

MONEY MATTERS

by Scott D. Miller, CPA

DEVELOPING A TRANSITION STRATEGY

Every business is going to transition at least once during the current owner's career. In fact, the business may transition more than once. A business transition is defined as a change in ownership control. That control may happen suddenly as with the sale of the company to a new buyer, or the process may take years if family members are at the heart of the process.

The benchmark of a successful transition is preparation and advanced planning. Business owners who anticipate the inevitable and embrace the process tend to control events and fulfill their goals. Timing is often a key consideration. There is a wide range of transition options to be considered carefully by the well-prepared business owner.

Think about the next "buyer" of your business. The buyer may be a family member, a competitor, inside

and younger than the transitioning owner, then such candidates are viable options.

ADVANTAGES: Family members who have been active in the business for a lengthy period have the chance to prove business acumen at the same time it is linked to the love and commitment that family members have toward one another. Because of these bonds, the seller may be more willing to assist with the transitioning process. Integral to this help is pro-

flounder and key employees may be tempted to flee. Family members may not possess the entrepreneurial skill to take the business to the next level.

MANAGERS AND EMPLOYEES

When the business is successful, the employees have typically contributed to that success. Key managers often have the skills to run the company in the future. Where the employment base is stable with low turnover in key positions, this is often a highly desirable buyer.

ADVANTAGES: There are truly outstanding tax-related financial incentives to encourage employee ownership through the use of an ESOP. Due to the tax incentives, it is more likely that the employees can purchase the business. If the seller decides to use an ESOP in part with a sale to key managers, control is maintained until the seller decides to relinquish it. When such transactions are properly structured, the results are often great financial successes for the seller and the employees. Federal legislation passed in 2001 highly favors sales of stock to employees in S corporations.

DISADVANTAGES: Transitioning to employees with an ESOP typically takes time to accomplish, as it is often impractical to sell the entire business in a single transaction. The seller will typically have to assist with financial arrangements either as a guarantor of the debt or in some cases even providing the funds for the purchase. If an ESOP is employed, there are many specific legal compliance issues related to the Employee Retirement Income Security Act (ERISA). It takes time to successfully install an ESOP, and if a quick transaction is required, this may not be an option.

Failure to plan ahead will almost certainly result in a fire drill transition when the negotiating strength of the seller is dramatically weakened.

managers, an Employee Stock Ownership Plan (ESOP), or someone not even familiar with your particular business. The list of likely buyers in most cases is remarkably short if the business is to be successfully sold. This article examines the most likely candidates for the closely held business.

FAMILY MEMBERS

It is the dream of most entrepreneurs to build a successful business and pass it along to family members, most likely children. If there are family members active in the business

viding financing to the "seller" for the transition. In this case, seller financing is far more desirable than third-party bank financing. The seller is also in control of the transition process and may relinquish control on terms that are acceptable.

DISADVANTAGES: Family members may "expect" the business and not have the critical skills to manage the company. The seller may be hesitant to relinquish control of the company to someone not perceived to be capable of managing the business. If family members do not agree on basic matters of control, the company will

OUTSIDE BUYER: “STRATEGIC” BUYER

If there is no logical inside buyer for the business, the next most likely buyer is someone familiar with the business and the industry. This is a strategic buyer with knowledge of the business from a preferential viewpoint. Strategic buyers often are competitors or other industry insiders. Competitors can be excellent candidates because the potential sale eliminates a source of significant rivalry. Correspondingly, industry insiders may see synergies with the purchase due to such things as increased buying power, greater standing with key customers and vendors, and economies of scale in operations.

ADVANTAGES: The strategic buyer is already familiar with the business and typically brings significant economies to the bargaining table. Such economies or synergies often result in a more favorable price. The strategic buyer is entering the transaction from a more informed vantage with a smaller likelihood of legal liability to the seller. Strategic buyers often have significant financial strength to close a deal quickly.

DISADVANTAGES: Once serious negotiations begin, the seller is typically compelled to disclose the most sensitive financial and competitive information to the candidate buyer. Since a very high percentage of all potential deals never become consummated, the risk of serious damage is real if the deal fails. Another viable concern is the lack of control over the process because strategic buyers often purchase absolute control of the company. Once control is passed, the seller is out of the business. The owner must be ready for the psychological jolt to the system from being the center of attention one day to being “cast out” the next.

OUTSIDE BUYER: “FINANCIAL” OR “INVESTMENT” BUYER

Such buyers are often very difficult to find unless you happen to be in an industry that investment bankers are courting. Financial or investment buyers represent parties looking for returns on their investment. Typically, these buyers have access to investment dollars and have little if any interest in managing the business on a day-to-day basis.

ADVANTAGES: Within certain industries that are targeted for investment, such buyers bring substantial financial strength to the negotiations. Sellers can often negotiate favorable terms because such buyers often find them and try to entice a sale. Financial buyers often insist that the seller remain active in the business during a transition period, since the buyer does not have the expertise to manage the business.

DISADVANTAGES: The financial buyer usually has a time horizon of only three to six years. At the end of this time, the buyer wants to convert the investment to liquidity, often at a substantial gain. The exit vehicle may be a public stock offering or a sale to another financial buyer. The expected rate of return targeted by financial buyers is often far in excess of reasonable projections, with the result that most investments are disappointments. The few investments that financially soar underwrite all the failed efforts.

LIQUIDATION

In some instances, the best buyer for the business is liquidation. While such instances are not common, they do happen. For exam-

ple, the underlying liabilities of the business may be so great that the best strategy is to liquidate the assets and dissolve the company.

ADVANTAGES: The operations of the business cease and the assets are sold and converted to cash in reasonably short order. The business owner typically has no ongoing commitment to the business and symbolically “walks away.”

DISADVANTAGES: The total consideration paid for the assets is often discounted due to a lack of ongoing concern. The assets often are sold under duress circumstances. Assets are often worth less in liquidation than in a successful operating company.

SUMMARY

The well-prepared business owner has a wide range of transition options to consider. The value of the business is often optimized by adopting a patient approach to the process and waiting for the right mix of circumstances. There are many points of interest to consider from family members, management and employees, outside buyers and possibly liquidation. Failure to plan ahead will almost certainly result in a fire drill transition when the negotiating strength of the seller is dramatically weaker and lifelong goals are largely unattained.

Be a winner during the journey; think positively and embrace the challenge.

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