Succession Planning Guide for Small Businesses

A helpful resource for business owners who are starting the business succession planning process.

First and foremost, congratulations on being a small-business owner.

Entrepreneurship is an all-consuming lifestyle that brings highs and lows throughout the journey of establishing and growing the business.

When close to the point of sale, it can be hard for a business owner to view the value of their business objectively. The owner's personal feelings and experiences with the business can create significant biases within the owner. These biases can affect the clarity needed to negotiate the sale. The valuation, terms of the transaction, employees and ongoing reputation of the business are some of the areas where a biased seller can struggle with letting go and make transitioning from owner to former owner of the business difficult.

Modera advisors encourage owners of closely held businesses to plan their transaction years in advance of listing the business. This includes having company information benchmarked to industry averages, which will help the owner evaluate the business through a similar lens as a potential buyer. Having a firm understanding of various options for the sale transaction helps the owner plan for tax, legal and investment implications before listing. Additionally, gaining an understanding of what drives the value of the sale transaction critically informs the owner on how to run the business leading up to the sale.

Even though it might be difficult to carve out time to work on your succession plan, it is imperative to start this process well ahead of time. This guide will illustrate succession plan scenarios across several industries and provide tips and resources to help further your knowledge. When you are ready, Modera financial advisors are happy to offer you a free, no-obligation meeting to discuss your unique situation and how Modera can help.

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Succession Planning Varies by Industry, Business and Owner*

Every owner has their own unique emotional and financial considerations regarding their business and every industry presents its own challenges related to succession planning. This is why every succession plan is unique and needs to be handled strategically to ensure the best plan is presented for all those involved.

*Client stories: Our stories are based on a composite of real client stories, each of which had a particular set of goals and objectives. The services described in these stories may differ from services provided to other clients, and the results achieved may not be similar, as every client's goals and objectives are unique.

In one instance, a dentist who had been practicing for more than 30 years was eager to retire yet could not bring on partners with the intention of selling to them, largely due to monetary factors. The dentist was having trouble coming up with a suitable valuation of the practice and was unclear about what he would need to get from the sale of the practice in order to maintain his current lifestyle. Modera advisors ran several "what if" scenarios based on different ages of retirement and various valuations of total investable assets after assumed sale of the practice. This exercise helped determine what he needed in assets to sustain his standard of living regardless of what the real value of the practice was. Shortly thereafter, he received a cash offer that would allow him to cut ties from the practice on the closing date. After running the analysis to determine if the cash offer was enough to maintain his lifestyle (using various portfolio allocations to determine his required rate of return in conjunction with his ability to assume market risk), he agreed to the sale and retired four weeks later. Even though he did not receive what he thought the valuation should be because of his emotional ties to the practice and the staff he had cultivated over the years, he received enough so that he could live comfortably, with proper management of his assets.

Medical doctors often have unique situations to work through depending on existing partnerships with local hospitals.

Sometimes a clean break isn't feasible. In another instance, the owner of a successful industrial storage business was eager to pursue other endeavors. He determined a value for the company and implemented a marketing strategy to attract buyers. He identified a buyer, and they agreed on a valuation. The owner received cash in the transaction but also provided financing to the buyer in the form of a promissory note. Two years after the sale, it was apparent that the new owner was having trouble operating the business and was missing payments on the promissory note. The prior owner was able to make an offer to repurchase the business at very favorable terms and has since returned the business to profitability. Modera advisors are now working with him on estate planning strategies as the business valuation exceeds the federal estate tax exclusion limits.

A final scenario to consider is that of a medical doctor. Doctors often have unique situations to work through depending on existing partnerships with local hospitals. One doctor decided not to sell his practice to his local hospital and instead set a fair market price for goodwill and his practice's value. He found a buyer and formulated the buyout to be a steady stream of income, which in his case was over half of his final year's receivables paid over the following three years. This arrangement allowed him to have a reliable income for the short term before he was able to tap into his savings with his IRA.

