Fifth Excerpt: Part Five

A guide to selling your business
in a highly competitive market

YOUR EXIT MAP

NAVIGATING THE BOOMER BUST

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Content

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PART FIVE

Beating the Boomer Bust

Fifth Excerpt: Part Five

This is an excerpt from the book,
Your Exit Map: Navigating the Boomer Bust.
Some pages have been omitted.

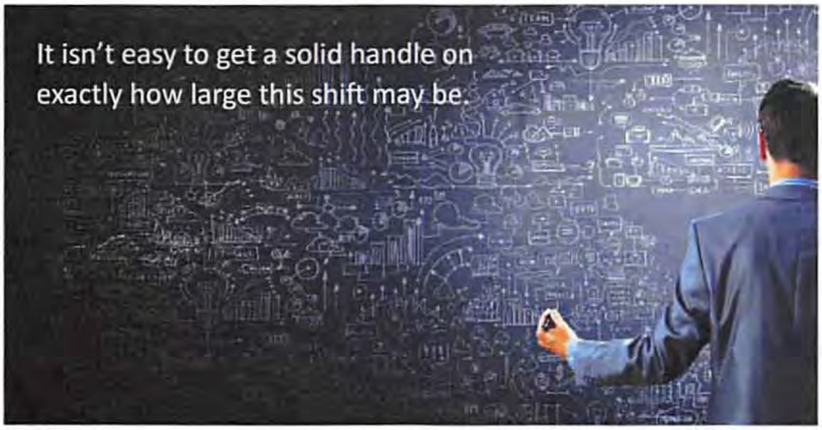
5.1 Understanding the Odds

The bad news for Baby Boomer business owners is that they are entering a fiercely competitive market for selling small and midmarket businesses. There is some good news, however. Boomers are competitive and ambitious. They have, after all, competed at every stage of their lives. This is just a new race where once again, some will meet with enviable success, while some won't.

"How Do You Know?"

I'm often asked where I got my numbers. It isn't easy to get a solid handle on exactly how large this shift may be. My calculations came from combining pieces of data from the Small Business Administration (SBA), the United States Census Bureau and the Department of Labor (DOL) Statistics.

I expected that these organizations would have paid a little more attention to an issue this massive, but perhaps I shouldn't be surprised that it receives so little attention. After all, these are the same people who remove someone from the unemployment rolls for working even one hour in the previous month, simply because they don't want to upset the electorate with bad news.



Politicians know that discussing tough issues won't get you elected.

Our political system isn't in the business of delivering bad news. I just finished Ron Chernow's *Hamilton*, where he discusses how the first few U.S. Presidential administrations settled on a policy of always communicating an conservative viewpoint. Politicians realized 200 years ago that focusing on tough issues won't get you elected.

Here's what I know, and what I've extrapolated.

According to the Small Business Administration, there are between 28,000,000 and 29,000,000 private businesses in the U.S. at any given time. Around 19,000,000 have either 0 or 1 employee (home based, real estate partnerships, corporate shells).

That leaves at least 9 million businesses with employees. That much we know for sure. Various other studies give the same result.

From there, it gets a little fuzzier. Various studies (sponsored by grants from the SBA, DOL, or Census Bureau) put the number of businesses with five or more employees at between 6 and 9 million, and those owned by Boomer-aged folks between 51% and 61% of those. As a long-time coach to privately held businesses, I can attest that both my coaching client base of business owners and those of my colleagues around the country easily reach that percentage of Boomers.

Now we have a spread from as few as 3 million to as many as 5.4 million companies, depending on whose numbers you use as factors. I use 3 million because it is the lowest likely number.

It could be much higher, but we will work with the more optimistic scenario of 3 million. Now for the extrapolation.

About 3% of Americans own businesses, but from 1976 to 1985, the Boomers formed businesses at a rate almost 250% greater than previously; a percentage of the generation that hasn't been approached since. The total percentage of Boomers who own businesses still appears to be more than double the average, although we don't know how many of those companies have five or more employees.

"How Many Businesses Will be Sold?"

Let's be very cautious, and say only 4% of Boomers own businesses with employees, or only about a third more than the national average. Again, that is reasonably conservative.

Boomers are currently reaching age 65 at a rate of about 10,000 a day, or 3,500,000 a year. That means that at the low end (our 4% estimate), some 140,000 business owners a year are retiring or at least *reaching* retirement age (because we know that Boomer owners tend to hang on longer).

The brokerage industry currently sells about 8,000 companies a year. The mid-market (M&A and Private Equity Groups) account for another 1,000. These numbers are from the intermediary industry's own statistics.

Statistics indicate that sellers will fail to find buyers at a rate of 350 a day.

So, if we take our conservative estimate of Boomer ownership and reduce it by the full number of brokered sales each year, we are still short of buyers by about 11,000 a month, or 350 a day (including

weekends) for the next two decades. Assuming that Boomers own a higher percentage of businesses just makes those numbers worse.

That seems ridiculous. How could over 350 businesses a day disappear and not be noticed, or fail to create headlines nationwide? There are several possible answers.

First, over 6,500 people die in the U.S. every day, yet we only infrequently experience the passing of someone we know personally. Our network of friends and family is far broader than our business "network." How many times have you seen an empty storefront next to one you were entering, and were unable to even remember what business used to be there?

Over 90% of Boomer employers
have yet to transfer.

Understand that these numbers only project businesses that won't find a third-party acquirer. No one tracks the businesses that sell their customer list to a competitor, are bought by employees, passed on to family, or close voluntarily. Those are growingly popular options, and are completely untracked statistically.

Businesses close for many reasons. In fact, normal attrition, according to the SBA, is over 5,000 a day or 2,000,000 a year. If 350 are Boomer-owned employers; that is less than 6% of all closings.

So the lack of buyers is only important to someone who is planning on selling his or her company. Our 350 a day doesn't sound like much, but remember we aren't discussing *all* businesses, just those that support employees and their families.

