On The Horizon

Formulating Your Five-Year Succession Plan

By Thomas M. Edens

Let's face it. Most family-owned businesses do not transfer to the second generation. Therefore, ultimately, there will be a change of control event that becomes an integral part of the succession strategy of your company. It only makes sense to formally plan for the day when you will "cash out," especially if one of your goals is to maximize the proceeds you receive from a sale.

Many financial experts suggest planning your exit about five years out. You may be able to properly prepare for a sale of your business in a one- or two-year period. The actual time period is not important—adequate preparation is.

One of the primary reasons for planning the timing of your company's sale is that if you do not control the timing of your exit, someone else may take control from you. Almost all business owners receive a constant flow of letters and phone calls from prospective buyers wanting to buy "their" businesses. It is strongly suggested that you do not react to a "bad Friday" by responding to a phone call and saying, "Yes, I'll sell." Instead, use such a call as a reminder to ensure that you are on track with your exit plan. You have spent many years building the business, and you deserve to realize as much as you can get. A plan will help you achieve maximum net proceeds.

The following suggestions do not apply to all cases, but hopefully you will find some instructive elements that will prove beneficial.

Timing

Ideally, the best time to sell your company is when three important factors are aligned for maximum rewards to you. The timing must be right for:

1. The company.
2. You and your family.
3. The economy and general acquisition environment.

You, as a business owner, have significant influence over the first two factors, but little control regarding the third—the merger and acquisition environment in the accounts receivable management industry. The economic and market conditions are very favorable now (low interest rates, money flowing into the industry, high valuations in the public market sector, favorable capital gains rates, etc.), but predicting future economic cycles is beyond the scope of this article. Therefore, if your ideal exit strategy is to sell in five years, you should adopt a four- to six-year plan, hoping that somewhere between the fourth and sixth year, the M&A market will be strong.

Preparing for the sale

There are a number of actions you can take to prepare your business for sale. Some of these can be initiated immediately. Others will take much longer to see results from their implementation.

Legal issues: If there are FDCPA, employee grievance, minority interest disputes or other lawsuits and contingent liabilities pending against the company, it is usually best to resolve the disputes before talking to buyers. One of the greatest compliments a buyer can pay a business owner is to say that the business is a "clean company." Being a clean company is just one of the many components that contributes to a minimization to a buyer.

Your corporate records will be scrubbed in the due diligence process in a transaction. Are there out-of-date stockholder agreements or option agreements with employees that were terminated years ago, and you never cleaned up the legal paper trail? The last thing you want to happen at the time of negotiations with a buyer is to seek a release from a former key employee. That could cost you dearly or hold up the closing process. Accordingly, make sure the company's legal structure and rights to ownership are correctly documented.

Accounting and tax issues: There are a number of planning issues dealing with your company's financial matters. The financial statements are usually the first corner stake that acquirers lay in order to place a value on your company. The financial statements are also the foundation which the buyer's lenders or private equity sources use in determining whether to advance funds. Sure, your clients (and the cash flow they

generate) are of critical importance, but it is the financial statements that become the core document.

Ceteris paribus (all things remaining equal), the more your outside CPA is involved with your financial statements, the better. It may be your opinion that your company is not large enough to bear the cost of having an annual audit or review, but at a minimum, your CPA should compile your statements. However, an audit will usually pay for itself in reduced due diligence cost and give greater confidence to a buyer (lower risk equals higher value).

You will also want to have your financial statements prepared on a monthly basis. It is all too common for privately held companies to have their internal financial statements prepared only quarterly or semi-annually and then prepare the annual tax return. Buyers want to see monthly statements, and it is usually in your best interest to have a trailing 12-month recast income statement in order to maximize your value calculation.

You should also give strong consideration to having your financial statements converted to an accrual basis if they are currently prepared on a cash basis. You can still maintain your books and records and file your tax return on a cash-basis. Your CPA will make period-end adjustments to cash basis statements, such as recording accounts receivables and payable accruals.

The most favorable impact to earnings on an accrual conversion will be for companies with material gross remit claims and/or businesses that are growing at an annual rate of 10 percent or greater. Most acquirers will convert your books and records to an accrual basis after a sale. The extra cost for your CPA to convert cash basis financial statements to accrual basis will be rewarded in an increased value calculation.

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Formalized budgets that are used in the management of your business are often looked at favorably by acquirers, especially if historical projections have routinely been met or exceeded. What is not too meaningful are projections made at the time of a sale with a lack of credible assumptions or "hockey puck" projections with a current base that does not support the turn-around. These same comments are applicable for companies that operate from a formal business plan.

From a tax standpoint, any IRS disputes or audits should be resolved. You may have had IRS difficulties years ago and a lien was placed on your business. Have your attorney do a UCC search to ensure the lien was actually released. You do not want the acquirer to discover an unreleased lien in due diligence.

You should include your CPA in discussions regarding your exit planning. He may be aware of tax planning issues that could save you money in the future. Your tax advisor may suggest that you invoke a Subchapter-S election if you are a "C" corporation and there is enough time before a sale to minimize the built-in gains implications.

Management issues: It is very common for a pre-retirement age business owner to manage the company for the acquirer after a sale (at an agreed market salary). However, if it is your plan not to remain with the company, then it is usually in your best interest to groom an executive capable of managing (both operationally and P&L responsibility) the company.

