

Strategic Success Option

Alternatives for the closely held business

Business owners have a number of options available to them when deciding the appropriate destiny for what is probably their largest asset. The determination of which route to choose is one that should be undertaken with utmost care and professional guidance. This article will address the mechanics of the different alternatives, deferring the emotional process of business succession to a later discussion.

Diagram A illustrates and summarizes the different succession alternatives available to the business owner. They are classified as either Internal or External options. Internal options are typically those that the business owner can initiate without ownership being transferred to parties outside of the current stakeholders. External options often involve a transaction with parties outside the stakeholder group, and the degree of success may depend on market conditions.

Stakeholders in the succession process typically would include current shareholders, family members and dependents of the shareholders, management and employees. The larger the company, the more succession options are available to the shareholders. This is due, in part, to the ability to absorb transaction costs related to the alternatives, or to the attractiveness to financial partners available to participate in the transition.

Shareholder goals and company resources/capabilities

To arrive at the best succession alternative for the business, careful analysis should be undertaken. The first important step is to determine the goals of the shareholders and the resources and capabilities of the business. Common

shareholder goals regarding business succession might include any, or several, of the following objectives:

- Transfer the business to family members.
- Have long-time, trusted employee take over the business.
- Maximize the cash proceeds from a transaction.
- Provide for the dependents of the shareholders.
- Minimize the effect of the business succession on estate and gift taxes.
- Have a steady stream of post-retirement income.
- Sell the company to employees as a group.
- Implement charitable giving and philanthropic objectives.
- Ensure the continued operations and legacy of the business.

DIAGRAM A



- Ensure the well-being of the employee workforce.
- Minimize the succession plan's effect on the business' operations.
- Preserve family harmony regarding succession decisions.

In conjunction with establishing and defining the shareholder's succession goals, the resources and capabilities of the company should be realistically determined. In many of the succession alternatives, the use of outside financing will be a significant part of the plan. Also assisting with the decision process will be the knowledge of the current value of the business and expected value at the time of the execution of the succession plan. In both of these analyses, the amount of free cashflow will often be a primary driver and dictate the succession alternatives that are feasible for the company and its shareholders.

Since collection and receivable-related companies have relatively little tangible assets to collateralize a loan, cashflow becomes the primary leveragable attribute. Accordingly, positioning your company to a condition where it generates dependable cashflow will increase your options and minimize risk of your succession plan's failure.

Internal options

Sale or Gift to Family Members: The most common internal succession option is the sale or gift of the business to the next generation. The succession plan might call for the son or daughter to buy the company over time, utilizing the cashflow from the business to fund the note payments. This succession alternative, of course, would depend heavily on the confidence in the family member's management capabilities and the sustainability of the company's cashflow. As long as the amount paid by the family member is for full and adequate consideration, there should not be a related gift tax liability. A key premise of many estate plans is to always give shares in minority

interest lots in order to maximize the transfer leverage offered by valuation discounts.

Gifts to children can take place through a number of vehicles and at a flexible pace. It would not be uncommon for the business owner to initiate both a gifting program and a sale to a family member. For example, an effective estate plan might call for the shareholder to gift 35 percent of the outstanding stock over four years while the beneficiary also executes a seven-year installment note to purchase the remaining 65 percent.

Still other means of effecting a sale or transfer to family members is to have the business transferred at death of the shareholder. The funding of such transfers, in conjunction with estate tax considerations, is usually accomplished by the proceeds of an insurance policy. The main questions to be answered by a sale or transfer to family members are:

1. Who gets the business?
2. How does the transfer take place?
3. When does the transfer take place?

Management Buyouts: Management Buyouts (MBOs) may be appropriate when a current executive(s) has the desire and executive capability to purchase the company from the current owner. This process can be quite simple if the selling shareholder is willing to hold a large percentage of the value in an installment note. An owner financing the majority of the MBO would want to obtain liens, guarantees and salary caps from the management/buyers. Other MBOs can be quite sophisticated. In order to execute an MBO where the shareholder walks away with a substantial percentage of cash, the company would need to be one of the larger companies in the industry in order to attract the financing needed to complete the transaction.

The financing market in 2001 and 2002 has been difficult, and the amount of

financing from a bank may be only two times the cashflow of the business. Assuming you have valued the business at five times cashflow, the gap of three times cashflow must come from somewhere. There are three main sources for this gap. Mezzanine lenders may provide capital and would expect a cash dividend in the 13 percent range and require future equity rights in the form of warrants. If the company is large enough to attract a financial sponsor, the sponsor may provide substantial cash equity to the transaction and receive a majority of the ownership in return. The shareholder could receive a note to facilitate the remaining portion of the purchase price.