These numbers are startling. If you've ever studied statistics, we are currently seeing only the third deviation to the left of the bell curve. The businesses selling in the third-party market now are largely owned by the Boomers born between 1945 and 1950, formed businesses around 1975-1980, and are turning 65-70 this year. The historical birth rates and business formation rates both indicate that the main event, about 97% of employer transfers, is yet to come.

"When Will the Crisis Hit?"

The numbers indicate that the crisis will hit between 2017, when the differential between Boomer and Generation X birthrates spikes, and 2025, when the youngest Boomers reach their 60s.

It could actually be sooner or even later than that. It could be a media driven topic of the moment, or it might pass without mention, since the majority of folks who don't own businesses have little interest in the issue.

As I have said previously, some pundits believe that we will replace thousands of small businesses with technology. Think of Amazon as your store next door. Larger companies will absorb much of the available space. A high profile example is McDonald's expanding into gas stations and Walmarts, replacing local lunch counters and those in the five and dime stores.

In 2008 85% of business owners said they plan to sell their businesses to a third party in the next 5 years. That was 85% of 60-year-old owners, 85% of 65-year-old owners, and 85% of 70-year-old owners. **-Price Waterhouse Coopers**

Many Mom and Pop stores will close quietly, because their owners no longer want them and their families no longer need them. Corner groceries in New York City passed from immigrant Italians, to Eastern European Jews, to Koreans and then to Arabs as each generation grew up, educated their children, and joined the suburban middle class.

The surge of sales may not ever be obvious. Some businesses will be sold privately without an intermediary. Many are log-jammed by owners who haven't figured out their exit yet. A substantial number of Boomers may work until age 70 or later. The youngest Boomers are still in their early 50s. They still have a while, but inevitably they will get there.

No matter what the reasons for delaying any individual exit, the fact remains: Sooner or later every owner leaves his or her business, and the transition of the Boomers will be like nothing ever seen in the business history.

5.2 Eyes on the Prize

The triangulation process described in the previous section is an absolute prerequisite before setting out a roadmap for action. Since the transfer of your company is likely to be the largest single financial transaction of your life, you really want to pay attention to the underlying drivers.

Putting a practical, well-grounded plan in place can be the difference between adding years of struggling to achieve your goals, and executing on time with minimum diversions.

Triangulation starts with knowing where you stand today. Taking inventory of your net worth and potential future income, including insurance and retirement payments, is the bottom left-hand base point of your planning triangle.

Be absolutely ruthless in your estimates of value. You may be driving a $100,000 automobile, but unless you intend to sell it, invest the proceeds in your retirement account, and drive something far less expensive, it is not an asset for your future planning.

You can triangulate your own scenarios with the free tool at **www.YourExitMap.com**.

Similarly, the equity in your home is only going to support you if you sell it and move somewhere more affordable.

The next point to identify in your triangulation exercise is determining the right-hand terminus of the graph; your eventual financial goal. This is the amount you will need in order to retire, or progress to your next career with sufficient funds. You may not need professional help to calculate your current net worth, however, it's advisable to get some assistance with other calculations.

Thank you for taking the time to read this excerpt.

Your Exit Map: Navigating the Boomer Bust examines the issues surrounding retiring Baby Boomers and planning for the next stage of their lives. It is supported by FREE tools and resources for business owners and their advisors at

www.YourExitMap.com.

For more information, please contact us via email at info@YourExitMap.com or by calling (800) 653-5405.

OWNERSHIP **TRANSITIONS**

Selling to an ESOP Versus a Sale to Another Company

The table below compares what issues come up in the sale of a company to an ESOP compared to a sale to a third party. It was prepared with the advice of professionals who have done both kinds of transactions. The table indicates that the overall level of complexity is similar, but ESOPs are much less risky in terms of the likelihood of finding a buyer. They are also considerably less costly, mostly because in the case of a sale to a third party, in addition to substantial legal, accounting, and sometimes other fees, the price paid to the seller is usually reduced by brokerage commissions paid by the buyer.

	ESOP	Sale to Another Company
Key legal documents	• ESOP plan document • Trust agreement • Lender agreements • Corporate resolutions • Stock purchase agreements • Corporate governance agreements • Employee contracts/management incentives	• Detailed selling memorandum • Sale agreement (similar to stock purchase) • Non-compete agreements (often) • Liens, escrow, security agreement, and personal guarantees • Corporate resolutions • Employee contracts/management incentives
Feasibility studies and preparation	Feasibility studies assess whether the company has sufficient payroll and cash flow to buy the desired amount of stock. Can be performed internally or with expert advice. Forensic due diligence rarely needed.	Companies must prepare a detailed and accurate description of the firm and its finances, prospects, and risks. Buyers will want to do a forensic due diligence investigation, and sellers should do the same to assess the financial soundness of the buyer and the terms of the offer.
Valuation	Outside appraisal required; valuation based on fair market value.	In smaller deals, outside appraisal not required but recommended; in larger deals price usually set by controlled auction.
Terms and risks	Plans can be structured in a variety of ways: • Flexibility in financing. • Rules for operating the plan must comply with ERISA, but there is lots of flexibility in design. • Escrow may be, but usually is not, required.	Buyers will typically have multiple contingencies: • Earn-outs often required, often in the 10% to 20% range. • Escrow held back. • Purchase price adjustments in companies that underperform post-transaction may be required, based on working capital or earnings requirements. • Buyers prefer to purchase assets, with potential tax and liability implications for sellers. • Financing may fall through.
Time to sell	Once the seller has decided on doing an ESOP and its basic structure, four to six months.	Median formal offer to sale time is 10 months for companies in the small to mid-market range.
Role of seller post-transaction	Flexible, depending on seller interests.	Buyer will usually determine role in smaller deals; in large deals, role is usually negotiable.
Sale of minority interest	ESOPs can buy any percentage of stock from any number of sellers.	Buyers almost invariably want to buy the entire company.
Success rates	If an ESOP is determined to be feasible, only rarely do transactions fall through once a decision to proceed has been made.	Overall, only about 25% of privately held businesses put up for sale are sold, and only about 50% of businesses with 100 or more employees are sold.
Transaction costs	• For most closely held companies, between \$60,000 and \$100,000, with a minority in the \$100,000 to \$200,000 range. • A small number of ESOPs will require investment banking assistance to raise financing, adding to costs. • No broker fees should ever be paid in an ESOP. • The ESOP pays the diligence, financing, and legal fees.	• Legal costs may be somewhat lower. • Feasibility and due diligence comparable to or higher than ESOPs, and considerably higher in larger deals. • Legal costs are similar for smaller sales and much higher for large sales. Appraisal costs, if needed, would be similar. • The buyer usually pays the diligence, financing, and legal fees. Broker success fees are generally between 5% and 12% of the sale price in sale prices under \$5 million and drop as low as 1%–3% in larger transactions.

