PRIVATE WEALTH MANAGEMENT

Business Transition Series: Transition Options

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Business owners commit a significant amount of their time, talent, and finances to building their business. However, they often overlook planning for the eventual transition of the business. So, what are the transition options when they are ready to step back, or step out of the business?

When considering the transition of the business, owners have many options available to them. Understanding the traits and characteristics of each option will help the business owner ensure they meet their business, personal and financial goals. These options can be divided into two categories - internal and external transitions.

Transition Categories	
Internal Transition	External Transition
Intergenerational Succession	Sale to a Strategic Buyer
Sale to Partners / Shareholders	Sale to a Financial Buyer
Management Buyout	Recapitalization
Sale to Employees (ESOP)	Orderly Liquidation

Each option should be carefully considered to understand both the pros & cons.

Internal Transitions

Intergenerational Transfer
The transition of a business to the next generation is often the primary choice for business owners when children are actively involved in the business. This approach provides the owner a high degree of control, is less disruptive to the business and creates an ongoing family business legacy

For families with children active in the business, and other children who are not involved in the business, a key consideration that may need to be addressed is the impact the transition could have on family dynamics. Additionally, it is important for the business owner relying on proceeds from the sale for their post-transition lifestyle to consider that the next generation may not have the funds to purchase the business outright. This is often addressed through a phased transition and/or financing of the sale. Effective planning can help a business owner avoid spending their golden years back in the office trying to right size the company.

Sale to Business Partners
Existing partners are well-informed buyers and can create a less disruptive transition. Transitioning to existing partners may make sense where they are actively involved in the business and have the needed skills to continue the growth of the business.

Possible issues may include discord between the partners, gaps in their competency levels, the buyer's potential lack of liquidity, and a potentially lower sale price due to lack of competition. Properly structured and funded buy/sell agreements are often a critical part of a successful transition strategy for a sale to business partners.

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Management Buyout
Existing management may be a good option for a smooth transition. Transitioning to existing management provides for knowledgeable buyers, continuity for customers and employees, and the opportunity for the owner's continued involvement in the business.

Like other internal transitions, management team members may not have the necessary liquidity to purchase the business outright. It is also important to consider whether managers have the entrepreneurial spirit required to maintain and grow the business.

Sale to Employees (Employee Stock Ownership Plans "ESOP")
An Employee Stock Ownership Plan enables employees to own all or part of the business they work for. The company creates a trust, that then borrows funds to purchase the owner's shares. The trust holds the shares on behalf of the employees. The ESOP is a qualified retirement plan for the benefit of the employees that can create an ownership mindset. For the business owner, the ESOP provides immediate liquidity as well as significant potential tax advantages.

Establishing and maintaining an ESOP can be complicated and expensive. The owner may be required to provide some portion of the financing to the ESOP. Also, the share price is limited to an appraised fair market value, possibly reducing the price the owner could receive from other options.

External Transitions

Sale to a Strategic Buyer
A strategic buyer is typically a company in the same or complementary industry, interested in capturing the synergies through an acquisition. Prices tend to be higher than internal options with more cash upfront allowing the owner to step away more quickly. The business can also experience a "refresh" of growth through the synergy.

A negotiated sale can be a long process, averaging 9 – 12 months, creating the potential for distraction as well as privacy concerns. Unlike an internal solution, it can be a more emotional event for the owner.

Sale to a Financial Buyer
A financial buyer is an investor (usually a Private Equity company) interested in the return that can be generated by buying a strong company. They will increase cash flow by boosting revenue, cutting costs, and/or creating economies of scale by buying similar companies. Financial buyers may ultimately use an initial public offering (IPO) to monetize their investment. Financial buyers will look for companies with solid management in place. Many of the advantages are the same for both strategic and financial options - higher price, cash up front, the ability to step away, etc. Because these sales are often done as an auction (competitive bids), this can be the highest price for the owner. The disadvantages are also similar to those with a strategic buyer - a long process, potential distractions, complexity, and a possible emotional impact on the owner.

Recapitalization
A recapitalization (recap) is a financing technique that allows the owner to take substantial equity "off the table". Financing is commonly provided by a private equity company in exchange for an ownership interest. Private equity buyers often seek a majority ownership interest but are sometimes willing to consider a minority stake. A recap allows for a partial exit and the diversification of the owner's assets. In addition, a recap provides the owner with the opportunity to participate in additional future liquidity events.

Disadvantages may include a loss of control as well as ongoing accountability to the financial partners. This option typically requires the owner's continued engagement in the business and a likely cultural shift in the company.

Orderly Liquidation

An orderly liquidation may be an appropriate option when the assets of the business have a greater value than the ability of the business to produce enough income to support ongoing operations. The assets would be sold, and the business would be wound down. This may be the better option when the sum of the parts is greater than the whole. This is not typically an option for a sustainable business. Disadvantages include uncertain proceeds, termination of employees and the emotional toll on the owner.

Conclusion

All businesses will eventually transition. Understanding the transition options available, the advantages and disadvantages of each, and planning well in advance are best practices for a successful business transition. Your Regions Wealth Advisor can help you build your transition team and support you throughout the transition process.

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