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As A Family Business Owner, It's Important To Know All Of Your Options As You Plan For Your Business Transition

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Family business owners spend years working to build and maintain their businesses, but often fail to plan for what will happen when they are no longer involved in the business. Ownership and control of all businesses must transition at some point, and having a plan is essential to maintaining business value and family harmony. Business transition planning involves understanding the ownership transition options, determining the options that best meet the objectives of the owner and their family, and then preparing the business and the family for the transition. This paper provides an overview of the most common ownership transition options and considerations for each.

There are essentially three alternatives for transitioning ownership of a family business.

1. Keep the business and transition ownership to the family;
2. Sell the business to a third party; or
3. Sell the business internally (to management/employees).

Transition Business to Family

There are several reasons that a business owner may choose to transition their business to the next generation of family members. This may be the obvious choice if members of the next generation are actively involved in the business, can lead the business, and, perhaps most importantly, want the business. This may also be the best option when the value of the expected long-term cash flow of the business exceeds what the business can be sold for. However, the decision to keep the business in the family is the transition option that requires the most advanced planning to avoid issues down the road.

If the next generation cannot agree on the future ownership or control of the business, then transitioning the business could create family dynamics issues. Similarly, if the next generation cannot successfully lead, then keeping the business in the family could result in loss of value or even failure of the business. In these situations, the business owner must determine whether an independent trustee or board could be put in place to control the business and whether the management team could be maintained to ensure that the business continues to prosper even without family involvement.

In addition to the family dynamics and business continuity issues associated with transitioning ownership in a business to family members, the business owner's personal financial needs and retirement timeframe must also be considered. Transitioning the business to family requires the owner to remain active in the business long enough to implement the transition plan, and the owner must generally be willing to forego the potential payout that may have resulted from the sale of the business outside the family. In addition, the owner is often subject to retained risk, relying on the next generation to maintain the value and cash flow of the business necessary to meet the business owner's financial needs.

Third-Party Business Sale

A business sale to an external third party generally yields the highest sales proceeds, provides the owner with the greatest immediate liquidity and least retained risk, and requires the smallest amount of continued involvement by the owner. These are compelling reasons for a business owner to choose a third-party sale as their business exit strategy. However, depending on factors such as the industry, owner involvement, and size of the business, there may not be a realistic external buyer. In addition, a third-party sale can be a lengthy and intense process, and a third-party sale is often structured as an asset rather than a stock sale, which can have negative tax consequences to the seller. There may also be earnout requirements, which may increase or decrease the amount the seller receives, depending on whether future performance meets certain metrics. External buyers include strategic and financial buyers.

Strategic buyers tend to be competitors, customers, suppliers, or other participants within or interested in entering the seller's industry or market. Strategic buyers typically purchase 100% of the business to gain full control and allow the business to be quickly integrated. These deals are often all cash, but if a buyer is unable to fully fund the purchase price, they may request seller financing or use acquiring company stock as partial consideration. Earnouts are also common, especially for smaller business sales where there are few potential buyers, or may be used to bridge a gap in the negotiated value. The sale to a strategic buyer often results in the highest valuation because of anticipated synergies, and, because a strategic buyer already understands the business, the seller can generally walk away with little or no continued involvement. However, if there is only one or two potential strategic buyers, then it may be difficult for a seller to obtain the desired value for the business.

Financial buyers are typically private equity firms, but also include family offices and other permanent capital providers. Financial buyers generally do not have the industry knowledge necessary to assume management of day-to-day business operations. Because of this, financial buyers want a seller to have a strong management team and often require the owner to remain involved for a certain period of time after the sale. Financial buyers will always purchase at least 51% of the business to acquire a controlling interest. These deals generally consist of cash for the equity being sold, and sellers are expected to retain or "rollover" a portion of their equity, which aligns the seller's interest with those of the buyer but also allows the seller to retain an interest in the upside in the future of the business. A financial buyer is typically easier to find than a strategic buyer. However, businesses generally need EBITDA (earnings before interest, taxes, depreciation, and amortization) of at least $2M for private equity firms to be interested, as well as clear growth potential and exit options.

Internal Business Sale

If there is no third-party buyer and a transition to the next generation of family members is unfeasible, then an internal sale may be an owner's best choice for their business succession plan. Internal sales are generally much easier and less expensive than a third-party sale and are almost always structured as a stock sale, which generally results in less tax to the owner. Internal sales are also less disruptive to employees and can aid in retaining a strong management team. Internal sales generally consist of cash and some form of seller financing, which is secured by the equity being sold but is likely to be subordinated to any third-party business loans. A management buyout is a common type of internal business sale. If the management team does not have sufficient capital to purchase the business, another option is an employee stock option plan (ESOP).

A management buyout can help to keep a management team in place, but generally results in a lower price for the business and typically involves more retained business and payment risk. For a management buyout to be successful, the management team must be committed to completing the long-term buyout and to becoming "owners" instead of simply being employees. A management buyout often consists of a relatively small amount of cash, with the rest being seller-financed, and the selling owner may need to remain involved in the business, depending on the quality of the management team. Although the selling owner and management team likely have a good relationship, it is important to properly document the terms of the sale, including clear control, default, and buy-sell provisions.

An ESOP is a federally qualified retirement plan that can allow a business owner to essentially create a buyer for a good business that may otherwise be difficult to sell. An ESOP can also provide significant tax benefits to the seller and the business itself. Owners typically keep at least 51% ownership to maintain a controlling interest until they are ready to fully exit the business. Although there is no minimum size requirement, a business generally needs to have a market value of at least $5M or at least 25 employees for an ESOP to be appropriate, and a feasibility study will need to be prepared. An ESOP is the most complicated of the business transition strategies, and business owners considering this strategy should contact an ESOP advisor to determine if it may be right for them.

Ownership and control of all businesses must transition at some point, and having a plan is essential to maintaining business value and family harmony. It is important that family business owners understand the different transition options that are available to them, determine the transition option that best meets their objectives, and implement a business transition plan. Your financial advisor can provide additional information about business transition planning.

If you have any questions or would like to discuss your business transition plans further, please reach out to your client service team, visit us at hbwealth.com, or call 404.264.1400.

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