EXIT ROUTES FOR BUSINESS OWNERS
WHITE PAPER

When business owners start to think about exiting their companies, the number of possible exit routes can seem limitless, but in fact, there are only eight:

- Transfer the company to family member(s).
- Sell the business to one or more key employees.
- Sell to employees using an Employee Stock Ownership Plan (ESOP).
- Sell to one or more co-owners.
- Sell to an outside third party.
- Engage in an Initial Public Offering (IPO).
- Retain ownership but become a passive owner.
- Liquidate.

Which of these exits do owners intend to use? A January 31, 2005, survey by PriceWaterhouseCoopers indicates that:

- About one-half anticipate a third-party sale;
- Nearly one-fifth anticipate a transfer to the next generation;
- Fourteen percent anticipate a management buyout;
- Seven percent expect to sell to an ESOP; and
- Ten percent anticipate an IPO or other option.

This White Paper examines the advantages and disadvantages of each route and describes a process that enables owners to choose the best exit path for them.

Let's begin with a fictional company case study.

Ben (55), Tom (45), and Larry (35) purchased Front Range Powder Coating from its former owner in 2004. They paid "book value" or about $1 million. Now, seven years later, they are at a crossroads: Ben, the oldest, is interested in reducing his role in the company and has approached Tom and Larry about purchasing his one-third interest.

But there's a kicker. Ben is not interested in selling his interest on the same basis as he acquired it—book value. Instead, he wants one-third of the fair market value of the company.

Since the company has increased its book value to $2.5 million and its annual cash flow from $200,000 to more than $2 million, Tom and

Larry face a major cash crisis. Should they proceed with the buyout?

As these owners discussed their objectives, it became clear to them, as it does to all owners, that business succession planning has little to do with the characteristics of the business and everything to do with each particular owner's personal exit objectives.

- *Ben wants to exit immediately for fair market value.*
- *Tom wants to continue to work for a number of years but isn't too keen on dedicating the company's entire cash flow to the purchase of Ben's stock. Tom believes that it is a risky proposition to use cash flow to pay off Ben rather than to fuel future growth. Further, Tom figures that, at just about the time Ben is paid off, it will be his turn to retire (at, he hopes, an even greater value).*
- *Larry, the youngest, shares Tom's cash flow concerns, but is sensitive to the desires of several non-owner managers—the next generation of ownership. Several key employees are quietly, but rather insistently, clamoring for ownership or similar ownership-based incentives.*
- *Larry wants to remain active in the company for the next 15 to 20 years as its principal owner and knows he can't indefinitely defer meaningful incentives to the key employee group.*

Start thinking about your exit before you are ready to exit. Owners who give themselves time to plan give themselves the greatest number of exit path options.

HOW TO CHOOSE AN EXIT ROUTE

How can the owners of Front Range Powder Coating choose an exit path when they have three very different opinions? When they finally met with their advisors to determine the best exit path for Ben, or perhaps all three of them, their first question was: How do we agree on an exit strategy that is fair to all of us?

The answer their advisors gave them is one that applies to all owners.

Step 1: Start thinking about your exit before you are ready to exit. Owners who give themselves time to plan give themselves the greatest number of exit path options.

Step 2: Owners should each put in writing their objectives and the resources available to reach each objective. Objectives may include when they want to leave and how much money they will need. Resources include: business value, non-business income and business cash flow.

This exercise helps owners to evaluate how well each exit path matches their objectives and resources. It also facilitates frank discussions based on realistic possibilities (rather than conjecture or wishful thinking).

Step 3: Each owner sets his or her own objectives related to desired date of departure, amount of cash desired upon departure and desired successor.

Step 4: Owners should retain a professional to determine a company's "fair market value" to place all owners on the same objective page.

Valuation results often eliminate potential exit paths. For example, if the value of a company is high, but the owner is not willing to devote the time necessary to orchestrate a transfer to employees, a sale to a deep-pocketed third party is a better option for him.

Step 5: Owners must perform cash flow projections to determine if there is sufficient cash available to even consider an "insider" purchase; in this case, a purchase of Ben's stock.

Step 6: Owners must evaluate the tax consequences of each exit path.

Keep in mind that while this analysis takes place, owners must continue to increase the value of their companies. Additionally, they will likely need to revise their existing buy-sell agreements to reflect the true value of their companies.

Let's now examine each exit path available to business owners.

TRANSFER TO FAMILY MEMBER(S)

Owners who consider transferring their businesses to family members usually do so for a host of non-financial reasons. These reasons include:

- Put the company in the hands of a known entity—specifically one's own flesh and blood—who the owner believes will run the company as s/he did;
- Provide for the well-being of the owner's family;
- Perpetuate the company's mission or culture;
- Keep the company in the community; and
- Allow the owner to remain involved in the company.

The major disadvantage to a transfer to family members is the owner's heightened exposure to financial risk. In almost all cases, family members are incapable of paying an owner the amount of cash s/he wants or needs for the company. As a result, owners remain tied to the company's future financial performance. To mitigate this risk, most owners choose to stay active with the company to ensure its (and their own) financial success.

Since family-member buyers have limited financial resources, owners often receive little or no cash at closing. That's a clear disadvantage to owners who must convert their largest, illiquid assets (their companies) into cash for retirement.

Realistically, all owners are not blessed with children able and willing to assume ownership of a company that is much larger and more complex than when its owner was the child's age. Even children who have demonstrated success in managerial roles may not be equipped to assume the responsibility of ownership.