In MBOs where management is bringing little cash to the transaction (which is most cases) and the private equity sponsor is providing the equity, the management team might end up with 5 to 15 percent of the equity (gained through initial management cash investment or options vesting over time), and the private equity firm would retain the remainder. Management can usually gain additional equity through incentive plans or the company reaching certain rates of return criteria at the time when the company is resold. The main asset that management brings to the transaction is their credibility and proven success.

Recapitalizations: One of the most common forms of recapitalizing a closely held business is in the form of a leveraged recapitalization (recap). The recapitalization usually involves converting material portions of the company's shareholder equity to debt in conjunction with a substantial distribution to the shareholder in the form of a stock redemption.

The business owner effectively has the opportunity to sell the business twice. First, the shareholder may sell 70 to 80 percent of the company to an equity sponsor who funds the major portion of the transaction with leverage that is ultimately reflected as debt on the balance sheet. Since many private

equity firms have a five-to-seven-year investment horizon, the amount of equity that was retained by the shareholder would be sold in conjunction with the financial sponsor's exit.

The objective is for the originally retained 20 to 30 percent to be worth as much as the original equity percentage sold to the financial partner. This often assumes an accelerated growth plan initiated and supported by the strategic and financial resources of the private equity firm.

Some of the advantages of a leveraged recap are as follows:

- Generates liquidity for the shareholders.
- Allows shareholders to retain a significant stake in the company.
- Often structured to allow existing shareholders to retain control of business.
- Benefits from a sophisticated partner with additional capital for growth.
- Removes personal guarantees from the existing shareholders.
- Provides flexibility for the different goals of multiple shareholders.
- Maintains a high degree of confidentiality regarding the transaction.
- Little disruption or transition stress directed towards workforce.

Many private equity funds have a fairly high minimum transaction value—typically \$50 million or so. However, there have been funds raised by several sponsors to meet the needs of companies with enterprise values as low as \$10 million to \$40 million. In addition to size factors, a company eligible for a leveraged recapitalization should have a very strong management team and a solid business plan.

A leveraged recap can be accomplished without bringing in an equity sponsor. The shareholders may be able to secure the leveraged component and complete the reorganization with only other insiders. Accordingly, a leveraged recap can be viewed as an internal or external succession option.

ESOPs: Employee Stock Ownership

Plans (ESOPs) have steadily gained popularity since their authorization in 1974. According to the National Center for Employee Ownership (NCEO), there are now over 11,500 companies that have adopted ESOPs for a total participation of over 8.8 million employees. ESOPs are applicable to large public companies such as Avis Inc., as well as thousands of smaller privately-held companies. Over 95 percent of ESOPs are private companies, and the median number of employees in the plans is 125, as reported by NCEO.

One of the first steps in exploring ESOPs is to have a feasibility study conducted by an ESOP expert. Due to the initial setup costs (\$10,000 to \$25,000) and ongoing maintenance costs, companies with annual payrolls greater than \$1 million would be the best candidates for ESOPs. It is not uncommon for business owners to determine that, with the annual valuation and other administration costs, the highly regulated ESOP alternative is cost prohibitive. Costs could be significantly higher if the plan is a leveraged ESOP, due to the bank's requirements for legal opinions, commitment fees, and loan documents.

The mechanics of an ESOP include the selling of the company's stock (either newly issued or from existing shareholders) to a trust. Generally, owners who sell 30 percent of their stock to the ESOP can achieve tax deferral indefinitely on the sale. To achieve this tax deferral, the proceeds are required to be reinvested in "qualified replacement property," which can be in the form of securities such as publicly-traded stocks and bonds. Usually there is a plan requirement that employees must work full-time and accumulate ownership rights to their allocated shares over a five-to-seven-year vesting period. The vesting period would affect many employees' ownership rights due to the especially high turnover rate of collectors. A similar demographic reference is the construction industry, which also has a high employee turnover. Yet, according to the ESOP Association, about 12 percent of the ESOPs are construction companies,

which have similar employee retention challenges as collection agencies. A related issue is the company's ability to develop and function under an employee ownership culture.

Although shares are sold to an ESOP, the company can later be sold to a strategic or financial buyer. The ESOP should be viewed as another shareholder who is selling its interest. However, the employees would generally have the right to vote on major corporate issues such as a sale of the company.

Advanced Estate Transfers: Estate taxation is often a fundamental driver of succession planning. There are numerous estate-planning tools that can be utilized to assist in the implementation of the succession plan for closely held companies. Several of the more common techniques are:

Family Limited Partnership—One way to accelerate the rate of tax-efficient gifting is through the use of a family limited partnership (FLP). The partnership offers several business purposes while maximizing the use of valuation discounts. Discounts can accelerate the percentage of ownership transferred for any given time period. An additional advantage of the FLP would be the ability of the shareholder (in its capacity as general partner) to retain control even as greater than 50 percent of the interest is transferred to the desired beneficiaries.

