PASSING *the* BUCKS

Successful Business Continuation and Management Succession Require a Comprehensive Exit Strategy

By Ben M. Brahinsky

Developing and executing a comprehensive exit strategy from your company is the ultimate test of a truly successful business owner. Many owners underestimate the time and difficulty involved in completing this critical task. A simple five-step process will help you plan for transferring company ownership and management.

Understand the Problem. The first step in solving any problem is to recognize that you have a problem. A business continuation "problem' is an easy one to ignore because it is not nearly as pressing as an upcoming bid, an unhappy client or a job in trouble. Besides, you are going to live (and work) forever, right?

Part of the problem is that contractors do very little actual planning in this area. This fact was reinforced by a contractor survey conducted by FMI that revealed only 40 percent of companies had written plans to address the continuation of their company. Further analysis revealed that many of those plans were no more than simple wills, leaving everything to spouses or trusts. In other companies, the plans consisted of large life insurance policies payable to the company. The real issue is that most of these plans functioned only at death and did not address a transfer while the owner was alive.

Only 15 percent of those surveyed had communicated their plans to their employees. It's hard to implement a plan if no one knows about it. Optimistic as always, 84 percent of the contractors said their businesses would survive into the next generation. Statistics reveal, however, that fewer than 20 percent of those companies will actually make it. Proper planning and time, not luck, is required to ensure a smooth transition.

The two impediments most frequently cited to a successful transition were a lack of financial resources by the employees to conduct an internal buyout, and the existing owner/manager refusing to transfer control and management. Procrastination and delay of continuity planning was also common.

Most of the reasons are ego-driven, emotional and difficult to address. In a family owned company, it is often easier to not tackle important decisions in order to avoid potential conflicts or family stress.

If there are three children, then each is entitled to equal ownership, right? What if one child is the heir apparent due to his active participation in the business and the other two are uninvolved in the business? Avoiding such situations with family or employees impedes planning and reduces the chances for an effective transition.

Due to the complexity, tough decisions and emotions involved, many contractors retreat into inaction. There is a bundle of interwoven issues that need to be simultaneously addressed. Some of these are tax, legal, financial, management, family, estate, valuation, insurance, risk, leadership and performance.

A contractor should avoid becoming an expert at management succession, tax matters and corporate reorganizations. The "how to" should be left to the experts, while the owner should assume responsibility for deciding what is to be accomplished, by whom and in what time frame.

Defining Objectives and Parameters. Where do you start now that you realize that there is a problem and you have a desire to solve it? Most business people assume that the first step is to become thoroughly familiar with all the tax, legal and accounting issues affecting the transfer of ownership. They often spend a great deal of time consulting their attorneys, accountants and insurance advisers. Then, they spend even more time consulting someone else's attorney, accountant and insurance adviser. As a result, they find themselves trying to absorb and sort out confusing and often conflicting advice about transferring ownership.

By addressing the following questions and issues, you will build a blueprint for your succession plan.

- Business continuation: Sell? Internal transfer? Liquidate?
- Stock ownership: Who? When? How much? How will it be paid for?
- Voting control: Who should have it? One person or a group?
- Do you have a contingency plan in event of death? In event of disability?
- Family: How much involvement? Ownership? What are their employment opportunities?
- Financial objectives: Gash flow. Equity removal. Estate. Insurance.
- Indemnification and Guarantees. Reducing risk Transferring risk to the next generation. Who signs and when?
- Buy-Sell Agreement. Price? Terms?
- Retirement. When? To what extent? What role do you want to play? Compensation?

Now that you have a better understanding of the questions and issues, the next step is to develop and implement a comprehensive plan.

Experience suggests that selecting an

outside adviser to direct the process and guide the development and implementation of your plan will yield the best results. Your adviser should gather input from you and your employees and coordinate the process with your other professional advisers. Resist the temptation to acquire information from a lot of outside sources and to manage the entire process above. You will only become the victim of confusion.

Determine Your Company's Value. The primary question in the valuation of a contracting business is, "Who's asking?" Is it the Internal Revenue Service, a third-party buyer or the employees? Each has a different perspective, different objectives and resulting value. A detailed treatise on corporate valuation is beyond the scope of this article. However, a few key points about valuing construction companies should be made.