In summary, the disadvantages to an owner of a family transfer are:

- Without planning* there is little or no cash at closing available for the owner's retirement;
- On-going financial risk to the owner;
- Requires owner involvement in company post-closing;
- Children may be unable or unwilling to assume the ownership role; and
- Family issues complicate treating all children fairly or equally.

*Planning—well in advance of one's departure date—can minimize or eliminate many of these disadvantages. Please contact us for our White Paper, "Successful Transfer of the Family Business" for more information.

In terms of advantages and disadvantages, the sale to key employees is remarkably similar to the transfer to family members.

SELL TO KEY EMPLOYEE(S)

In terms of advantages and disadvantages, the sale to key employees is remarkably similar to the transfer to family members. (Recall that Larry's exit strategy involved a transfer to key employees.) So similar are the two paths that if you substitute "key employee" for "family member," the advantage/disadvantage lists are the same.

The owner who considers a transfer to key employees hopes to achieve the same objectives as the owner transferring to a family member.

- Put the company in the hands of a known entity;
- Perpetuate the company's mission or culture;
- Keep the company in the community;
- Allow the owner to remain involved in the company; and
- Achieve financial security.

The perils of this exit route are the same as those present in the family transfer:

- Without planning there is little or no cash at closing available for the owner's retirement;
- Owner experiences on-going financial risk;
- Requires owner involvement in company post-closing; and
- Employees may be unable or unwilling to assume the ownership role.

Many of these disadvantages can be minimized if owners begin planning this type of transfer well in advance of their departure dates. For more information, please contact us for our White Paper, "Transferring Your Company to Key Employees."

TRANSFER TO EMPLOYEES VIA EMPLOYEE STOCK OWNERSHIP PLAN (ESOP)

ESOPs are qualified retirement plans (typically profit sharing plans), in which all employees participate, that must invest primarily in the stock of the sponsoring employer.

Transfers to key employees and to ESOPs appeal to owners who wish to transfer their companies to known entities, perpetuate their companies' mission or culture and keep their companies in their communities.

The owner who uses an ESOP to transfer to employees may enjoy three benefits that the owner in a standard transfer to key employees may not:

- **Beneficial tax treatment.** Using an ESOP, an owner may be able to defer or avoid tax on the sale of the stock to the ESOP. Even more importantly, the company can pay for the owner's stock with pre-tax dollars.
- **More cash sooner.** The owner may be able to leave the closing table with all of the cash necessary for a financially secure retirement due to more favorable tax treatment, and the greater possibility of at least some outside financing.
- **Motivated work force.** Perhaps because all employees participate indirectly in the benefit of ownership as ESOP participants, performance may improve. Studies, including one by Douglas Kruse and Joseph Blasi of Rutgers University, indicate that this can be the case.[i]

Of course, not all aspects of the ESOP exit route benefit the owner. Disadvantages include:

- Owners must take into account the cost and complexity of setting up and maintaining an ESOP.
- At closing, owners may receive more cash than they would in other key employee transfers, but perhaps not as much as they would have had they sold to a strategic buyer.
- In securing the ESOP loan, the owner's assets may be tied to the company as collateral.
- In many cases, key employees may not benefit as significantly as the owner might have anticipated nor as much as the employees may demand to stay on and run the company after the owner leaves.

Of course, good planning—well in advance of the owner's exit—may substantially minimize or eliminate these disadvantages. Please see our White Paper "ESOP Opportunities" for ESOP planning tips.

SALE TO CO-OWNERS

Once again, the owner (like Ben) who examines a sale to a co-owner or co-owners finds the list of advantages and disadvantages nearly identical to those on the lists for a transfer to family member or key employees.

The advantages to a sale to co-owners are:

- Buyers whose commitment, skills and knowledge are known to departing owner;
- Perpetuates the company's mission or culture;
- With planning* the owner can remain involved in the company.

- Gradual, incremental sales staged over several years offer an owner the possibility of upside gain while maintaining his or her voting interest until finally cashed out.

The disadvantages of the sale to a co-owner are:

- Owner is not generally cashed out at closing;
- Owner experiences on-going financial risk;
- Owner involvement may need to continue post-closing; and
- Owner typically receives less than full fair market value. (That prospect holds little appeal to Ben!)

A number of planning concepts that take time to implement (usually three to ten years) may well allow Ben to reap his full share of the fair market value of the company and do so with less risk. For example, this buyout can be designed so that Ben sells no voting stock until he receives the entire purchase price.

*As is always the case, smart planning undertaken well in advance of the transfer can minimize the effect of these disadvantages.

SALE TO A THIRD PARTY

This exit route usually offers owners the best chance at receiving the **maximum purchase price** for their companies. In addition, owners of larger companies who sell to third parties are best positioned to receive the **maximum amount of cash** at closing.

Owners who top their list of objectives with, "Leave for Tahiti the day after closing," initially choose this exit strategy. This route also appeals to owners who want to propel the business to the next level—on someone else's dime.

...sellers to third parties may not receive all cash, or even substantially all cash. Much depends on the size and intrinsic strength of the company, and on the state of the Merger and Acquisition marketplace.

Our list of advantages looks like this:

- Achieves maximum purchase price;
- Usually maximizes cash at closing;
- Allows owner to control date of departure; and
- Facilitates future company growth *without* owner investment or risk.

This is undoubtedly an impressive list of attributes, but before you grab the phone to call your favorite investment banker, let's review the drawbacks of this exit route.

The first difficulty is that this exit route does not match the stated intentions of most business owners. If you look back at the survey results quoted at the beginning of this Paper, just over half of business owners wish to transfer their companies to an "insider" (family member, key employee or co-owner).

Second, sellers to third parties may not receive all cash, or even substantially all cash. Much depends on the size and intrinsic strength of the company, and on the state of the Merger and Acquisition marketplace.

On a personal level, owners who choose this exit route must be prepared to walk away from their companies, but often not before working for the "new boss" for one to three years. All owners who sell to third parties wrestle (with varying degrees of success) with the issue of losing a meaningful part of their lives.