Buyers are looking for continuity of the clients and cash flow stream after a sale. Continuity of executive management will reduce the risk in the eyes of the buyer (often translating into higher valuation multiple). The more the owner can separate his identity from the identity of the business, the better. This may cost you more in the short run, but will mean more

to you at the end of the day.

Sales management is also important to most acquirers. Yes, most acquirers have a national sales force. However, they usually will pay a higher value for a company that has a proven sales engine in place to fuel growth and replace the constant churn of smaller clients. Most acquirers want to acquire growth capacity.

System and infrastructure issues: If you are planning several years in the future, it almost always pays to have invested in a state-of-the-art software system. Not only will excellent software enable you to operate more efficiently (and hopefully more profitably), it expands your potential universe of acquirers. Some acquirers will automatically convert your software to their preferred platform. However, a significant number of other acquirers want to purchase a company with a major software platform that can be expanded.

Personnel issues: Now is the time to make difficult changes in your staff. Often there is a family member or longtime employee who is significantly overpaid. An example is a low-level administrative employee who has been with the company for many years and receives an annual salary of $65,000, whereas the market value of the services performed is closer to $30,000. Do not believe that you will convince an acquirer to give you credit in the valuation calculation by multiplying the excess $35,000 salary times a four or five multiple (or higher) and then transfer the unpleasant task of terminating the employee to a buyer. It usually doesn't happen that way. It is difficult to get paid for a change that you did not make. Therefore, the employee will be asked to take a pay cut or leave, and the buyer reaps the benefits of the justifiable reduction in payroll.

Accordingly, make the tough decisions now. You can always give this loyal person a bonus out of your sale proceeds. However, if the overpaid employee is not a loyal employee, just overpaid, make the adjustment now or suffer a decrease in your sale proceeds.

On the other hand, you may have a son or daughter in the business that you promised a 25 percent share of the company, but you never got around to issuing the shares. By planning ahead, you may be able to use valuation discounts to transfer the stock and have the recipient (son or daughter) get full benefits of capital gain treatment when the company does sell. Additionally, you may want to fully implement an annual gifting program of stock for your intended heirs.

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Client issues: In order to maximize your sale proceeds, acquirers are concerned with two major issues concerning your clients. The first issue is the stability of your clients and the historical placement patterns. Another reason for the four- to-six year window is the timing of a large new client. Say you were planning to sell in four years and in the 47th month you just landed a large account that you had been courting for two years; you may want to deter placing the company up for sale. You will usually be rewarded more for a stable of solid accounts than a promising new client with a one-month track record.

The second client issue that buyers are concerned with is the concentration of fees among one or more key clients. Often, this concentration can exceed 30 percent of your business. Before you sell your company, try to minimize the concentration of your clients. This concentration reduction is, of course, easier said than done.

Occupancy issues: The ideal office lease arrangement when you go to sell your company is one with a short time remaining on the term, with an option to renew for a long term, and also has rights of refusal on contiguous space for growth. The lease conditions just described give a prospective buyer flexibility with his plans for your company after a sale.

You never know which particular buyer will end up purchasing your business. He may already have a significant call center in your city and will want to terminate your lease, or it may be a buyer who wants to penetrate your particular geographic area and wants a locally domiciled company with a lease that can handle significant growth.

Try to avoid a situation where your business has a long-term lease at above market rates, with no room for expansion.

Other issues: There are other tangible and intangible issues that need to be addressed, such as who your advisors will be at the time of sale. You will need an experienced transaction attorney (not your neighbor, the divorce attorney), a tax advisor and usually a merger and acquisition advisor. You can be assured when discussions start taking place with a seasoned buyer, his acquisition team will be in place to close deals. Your advisors should be carefully

selected in advance in order not to get less than an "A" team players on your side. Your advisors can make or break a favorable deal for you.

It may be that you and your financial planning advisors conclude that the structure or ownership of your company needs to be changed in order to facilitate a tax-efficient sale or fulfill your charitable goals. These structure changes may include family limited partnerships, family trusts, personal holding companies or charitable remainder trusts. These changes require careful planning and time to execute.

You should also have a contingency plan. Suppose you are planning to sell your company four years from today. Are appropriate business continuity agreements (buy-sell, etc.) and a contingency plan in place in case you die or become disabled one year from now?

Ideally, all the above issues have been addressed adequately, and your company is on a trajectory of profitable growth with a current history of strong, sustainable earnings. If so, your business is probably ready for negotiations with acquirers.

The most important consideration

What about you, the business owner? Have you given full consideration to what you will do to occupy your time after a sale? You may want to stay on and manage the company for an acquirer or perhaps improve your handicap through more time on a golf course. If you have not adequately thought through how you will occupy the substantial increase in free time, the timing may not be right to sell. It is important that you establish a convincing and logical reason for wanting to sell your company, both for yourself and a buyer.

By discussing the planning and timing of a business sale with your spouse and the impact on your lives, both of you can reduce the stress that is a natural consequence of a business sale.

As it relates to the economic side of preparing yourself, are you comfortable with the retirement projections you have made? An integral part of these calculations is the estimated value of your business and the expected net proceeds from a sale. A good idea is to know what the value of your business is now, and what it needs to be when you exit. Again, ensuring that your post-sale net worth will be adequate is core to planning the timing of your sale. **CM**

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