Private Annuity—A private annuity is an installment sale with the acquiring shareholder making periodic payments for the duration of the selling shareholder's life for the consideration of an equity interest. The proceeds from this unsecured obligation result in capital gain, return of capital/basis and ordinary income (depending on the annuity portion).

Self-Canceling Installment Note—A Self-Canceling Installment Note (SCIN) involves the selling shareholder receiving a note for the business. The purchaser continues to pay on the note over time until either the note is paid in full or the selling shareholder dies. In the later case, the remaining balance of the note is canceled. The SCIN is a form of contingent installment sale. To compensate for the

cancellation risk (premature death of selling shareholder), a risk premium in the form of a higher selling price or interest rate is factored into the transaction. Any remaining balance of the note, which is canceled, does not become part of the selling shareholders' estate. There are a number of factors that go into this strategy, and only expert tax and estate guidance will provide the foundation for electing this technique.

Grantor Retained Annuity Trust—A Grantor Retained Annuity Trust (GRAT) involves transferring the business to an irrevocable trust while the shareholder retains an income interest for a period of time. The shareholder pays the taxes applicable to income earned by the trust, but does not pay taxes on the receipt of the periodic payments. A major goal of this strategy is for the shareholder to survive the annuity term and then exclude the value of the company from the estate. However, gift tax implications must be dealt with when utilizing this technique.

Charitable Remainder Trust—A Charitable Remainder Trust (CRT) is a technique that offers several advantages to a succession-minded business owner. A tax deduction is created when the stock of the company is irrevocably transferred to the charitable trust. The stock of the business is then sold by the charitable trust to a third party, and the cash is reinvested. The beneficiary (business owner) then receives income from the trust for the remainder of the shareholder's life. Oftentimes, life insurance is utilized to replace the wealth that was removed from the estate through the transfer of the company to the trust.

Combination of Internal Options: A business owner is not limited to just one of the above internal options. Depending on the attributes of the company and family goals, several of the above strategies may be implemented either simultaneously or in staged events over time. An example would be to both gift some shares to family members and sell other shares to an ESOP. As always, expert guidance is very important.

External options

Sale to Outside Third Party: Probably the most often-utilized external succession option is a sale of the business to a third party. After arriving at this decision, there cannot be too much said about preparing the company for sale. This preparation could easily take several years. Yet when the company is at its optimal position for maximizing the shareholders' harvest, the market for selling the company may be in a less than favorable state. Therefore, the selling process may need to be deferred until the market is more vibrant.

The main types of acquirers are strategic buyers, financial buyers, competitors and private investors. Usually strategic buyers will pay the most due to their being able to add immediate value to the transaction through synergistic attributes or through integration. Financial buyers are more focused on rates of return, growth and exit strategies. Competitors could be the best alternative for small collection agencies, even though discussions introduce higher than normal confidentiality and transaction risk.

The concerns of most business owners when selling their company usually include:

- Confidentiality.
- Maximizing after-tax benefits from a transaction.
- Minimizing the execution time and stress of a transaction.
- Ensuring that their employees and family members are taken care of after a transaction.
- Preserving of their business legacy.

Liquidation: An option that is always available to a business owner is the liquidation of the company. In the case of service businesses such as collection and receivable related enterprises, this alternative is not appealing. The underlying tangible assets as a percentage of total enterprise value is usually very low. The valuation strength of a service business is the cashflow generating ability and not the accumulation

of fixed assets. Liquidation in these instances is usually reserved for distressed situations.

IPO: Selling equity in the public market through an initial public offering (IPO) is usually reserved for larger companies that have several important attributes. The size of the company should be large enough to attract a following of analysts and a sufficient number of market makers to support the stock price. Strong management with the ability to maintain a growth strategy that delivers short-term results while being mindful of actions that ensure the longer-term benefits to the company is of utmost importance. A company undertaking an IPO must also recognize that it should have the ability to absorb additional overhead costs as a public entity for reporting and corporate governance.

The market for IPOs so far in 2002 is the weakest since 1991. Even in strong markets, many companies elect not to participate in this exit strategy due to the transparency required and the demands of a fickle public market on short-term results.

Summary

This article provided a general outline and brief overview of the succession alternatives. The actual decision regarding the implementation of a specific succession option should depend heavily on competent legal, tax, financial planning and valuation advice. Whatever alternative is chosen, the integration of the shareholders' estate plan and succession plan is very important. And, a thorough succession plan that includes any of the above alternatives will also include a contingency plan to provide for the unknowns. **CM**

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