Also lost in a sale to a third party is the company's corporate culture or mission. As a company merges with a competitor or is assumed into a larger entity, its culture and its role inevitably change.

Last on the list of disadvantages is the owner's *perception* that a sale to a third party means that employees' jobs are at risk and that their career opportunities are, at best, limited and, at worst, jeopardized.

This perception appears on the list of disadvantages because it is so widely held by owners of privately held companies. Extrapolating from the mergers and acquisitions that they see among public companies (that in fact, often do lead to massive layoffs) they assume that the effect on their employees of a merger or acquisition of their company will be the same.

In our experience, however, few employees lose their jobs. Employees may, and often do, choose to leave a new employer for reasons that have nothing to do with limited or diminished career opportunities. In fact, because larger (and often public) companies do the acquiring, employee career opportunities frequently improve. Compensation and benefit packages rise to the level of the larger organization. When competitors make an acquisition, they put high value on the workforce of the acquired company.

The disadvantages of a sale to a third party are:

- Inconsistent with original exit goal of approximately 50% of owners (see study cited on page 1);
- Loss of owner identity;
- Loss of corporate culture and mission;
- Receipt of a perhaps significant part of the purchase price subject to post-closing performance of the company; and
- Potentially detrimental to employees.

Note that owners of smaller companies are less likely to close all-cash transactions and will likely have to accept promissory notes and a loss of control.

For more information on sales to third parties, please contact us.

IPO

The exit route marked "IPO" or Initial Public Offering occurs very rarely, but attracts the attention of business owners amenable to a sale to a third party for two reasons. First, the valuation of the ownership interest is usually higher than in any other form of transfer—including the sale to a third party. Second, an IPO brings with it an infusion of cash (from a pocket other than the owner's!), which propels the company to a new level.

Not surprisingly, the advantages of the IPO:

- High valuation on ownership interest; and
- Cash infusion for the business

are extremely attractive to the owner weighing various exit routes.

Unfortunately, the IPO is not without significant disadvantages. The primary one is that despite the high valuation placed on and paid for an owner's interest, *the IPO is not a liquidity event for the owner.*

An owner's interest is exchanged, at closing, for interest (shares of stock) in the acquiring entity. The owner is typically prohibited from cashing out these shares until a prescribed future date. Also prescribed is the rate at which the owner can sell his new shares. And last, but certainly not least, when the former owner does sell his shares, the price per share varies (often significantly) from the price at closing.

Not only is the closing a non-event from a liquidity standpoint, it is also a non-event from a departure standpoint. In most IPOs, the owner is required to stay on with the acquiring company. Staying on is difficult because the former owner is no longer in control. She may still be the CEO, but she is accountable to shareholders, analysts, the Securities and Exchange Commission and more.

Another exit route that an owner can choose is to keep the business while assuming the role of a passive investor.

Finally, an IPO creates a public company. As such, it is subject to reporting requirements and must uphold fiduciary responsibilities not required in privately held companies. Many business owners chafe under these additional requirements.

To summarize, the disadvantages of an IPO are:

- No liquidity at closing;
- No exit at closing;
- Loss of control; and
- Additional reporting and fiduciary requirements.

ASSUME PASSIVE OWNERSHIP

Another exit route that an owner can choose is to keep the business while assuming the role of a passive investor. This route attracts owners who wish to:

- Maintain control;
- Become gradually (or rapidly) less active in the company;
- Preserve company culture and mission;
- Minimize risk (or owners perceive risk to be low); and
- Maintain or even increase their cash flow with less risk of income loss.

The first four advantages listed above are the same as those listed in other exit routes. The last, however, deserves comment.

In some cases, especially in businesses with a value of less than $5 million, owners feel they are at less risk keeping their businesses than selling them when a third party buyer makes a major part of the purchase price subject to a promissory note or some type of "earn-out."

The disadvantages to this exit route are fairly obvious. The owner:

- Never permanently leaves the business;
- Receives little or no cash when he leaves active employment;
- Is delayed on her journey to a significant post-business life; and
- Continues to experience risk associated with ownership.

LIQUIDATION

There is only one situation in which this exit route is appropriate: the owner wants to (or must—usually for health reasons) leave the company immediately and has no alternative exit strategies in place. Liquidation offers then, the two benefits most important to the owner in that position: speed and cash.

Not surprisingly, the disadvantages to this exit route are numerous. First, liquidation yields less cash than any other exit route primarily because no buyer pays for non-existent goodwill.

Second, owners who liquidate often must allocate a greater proportion of their proceeds to taxes than do owners in any other type of sale or transfer.

Finally, owners considering liquidation must anticipate a devastating effect on employees and, to a lesser extent, on customers.

Given these disadvantages:

- Minimal proceeds,
- Significant tax consequences, and
- Affect on employees/customers,

few owners pursue liquidation unless they have no alternative or unless they operate in an industry that is clearly in decline. In that case, however, if owners engage in significant tax planning years in advance of their exit dates, they can accomplish significant income-tax savings.

CHOOSING YOUR PATH

Which exit route is best for you? Which one meets your Exit Objectives? Which path is best for Ben, Tom and Larry in our case study?

Comparing the advantages and disadvantages of each path is a good way to start making that determination. Make this comparison through the lens of your objectives is the basis for your Exit Planning process: your exit objectives and your company's value.

Owners need to establish their objectives (financial and personal) before they can identify the best buyers for their businesses. Once established, objectives (the timing of your exit, the amount of cash you need, and the type of future owner you prefer) become standards by which you can evaluate the various exit routes.

In determining company value, you learn important information about what you can expect to receive in a third party sale or through an IPO, for example. An accurate valuation will also tell you how much, in a sale to key employees, co-owners or family members, you will leave on the table. For all owners, valuation indicates the distance they must travel to reach financial security. How they reach this and other exit objectives depends on the exit path they choose.

For all owners, valuation indicates the distance they must travel to reach financial security.

In creating the best road map for your exit, use your objectives and the value of your business to carefully weigh the benefits and detriments of each path. Armed with this analysis and at least advisor skilled in exit planning, you can map out the most appropriate exit path for you.

