BusinessAdvisor

a resource for business owners

FROM THE LAW OFFICE OF MARY HANSON

VOLUME 39
NUMBER 1
SEPTEMBER
2022

Mary Hanson

About the BusinessAdvisor

The Business Advisor is written and published by Mary Hanson, a business attorney in Torrance, California.

Mary Hanson has a law degree from the University of Wisconsin and an MBA from the University of Southern California. She has practiced business law exclusively for more than 40 years.

She provides legal services related to owning, operating, buying, selling, and structuring businesses. Her clients are business owners in many different industries. She handles corporations, LLCs, new businesses, new ventures, and a broad range of contracts and business decision-making.

Her interests include flying and World War II.

Her law office is located in the Del Amo Financial Center, 21515 Hawthorne Blvd. #885, Torrance, California. She can be reached at (310) 543-1355 or by e-mail at mhanson@bizadvisor.com

Exit Strategies for Business Owners

by Mary Hanson

Every business owner should have a strategy for retiring and permanently exiting his or her business. The business owner should make the effort to identify the best plan for his or her exit and should operate the business in a manner that is not inconsistent with the exit plan. Whether the plan is to sell the business, to transition the business to the next generation, or to close the doors and liquidate the assets of the business, the plan needs to recognize the strengths and weaknesses of the business as well as the retirement needs and objectives of the business owner.

The best situation for a business owner is having a business that is profitable, well-situated against competitors, and blessed with a strong management team that is not dependent upon the business owner. Such a business should be attractive to buyers and also be a good candidate for a transition to the next generation. The owner of such a business will have more options for exiting the business and the ability to do so at a better price and on better terms.

The exit strategy should address the needs and objectives of the business owner, the circumstances of the business, the amount of time the business owner has to make an exit, and future management of the business.

Exit Strategy Questions for the Business Owner

Does the business owner wish to retire soon? How long does the business owner plan to work?

Does the business owner have health issues, family issues, or other issues that may necessitate an exit in the near future?

Is the business owner financially secure without funds from sale of the business? Can the exiting business owner afford to take the risk of not receiving payment for the sale of the business?

Do any family members have the ability to successfully manage the business – either permanently or in the event of an emergency?

Is the business sustainable? Does the nature of the business, the industry it is in, and its competitive situation suggest many more good years for the business?

Are challenging changes anticipated that will require significant effort or investment in future years? Does the business generate enough profit to cover potential changes and additional investment?

Does the business owner have additional resources that could be used to finance the business changes?

Does the business have vulnerabilities that impact its saleability or sustainability?

Are there interested buyers? Are there suppliers, customers or competitors that are likely interested buyers of the business?

Here are the alternatives most business owners consider for exiting a business:

Sale of the Business

A sale of the business is the most common exit because it provides sellers with the cleanest break from the business. Typically all (or almost all) business activity is transferred to a buyer

"Can the exiting business owner afford to take the risk of not receiving payment for the sale of the business?"

and retiring owners can cease all further involvement in the business.

The typical benefits of selling a business as an on-going concern include:

• Potentially significant purchase price based on future profit expected by the buyer;

• Transfer of liabilities such as payroll, rent, customer services, completion of contracts, and disposition of furniture, fixtures, and equipment; and

• Possible additional payment to the retiring business owner for personal services as an employee or consultant.

In order for a business to be attractive to a buyer and sell at a good purchase price the business must be profitable enough to offer a buyer a good return on investment. Key elements of a saleable business are:

• Profitability. Profit margins that cover the costs of labor, materials, and overhead, with profit left over for growth or additional compensation is always attractive.

• Diversified customer base. Having many customers insulates the buyer from the risk of losing most of the profit with the loss of a big customer. A broad base of customers signals a broad appeal of the company's products or services.

• Financial records that show a history of profitability and good management.

• A strong management team. Having a number of capable people in management positions gives a buyer confidence that the business can survive and do well without the retiring owner.

• Growth potential. Many business buyers look for businesses that can be grown or scaled up to a larger business.

• Unique value. Business buyers may look for businesses with some unique competitive advantage in order to support premium pricing and provide protection from competitors. A business has more value and more appeal if competitors can't match the products and services of the business without an investment of time and money.

Transfer to the Next Generation

The same features of a business that make it saleable to a third party are needed to make it transferrable to a new generation of management. A business may need to be even stronger for second generation ownership than for sale to a third party. A younger generation may need a stronger management team to support the business without the retiring generation. The younger generation may need higher profit margins to support growth – or to survive mistakes and missteps by the less experienced younger management. While an outside buyer might provide management personnel, business planning ability, and additional capital, a business transferred to a second generation will need to have these resources or find them elsewhere.