- There are three generally accepted methods for valuing closely held firms: assets, earnings and market, and they all should be considered in making a determination of value.
- The earnings value of the firm should ultimately be such that a buyer would be able to earn, via the after-tax profits, at least a 15 percent to 20 percent return on the investment.
- Book value or adjusted value may or may not reflect the real value of the firm. Most transactions in the construction industry are closely supported by underlying asset values. Most sellers won't take large discounts from book value, and most buyers will not pay large premiums over book value.
- In selling stock to employees, the abstract value is less important than the

ability of the employees to pay. Setting the value at $1 million if the employees can afford only $250,000 is futile.

- Perceptions of "value" vary greatly depending on one's perspective, knowledge and attitude.
- Unrealistic expectations of value can kill a deal before it gets started. What would *you* pay for this company?"

Transferring Ownership. Three options exist for removing equity from your business: liquidate, give away or sell.

Liquidation. You can shut the company down, sell everything that is salable, pay your taxes and take the money. The company, for the most part, simply ceases to exist. This alternative should always be considered because of its strong advantages. It is clean, usually quick, minimizes future risk and avoids difficult family and employee situations. There is, however, a large price to pay for this alternative from financial and emotional perspectives. Contrary to popular opinion, liquidation is an option that should be evaluated by nearly every owner. It is usually the last choice, sometimes the only one and often the best.

Give Your Company Away. When contractors choose to give their companies away, many think of family members first. That option works well, particularly if the recipients of the gifts are working in the company and performing in responsible management positions. There are some major disadvantages associated with giving away your company. Sometimes the recipients of gifts are not psychologically prepared to accept the responsibilities of ownership. Successful owners invest a great deal of themselves in their companies, and people who make no personal investment often lack the commitment required to successfully run a company.

Sell Your Company. If you don't want to liquidate and can't afford to give the company away, your only choice is to sell. Selling is the alternative most contractors choose. There are two potential buyers: "outsiders" or "insiders."

A sale to a third-party buyer is a perfectly acceptable alternative. Many construction companies are purchased by other construction companies who know the construction business, even though they may not be familiar with your particular market, customer base or type of work. A third-party sale has several advantages: It eliminates ongoing bonding and credit risk; the problems of succession and the business belong to the new owners; and the seller is generally cashed out at closing.

Many ways exist to structure buyouts and to keep your management team intact. Structuring the buyout so you can remain in management for some time can allow for an income stream. It also enables you to train your successor and, subsequently, build a stronger future for your company If a buyer can be found, selling to a third party is often the best alternative.

Ideally, however, many a contractor would choose to sell his company to family or key employees. In general, we believe that the people who buy the company should be the same people who are actively involved in the day-to-day management. Absentee ownership in a closely held construction company is difficult and can create problems.

Advantages of an internal transfer include ongoing involvement, opportunities to key employees, and continuing income and earnings participation. Disadvantages are the requirement of strong profits, an ongoing risk, a five- to 10-year time frame, and the owner must give up earnings to fund the transfer.

There are many approaches and combinations that can be used to transfer ownership. Every alternative should be considered. The resulting structure is usually a combination of techniques and concepts. The ownership transfer plan should be fully modeled for 10 years with tracking of earnings, equity, ownership structure and cash flows. Various what-if scenarios must be evaluated given different assumptions.

The most frequently used techniques are direct sale for cash or note, leveraged buyouts, stock redemptions, stock recapitalizations, stock options, stock bonus, restricted stocks, ESOPs, sub chapter S buyout, joint venture, permanent joint venture and either a spin off, or a split up.

Sometimes the decision is made to keep the stock in the family or sell to a small group of people. If key employees cannot be stockholders, how can you compensate them in a way that they will remain with the company?

There are several ways to assist those key employees in their efforts to accumulate long-term wealth without making them stockholders. These include deferred compensation, phantom stock, off-balance-sheet partnerships, profit sharing and insurance arrangements. The key objectives of these techniques should be to reward those employees who remain with the company and perform well.

Making It Work. Rarely has there been a situation where the owner's reasonable objectives could not be accomplished in an ownership transfer plan. You may need to exercise creativity in your individual situation—every family and every company is different.

Once you envision what the future ought to be and what you would like for yourself, your children, your key employees and the company, then there is a technique or a combination of techniques that will allow you to meet your objectives. Insist on answers that will workdon't accept excuses about why your visions cannot be realized. Pick a person you trust and have confidence in to oversee the process. There is only one opportunity to plan correctly, the costs of making a mistake can be enormous and may cause legal or personal difficulties. The approach outlined in this article will yield a comprehensive and integrated plan that accomplishes your objectives and gets done.

About the Author

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