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[i] See "Research on Employee Ownership, Corporate Performance, and Employee Compensation" at: http://www.nceo.org/main/article.php/id/3/printable/y/ for summary of 2000 study of performance of ESOPs.

Business Continuity Planning White Paper

Successful owners are usually optimistic people, somewhat averse to dwelling on the more unpleasant aspects of business. Contemplating one's demise certainly qualifies as an unpleasant aspect. Consequently, advisors to owners tend to use a lot of buzz words when we talk about business continuity. We ask, "What happens if the owner 'passes on' or 'leaves the scene?'" We talk about the consequences of an owner's death upon the business in theoretical, third party terms: "Should an owner die ..." Unfortunately, these oblique references gloss over the central fact that you, the owner, must take care of business *now* in case *you* (rather than some anonymous third party) die tomorrow.

This White Paper discusses business continuity planning in a way that you may not expect. Typically, when owners think of business continuity, they do so at the prompting of an insurance or legal advisor who warns that unless owners take prudent measures, they will leave their families unprotected in the event of death of permanent disability.

Business continuity, however, is not principally concerned with making sure that an owner's family is taken care of in the event of the owner's death or disability. As an owner, you must address those family concerns through proper *estate* planning.

Business continuity is, on the other hand, a means of handling a variety of transfer events and consequences that impact the business and the remaining (or new) owner when the original owner leaves.

This White Paper discusses the multiple problems – facing sole owners and owners in multi-owner companies – that an owner's death or disability creates for the business, for the other owners (if any), and sometimes, for the family. It also proposes solutions to each of these problems.

MAKING SURE THAT YOUR BUSINESS CONTINUES IF YOU DO NOT

The thought of what will happen to our businesses should we die is, at most, fleeting. In that brief moment, we seldom think beyond making sure our families are protected should the unthinkable happen to our co-owner, of course. Yet business continuity, in its most fundamental sense, has nothing to do with protecting an owner's family. It is about preserving and protecting the business, in the short term and in the long term, should its most important component, its owner, die or otherwise become incapable of continuing in the company.

Ownership succession is the most obvious problem facing a company but it is one of four vital issues:

- Continuity of Business Ownership
- Company's Loss of Financial Resources
- Loss of Key Talent – You
- Loss of Employees and Customers

Let's look at how each problem affects both sole-owner and multi-owner companies.

Problem: CONTINUITY OF BUSINESS OWNERSHIP

Sole Owner Company

Continuity of business ownership is the critical issue in a solely-owned company. In fact, there is no continuity unless you take steps now to create a future ownership group or owner.

Multi-Owner Company

Continuity of ownership is not an issue when a funded (with life insurance) buy/sell or business continuity agreement has been implemented. The problem is that most owners (and their advisors) fail to keep their buy/sell agreements up-to-date and, as a result, those agreements often create more problems than they resolve.

Problem: COMPANY'S LOSS OF FINANCIAL RESOURCES

Sole Owner Company

Sole owners typically give little thought to the loss of financial resources (represented by the owner and his financial statement) used for the benefit of the business. Without a replacement for that financial strength, the business may well not survive despite a plan in place for its continuity of ownership. More specifically, an owner's sudden death or incapacity can cause other "stakeholders" to discontinue their relationships with the business. These situations include:

Bank Financing. If you have personally guaranteed the company's line of credit or permanent financing, your sudden death or departure will make the bank re-examine its lending relationship with your company.

Bonding Capability. Construction companies are just one example of firms that need and rely upon bonding capacity to bid and obtain much of their work. Your sudden death will likely cause the bonding companies to refuse to extend bonding unless the financial statements of those left behind are as strong as yours. Inability to secure bonding can mean the end of your company.

Obligations Under the Lease. If you lease space or equipment, it is likely that you personally guaranteed the lease. While the lessor may be unable to do anything to terminate the lease (provided payments stay current) he is unlikely to renew the lease without the successor owner's guarantee backed by personal assets.

Capitalization Shortfall. Business owners periodically personally capitalize their companies because they keep little money in their companies. There can be sound liability and financial reasons for doing so. Your exit, however, may prevent your company from obtaining ongoing and adequate capitalization from any other source. Your deep pockets go out the door when you do.

Multi-Owner Company

If you, personally, are a principal source for financial funding (bond guarantees, line of credit guarantees, etc.), your death can put enormous pressure on the business to perform or face the risk of third parties refusing to lend or make guarantees on behalf of the company.

Problem: LOSS OF KEY TALENT - YOU

Sole Owner Company

Your death likely has the same impact upon your business as does the loss of any key person. Your talents, experience, relationships with customers, employees and vendors may be quite difficult to replace, especially in the short term. Without planning, few businesses have the financial resources or successor management to weather this storm.

Multi-Owner Company

Multi-owner companies seemingly avoid many of the problems endemic to single-owner companies. But, as it relates to the loss of key talent, this is only true if surviving owners can readily compensate for your loss. To the company, your death is the same as the loss of the key person. If the remaining owners do not have your experience or particular talents, the business suffers as sorely as if it had been solely-owned. Unless there is a key employee (co-owner or not) to fill the void, the business is wounded--perhaps mortally--upon the death of a co-owner who:

- was the marketing guru on whom the other owners were dependent to provide new clients;
- oversaw the operations of the company; or
- maintained most of the industry, customer or other key relationships.

Problem: LOSS OF EMPLOYEES AND CUSTOMERS

Sole Owner Company

A common and natural consequence of an owner's death is the speedy emigration of employees and customers unless an existing continuation plan is immediately implemented. Without such a plan, the key and non-key employees will wonder where their next paychecks will come from. Typically, they leave for greener and more secure pastures. When the workforce leaves, contracts cannot be completed and are breached, work is unperformed and creditors call in their paper. Of course, the resulting losses often require payment by the owner's estate as the case study below demonstrates.

Case Study

Clint was a successful and hard-working owner of two successful businesses. Like most entrepreneurs, he tended to make all the decisions himself. At age 43, he knew he was far too young to be concerned with his death or disability and how that might impact his family or business. And then one day, as he bent over to unbuckle his ski boot, he dropped dead.