Pros and Cons of Three Small-Business Transfer Strategies:

1 Intrafamily business transition (inheritance):

Positives:

- The owner of the business can keep the business asset in the family.
- It creates a legacy (source of future income) for children and family members.
- The owner can work for the business (and generate income) until they're ready to step away.

Negatives:

- The owner may not derive the maximum value from the business transition.
- Family businesses can cause conflict as the business is transitioned between generations.
- Identifying a family member who is willing/capable of running the family business can be difficult.

2 Private sale to an outside third party:

Positives:

- The owner often maximizes the value of the business.
- It allows the owner to walk away from the business and enjoy a traditional retirement.
- The third party often takes on all management responsibilities after the sale.

Negatives:

- The economic environment may not be ideal for a business sale/transaction.
- These deals often fall apart many times before the deal is finalized.
- The seller may not be able to replace the business income due to low interest rates (reinvestment risk).

3 Internal sale to employees:

Positives:

- The owner often retains a portion of ownership and cash flow throughout retirement.
- It creates a culture where employees are also owners of the company.
- Employee ownership promotes a positive client/customer experience.

Negatives:

- It can be difficult to find employees who are interested or able to be owners of a small illiquid company.
- The owner and employees often disagree about the value/price of the company.
- The owner may not derive the maximum value from the transaction.

The sale of a business can be quite messy and there is no one-size-fits all strategy for doing so. This is why we stress the importance of early planning with a qualified professional. At Modera, as with any financial planning conversation we have with our clients, our business succession planning begins with understanding the business owner's unique situation and objectives. When those goals are clear, we can then work on finding the appropriate strategy to help reach them.

Seven Steps to Succession Planning

Having a team of trusted advisors can help with many aspects of a business transaction or succession plan. The legal, tax and financial ramifications of a small-business transaction have huge implications, some of which are ongoing. Most business owners have spent a lifetime growing their business, and the value is often the majority of their net worth. Planning for the transition takes significant time and forethought.

Financial advisors can help the seller with tax and investment planning by working alongside appropriate tax and legal consultants to review a variety of scenarios with varying valuation and transaction terms. This planning helps open up the widest number of options for sellers to consider before entering into negotiations.

Modera has more than 75 financial advisors located in 16 offices across the East Coast who are ready to help small-business owners. As part of the overall financial planning process, advisors will look at cashflow and determine how to invest proceeds accordingly.

Here are seven steps to succession planning:

1 **Determine if the business should be sold.**
There are a range of both professional and personal reasons to sell a business, such as retirement, a job offer from another company or possibly a desire to go in a new direction. But it is important to weigh the rationale against external factors like market timing to determine if a potential sale is in the best interest of the owner.

2 **Determine if the business is saleable.**
Making the decision to sell a business doesn't necessarily mean that the business is saleable. Business owners should consult experts to perform due diligence to assess things like whether the business is in an attractive industry and a convenient location for potential buyers or if the owner has a solid customer base and a healthy balance sheet, etc.

3 **Value the business.**
Business valuation varies widely by industry and company. Sale price is determined by assets on hand (cash, receivables, inventory, equipment, real estate) and revenue stream. Assets are priced using market valuation. Revenue stream is valued by looking at a multiple of earnings, industry comps, historical growth and future growth potential.

It is not uncommon for businesses to transact as a multiple of cash flow or earnings, given that cash value is a key factor in determining value. A seller should be familiar with discounted cash flow analysis because a well-informed buyer likely will be. In professional service companies, the owner's compensation is also a key driver of business valuation.

Modera advisors encourage business owners to get an appraisal from an industry specialist, such as an accountant or business broker. Sometimes it is wise to get multiple appraisals, especially if it is a niche or complex industry where assigning value to assets can be difficult.

4

Prepare for sale.

Owners should organize and archive all historical financial statements and business-critical documentation. Buyers will complete due diligence on the business, including gaining access to all business contracts. Organization of all key materials will help avoid surprises and provide confidence that the books and records of the business are in good order. These basic considerations should be central to all business transactions, but the list becomes much more comprehensive as the business size and complexity grow.