This "exit strategy" is not a realistic exit strategy if the former owners (the parents) have to keep on working to keep the business running or have to keep advancing funds to prop up the business or the kids or both. Similarly, a business is not a good inheritance or gift to the next generation if the ultimate consequence is a great deal of time and effort by the second generation for very little financial reward.

There are greater challenges to running a small business today than there were in the past while the financial rewards are often less. Management today must deal with more government regulation, greater competition, higher employee wages and benefits, higher overhead, higher taxes, more legal threats and potential lawsuits, and a cultural shift away from long work hours and employee loyalty.

Questions for Transfer to the Next Generation

To determine whether transfer to the next generation will work as an exit strategy, business owners need to assess their financial needs, their ability to handle financial risk, the nature of the business (considering financial condition, profitability, sustainability, competitive position, availability of management and labor), and the management ability of the next generation.

Can the next generation manage the business without the involvement of the retiring generation?

Does the business have vulnerabilities that could make future operation of the business unsustainable, difficult, or unprofitable?

Can the retiring business owners afford to not get paid for the business?

Will transfer of the business to certain children create a problem of equitable treatment for all the business owners' children?

Small businesses are challenged by the limitations of capital, management personnel, employees, and economies of scale. A thriving business in the hands of the retiring owners can become a struggling business for the next generation.

Liquidation

The alternative of "closing the doors" and liquidating the business may sound easy and clean, but this is harder that it sounds. This alternative should be disfavored. Without a stream of income the business assets have much less value. The value of furniture, fixtures, equipment, and inventory without an on-going business is typically very low. A service business may have no meaningful assets. The final disposition of various assets will require business owners to find a number of interested buyers. Removal and transportation of equipment can be difficult and expensive. Even the sale of valuable assets may fail to generate significant funds, and the funds generated may fail to cover the obligations of the business. In addition to the low sale price of assets in liquidation, business owners liquidating a business must deal with the consequences of the termination of employees and disappointment of customers. Termination of a lease can leave the business owing many months of rent. There may be contracts to fulfill, storage of inventory and equipment, debt to be paid, and employee payroll continuing until the liquidation is complete.

The planned liquidation of a business using experienced business liquidators can generate much greater funds than an abrupt fire sale, but the proceeds are typically nowhere near the value that can be obtained by selling an on-going business with a stream of income.

Questions Regarding Liquidation

Are there no buyers for the on-going business? Is there a low price that

"A thriving business in the hands of the retiring owners can become a struggling business for the next generation."

Business Advisor
a resource for business owners
From the Law Office of Mary Hanson
21515 Hawthorne Blvd. • Suite 885 • Torrance, California 90503 • (310) 543-1355

Publisher's Note

There are other exit strategies that may be available to business owners whose companies generate strong profits and have a strong employee base. A business owner may transfer ownership of a company to the company's employees through the use of an Employee Stock Ownership Plan. Because of specific requirements of tax law and labor law establishing and implementing an ESOP takes time, effort, expense, and particular expertise. There are attractive benefits to the business owner, including the creation of a buyer of the stock of the company, tax-deductions for contributions to the ESOP trust, and the possibility of deferral of capital gains taxes for C corporation shareholders.

Sale to a private equity firm may be an option for some business owners, since private equity interest in smaller companies has grown. A typical private equity transaction involves the purchase of the business with the seller retaining a small percentage of ownership in the business. The acquiring firm's goal is typically to grow the business for a sale at a higher price in 3 – 5 years.

Mary Hanson
Attorney/Publisher

would entice a potential buyer to take over the business as a whole?

Can a portion of the business be sold as an on-going business, leaving just a portion of the assets to be liquidated?

Are there problems that make the business unsaleable? Can the problems be resolved to make the business saleable?

Merging Two Businesses

Combining one business with another business as a step toward retirement may also sound attractive. The greatest risk in this exit strategy is that the new co-owner of the merged business may lack the desire or the financial ability to facilitate the exit of the retiring business owner. A business owner wishing to retire typically needs a buyout commitment, not a partner. Once the retiring business owner merges his or her business with another business, he or she no longer has a business to sell to someone else.

Another risk is that the merged business may not be as financially successful as the original unmerged business. The business owner hoping to retire may be working harder than ever for less financial reward.

A business owner using a merger as an exit strategy needs the merger agreement to provide all the terms of the ultimate buyout, even if the agreement includes years of working together to build the combined business. The agreement needs to cover both the ultimate sale and the interim management of the merged business. How long will the seller work for the merged business? Does the "buyer" in the merger have the financial strength to meet all the commitments of the merged business and also pay for the exiting business owner's business? BA