Tragic as Clint's death was to his family, his failure to make any plans whatsoever for the businesses was a death-blow to his company. No one knew what Clint's wishes were with respect to continuing or selling the businesses. No one, (within his family especially) knew the overall business financial condition, administrative status or operational concerns. The key employees knew only one thing for sure: the businesses would not long survive Clint's death. So, these employees promptly found new employment; thus hastening the inevitable shutdown of Clint's once-vital businesses.

Multi-Owner Company

Companies with multiple owners must cope with the normal lifetime retirement of their owners. In most cases, retirement imposes a significant cash drain upon a company. In a death scenario, the surviving owners must be capable of *keeping* both the employees and the customers. Simply *having* a successor owner is not sufficient. These successors must be able to maintain cash flow as well as the confidence of the business's employees and customers. Confidence is best gained by having a written, well-capitalized continuity plan.

Solution: **CONTINUITY OF BUSINESS OWNERSHIP**

Sole Owner Company

How can you prevent the type of disaster that befell Clint's family? First, create and implement a plan to allow the business to continue after you are gone. Since there is no co-owner, you must provide for the business's continuity – even if owned by your estate or a trust for the benefit of your family – by securing the continued services of your important employees. Do everything you can to prevent your employees from leaving because they are indispensable to the business's continued existence. Secure their continuation by compensating them at a substantially increased level (usually 50% to 100% more than they ordinarily receive). This is best accomplished through the use of a stay bonus.

A stay bonus is a written, funded plan providing monthly or quarterly bonuses, usually over a twelve to eighteen-month time frame, for employees who remain with the company during its transition from your ownership to new ownership. (This applies whether the business is transferred to a third party, to employees or to family members.) The stay bonus provides a cash incentive for your important employees (perhaps 20 to 50 percent of the total workforce) to stay, hence its catchy name.

Typically, the stay bonus is funded with life insurance in an amount sufficient to pay the bonuses over the specified time period. The life insurance may be owned by the company or outside the company in an estate tax-sensitive trust. The plan is communicated to the important employees when it is created so that they know a plan exists and, consequently, that thought and planning (and money to pay salaries!) will ensure the continuation of the business.

The second linchpin of single-owner continuity planning is to do exactly what Clint didn't do – *communicate your continuity wishes now*. At a minimum, you must communicate, in writing, your wishes as to what should be done with the business upon your death or permanent incapacity:

- Designate key employee(s) or others who can be given the responsibility to continue and to supervise business operations, make financial decisions and oversee internal administration. Name today these individuals on the attached Business Continuity Form.
- Name advisors and others (such as a friendly competitor) who should be consulted in the ownership transfer process. (Again, put these names on the Form today.)
- If it is your wish that the business be sold, state that intention and list the names and contacts of businesses who have expressed an interest in acquiring your company or who you think would make an appropriate successor/owner. Do so on the Form. You may wish to indicate that it is your desire that the business be sold to key employees, continued in the family, or liquidated. The choice is yours, but you must make it while you are alive. Is there a better time than the present to do so?
- Finally, give the completed Business Continuity Form to your spouse and copies to your advisors.

Multi-Owner Company

From a continuity standpoint, the nicest thing about having multiple owners is that the business will continue if one of the owners dies, provided measures are taken (usually in the form of an up-to-date, adequately funded buy/sell agreement) for the remaining owners to acquire the deceased's interest in the business. Having said this, chances are, your buy/sell agreement has *not* been recently reviewed, *does not* reflect current business value and *does not* completely address the many possible transfer events such as:

- Death,
- Disability,
- Transfer to a Third Party,
- Termination of Employment,
- Retirement,
- Involuntary Transfer Due to Bankruptcy or Divorce, and
- Business Dispute among Owners.

Finally, it is likely that your buy/sell agreement *does not* fully address each transfer event (e.g, termination of employment of an owner) from the perspective of whether the company has (or the other owners have) an option, or put a mandatory requirement to reacquire the ownership interest.

As may be apparent, the biggest risk to the continuation of businesses that are co-owned is not the death or disability of one of the owners. Rather, it is that the above-listed events are considered once and memorialized in an agreement. All further thought and action on the subject are shelved – along with the agreement.

Solution: **COMPANY LOSS OF FINANCIAL RESOURCES**

Sole Owner and Multi-Owner Companies

The problem of dealing with unexpected losses or unexpected financial complications in the business can best be met in two ways. First, simply use life insurance to fund for the anticipated need. Although life insurance is part of the solution, it is a means to an end; by itself it is simply a source of cash. Realistically, if the business is to succeed long term, after your death, it needs more than life insurance. It will need successor management, motivated by ownership or cash (current and deferred). The only way to make certain the business continues without you is to make certain that the business is more than just you.

But any long-term solution, such as having a successor management in place today, cannot succeed without having adequate funds from the outset. And it is precisely this point that owners and their advisors overlook. The loss of an owner usually dries up the company's financial wellsprings:

- Bank financing, usually guaranteed by you;
- Equipment and other financing, guaranteed by you;
- Bonding capability, guaranteed by--guess who?--and
- Adequate capitalization, supplied by you.

These resources propel the business through difficult times into a brighter future. It is highly unlikely that successor management or ownership can replace your balance sheet with theirs.

A company's loss of financial resources can be mitigated by placing money, and lots of it, in the company coffers when you depart. A fully-funded (with life insurance) buy/sell agreement (including a current valuation) just buys out the deceased owner's interest. By itself, it does not place one penny in the company's bank account. For that reason, few companies have adequate cash to survive an owner's death.

To address the loss of financial resources, a business, for its own current and future needs, requires insurance on your life in an amount sufficient to replace its immediate losses and to provide it with adequate ongoing capitalization. These insurance proceeds will enable the business to grow and prosper without you and your personal balance sheet.

Solution: **LOSS OF KEY TALENT – YOU**

Sole and Multi-Owner Companies

In a solely-owned business, the key employee is almost always the owner. Usually, it is the owner's entrepreneurial drive, experience and dedication that stimulate a business. Losing its key employee, *you*, is a blow from which many businesses do not recover. If your business is a mirror image of you, it is unlikely that any amount of key person life insurance or other source of cash will suffice. You must create value (within the company and distinct from you) in the form of successor management capable of filling the void left by your unexpected departure.