Many small-business transactions may be succession planning agreements. Professional service companies — e.g., firms in the legal, real estate, tax, financial and medical/dental fields — can have significant business value, but transactions do not include much book value and tangible property. Instead, the professional service company's value is dependent on service, reputation and goodwill. Because of the risk of death or disability, succession planning and continuity agreements are critical to most practitioners if there is to be any value to the enterprise.

Owners should also resolve outstanding issues such as unpaid accounts receivable and debt (if applicable) and prepare projected financial statements and a business plan.

5

Look for a prospective buyer/successor.

This step could be quick, as sometimes there is an obvious candidate in-house based on tenure and management experience. Other times there are several qualified candidates and selecting one over the others might be problematic. If there are no active employees who should serve as the successor, it makes sense to look externally for an outside buyer. This might be a local competitor who is interested in absorbing the business, a savvy entrepreneur in the same industry or a loyal customer.

If the best option is the owner's children, ensure that the children have substantial experience working with the owner and other leaders in the business. Also, it is important to have an attorney prepare legal documents for terms, answering questions like what future role, if any, the owner will have in the company, what that might look like, what the dispute resolution process is and how to handle a potential default, among others.

Sellers should work with professionals to determine key aspects such as buyer qualification, payment terms, noncompete agreements and transition terms.

6

Negotiate/close the deal.

Exit strategy is extremely important. The seller should consider the likelihood of staying on with the new buyer and for what period of time. Transaction terms can include equity, notes receivable, cash, etc. These terms affect valuation and need to be considered in the presale planning.

It is very important for the small-business owner to have a plan for the assets they will receive in the sale. How will they be able to generate income from those assets, particularly if they are no longer going to be working for the company? Often small-business owners have all their net worth in the business that they control and will most likely have to invest in assets of companies they do not have direct control over. It can be a very emotional hurdle to overcome. Finding the right advisors to guide them through that process is crucial to their comfort level in selling the business.

7

Ease tax exposure.

Last but certainly not least, owners must work with a tax professional to discuss implications of succession planning as it relates to income tax, gift tax, generation-skipping tax and estate tax.

Transfers of business ownership interests can be structured in a multitude of ways, each having significantly different income and estate tax implications. Business owners should consult a tax professional to investigate areas such as whether to transfer stock or assets; how transactions are allocated to various kinds of assets; forms of business organization; and valuation issues. Moreover, although the estate and gift tax exclusion is at an all-time high, with careful planning there are ways to preserve it if needed in future years. An important part of preserving a legacy is keeping too much of it from going outside the family and a tax professional is invaluable in keeping that from happening.

We Are Here to Help

If you're a small-business owner considering a sale, Modera can work with you to understand your unique set of circumstances. Scenario planning, which looks at various ways to structure the terms of the sale, is extremely useful in the early stages. Planning with your advisor will better prepare you for negotiating with your potential buyer and achieving the most desired outcome. Modera also has accountants on staff to work alongside Modera advisors to build out a robust tax strategy that is complementary to your overall financial plan.

About Modera Wealth:

Modera Wealth Management is a fee-only, fiduciary financial advisory firm focused on providing clients with a high level of care and attention. We examine and evaluate each client's entire financial picture, offer prompt responses to their questions, and present customized solutions that always put their interests before our own. You want advisors whose services are comprehensive and who are able and willing to offer you support and guidance throughout the year on a wide range of financial matters. Choosing fiduciaries — those legally bound to act in your best interest — will provide you with objective advice and peace of mind.

Modera has maintained a client-first philosophy since its inception in 1983 when its predecessor firm established itself as one of the country's first fee-only advisory firms. Since then, Modera has grown its geographical footprint while adding depth and breadth to its expertise. Modera has offices up and down the East Coast, spanning from Massachusetts to Florida, and serves clients in cities and states throughout the country.

Learn how Modera works with business owners:
moderawealth.com/specialties/business-owners