post sale financial goals?
- Is the owner prepared for the likelihood that others will find out that there may be a transition of ownership of the company or that the company is actively seeking buyers?

TIP: LOOKING AT THE OPPOSITE POINT OF VIEW

SINCE EACH SIDE ON THIS TRANSACTION WILL HAVE DIFFERENT CONSIDERATIONS, THE OWNER(S) SHOULD ALSO LOOK AT THE TRANSACTION FROM THE BUYER'S POINT OF VIEW. HAVING A FIRM GRASP ON THE PROS AND CONS GIVES THE OWNER(S) VALUABLE INSIGHT TO CONSIDER DURING NEGOTIATIONS.

STEP 3: QUALIFYING AND ENGAGING BUYERS

Once an owner has a strong grasp on the valuation, potential transaction scenarios, and also their deal thresholds, they can begin qualifying and engaging potential buyers.

Negotiations can be time-consuming and also stressing on relationships with potential buyers, so it's important to set criteria that helps pre-qualify buyers. This is another area where an experienced professional can help.

From advice on setting the criteria, guidance on the proper ways to have conversations with family, management team, or potential 3rd party buyers, every step is critical.

EXAMPLES OF CRITERIA THAT NEED TO BE DISCUSSED WITH POTENTIAL SENIOR MANAGEMENT OR FAMILY MEMBERS INVOLVED IN THE BUSINESS INCLUDE:

- What level of interest do you have in owning all of part of this business?
- Are you in a financial position to gather the resources to purchase the business?
- Does the timing of the owner's exit date align with the potential buyer's desired timing?

STEP 4: NEGOTIATIONS

This can often be the lengthiest and potentially most frustrating step in the transition process. An attorney should start with a confidentiality agreement and also be prepared to discuss with the seller potential terms and financial expectations for review and presentation to the potential buyer. At this point, both sides need to determine if there is a "go/no-go" on proceeding further.

If there is interest from both the seller and buyer to move forward then the due diligence part of the process can begin. The sellers team of professionals can help guide the seller as discussions proceed, and again there will be a points along the way that there will be times of "go/no-go" in terms of advancing conversations with the potential buyer.

TIP: PROPER LEGAL REPRESENTATION

AN OWNER HAS A LOT AT RISK, SO IT'S IMPORTANT TO CHOOSE COUNSEL WITH SIGNIFICANT EXPERIENCE IN HANDLING TRANSITION TRANSACTIONS. THIS WILL POTENTIALLY BE THE LARGEST AND MOST IMPORTANT TRANSACTION THAT THE SELLER HAS CONDUCTED AND REQUIRES THAT THE SELLER BE WELL REPRESENTED.

THERE IS AN ESSENTIAL NEGOTIATION ITEM THAT CAN HAVE A SIGNIFICANT IMPACT ON THE SELLERS AFTER TAX PROCEEDS. TYPICALLY THE BUYER WILL WANT TO ALLOCATE THE PURCHASE PRICE OF THE TRANSACTION TO ASSETS, ETC. THAT RESULT IN INCOME TAX DEDUCTIONS, DEPRECIATION AND AMORTIZATION TO THE BUYER. HOWEVER, THE SELLER WILL PAY A HIGHER INCOME TAX ON THE TRANSACTION IF HE / SHE AGREES TO THIS SORT OF ALLOCATION. THE SELLER WILL WANT TO ENSURE THAT HIS REPRESENTATIVES IN THIS TRANSACTION HAVE SIGNIFICANT EXPERIENCE IN THIS AREA SO THAT THE SELLER'S FINANCIAL OBJECTIVES ARE ACHIEVED.

STEP 5: CLOSING

Once the contract is negotiated and finalized, there will be a final review and preparation for closing the transaction. Any final considerations or concerns of the seller need to be resolved at this time.

For many situations, it is important that the owner (who just sold the business) continues with some post-transaction counseling on lifestyle expectancies, market risk, risk tolerance, and asset allocation.

CONCLUSION

There are so many critical steps in a business transition plan that can make the difference between success and potential failure.

The experienced team at Reynolds and Associates, PLLC, a Houston-based CPA firm is positioned to help lead owners through this process.

For more information, please contact our office:

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