In a co-owned business the loss of an owner is not as drastic, provided your co-owner can carry on without you. If your co-owner cannot replace you, train employees to perform the same or parts of the same role as the dearly departed. You must take the same step if you desire to sell the business for top dollar during your lifetime. In either scenario (a lifetime sale or transfer caused by the death or disability of an owner) the underlying need is the same: capable employees must be available to assume the responsibility of running the business. In a lifetime transfer, if the owner is ready to leave the business but the business cannot survive or at least thrive without him, the owner is forced to remain operating the business until successor management is located and trained.

When an owner dies, however, the absence of the successor management is more devastating because you are not available and the best hope is to provide the company with adequate cash, in the form of life insurance proceeds, so that the business can survive until replacement management is located and trained. That cash is also used to produce a cash-based incentive plan designed to motivate and retain the new management.

In a co-owned business, the loss of an owner can severely strain the business but the remaining owner can, especially with sufficient life insurance proceeds, find and train replacement management as well as provide that replacement management with a significant cash incentive plan.

As you well know, finding and training your replacement can take years. Why not prepare your company today for an ownership transition? Remember, at some point you won't be in your business. We hope your absence will be due to a sale to an outsider or perhaps to the very key employee you have brought into the company. Perhaps, however, it will be due to death or disability. No matter the cause, your business will survive and thrive only if you have found, trained and motivated your replacement *before* you leave the business.

In a real sense the continuity of a business is a transition of ownership from you to equally capable individuals of an operationally and financially sound company. In the situations we have discussed here, (primarily death or disability of an owner) life insurance can instantly provide significant financial strength. But the business also requires talented, motivated key successor management. And for that, there are no quick fixes. The benefit of starting today to find that key successor management is that you will be building value within the company that will be converted to cash when you leave it. Leave it, we hope, alive and healthy.

Solution: LOSS OF TALENT: EMPLOYEES AND CUSTOMERS

As Clint's situation illustrates, the death of an unprepared owner ignited a cascading series of events for the business. Chief among these are the departures of employees and customers. The loss of employees is followed immediately by defaults under contracts. Because of the inability to perform promised work, customers inevitably leave.

Why do employees leave? Usually they fear that the business will not survive, thus jeopardizing their salaries and future employment. Additionally, when the owner's leadership role is hastily transferred to anyone but a recognized successor, employees and customers grow uneasy. With uneasiness comes migration to a new employment and to other vendors.

These financial and personal concerns must be quickly quelled by implementation of a preconceived, funded continuity plan. Employees must know that a plan exists that guarantees their compensation and clearly names your successor. With these assurances, most employees and customers will stay with the company.

Sole Owner Company

In a solely-owned business, financial and personal concerns about succession are handled through:

- A written (funded by life insurance) Stay Bonus Plan (described above in the Solution to Problem One) communicated to employees when it is prepared;
- A succession of management plan that you prepare, now, naming the person to be in charge; and
- A decision made now, by you, regarding the sale, continuation or liquidation of the business in the event of your demise.

Multi-owner Company

In a multi-owner company, loss of employees and customers does not usually present a problem because of the presence of other owners.

CONCLUSION

Business continuity issues can be divided into two camps: those that occur while the owner is alive and those that arise upon the owner's death. In the case of transfers during an owner's lifetime, you have the luxury of time to find and to train your replacement. Not so in the case of death. In order to survive your demise, your company must have adequate cash (almost always subsidized by insurance on your life) to survive:

- Continuity of Business Ownership
- Company's Loss of Financial Resources
- Loss of Key Talent -You
- Loss of Employees and Customers.

In the short run, money is required to:

- Effect a buy-out;
- Provide capitalization;
- Replace your balance sheet with respect to lenders; and
- Provide cash incentives to entice your employees to stay.

In the long run, a successful business is one you can either sell for top dollar and exit in style, or one that can survive, in style, your exit.

CAPITAL REGION
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BUSINESS CONTINUITY INSTRUCTIONS

The following people can be given responsibility to continue and to supervise these activities:

Business Operations: ____________________

Financial Decisions: ____________________

Internal Administration: ____________________

UPON MY DEATH OR PERMANENT INCAPACITY, THE COMPANY SHOULD BE:

- ❑ Sold to an outside third party. ____________________
- ❑ Sold to employees, specifically: ____________________
- ❑ Transferred to family members; specifically: ____________________
- ❑ Continued   Liquidated

As guidance, I suggest that:

- ❑ An acceptable price range would be between $__________ and $__________
- ❑ A minimum price range would be $__________
- ❑ You secure a valuation from: __________
- ❑ You ask __________ to recommend a valuation specialist

In the scenario I have chosen above, please consult the following professional advisors:

Name	Type of Advisor	Phone Number

If I have indicated that a sale is appropriate, below are names of people/companies that I have expressed interest or who I believe would be interested in acquiring the company:

Has expressed interest   I think may be interested

____
Name   Company Name

Has expressed interest   I think may be interested

____
Name   Company Name

Signature____________________ Date signed __________

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10 Questions Top Advisors Ask Every Business Owner They Meet

1. How do you see your involvement in your business changing or evolving in the future?
2. What's your next great adventure after you leave your business?
3. What obstacles are you seeing that could derail your business or personal goals in the coming years?
4. What role does your business need to play in helping you achieve financial freedom?
5. What is your plan for your ownership interest in your business: do you plan to pass ownership along, or arrange for a sale some day?
6. What method or methods have you used to assess the value of your business, and how confident are you in that process?
7. Given your (buyer or successor) plans, have you thought about who the best leader for your business might be?
8. Tell me about what will happen with your customers, your vendors, your employees, and your competitors if something happens to you.
9. What planning suggestions have other business advisors given you to prepare for the future ownership of your business?
10. What do you see as your greatest challenge when you think about planning for the future?

BONUS QUESTIONS:

- What other questions should I be asking?
- How can I help you and your business be more successful?