

The Role of Financial Executives in Exit Planning for Business Owners

By Michael Oleksak

Over the next several decades, millions of U.S. businesses will be sold, merged, recapitalized, gifted, closed, or liquidated. In any of these events, both the owner and the company's value will benefit from advance exit planning. Financial executives, whether internal or external, play a key role in educating company owners on the basics of exit planning.

If you are the lead financial officer of a privately-held business, such as CFO or VP Finance, part of your fiduciary duty is to protect the company from the risk of an unplanned change of ownership, through sudden death, of both the shares and the operation of the business. You also play an important role in increasing the company's value by strengthening it for the possibility of a future transition or transaction.

Whether you are an internal or external financial advisor, you should make the business owner aware of three things every owner must have: a will, a succession plan, and an exit strategy.

The will protects the ownership of the firm in case a tragedy or sudden death affects the owner. With a will, the shares will stay

out of probate court and land in the hands of the person or people chosen by the owner, thereby ensuring some sense of business continuity.

The succession plan will help with the orderly transition of the operation of the business if the owner is suddenly incapacitated. The exercise of preparing a succession plan will also help establish whether internal management is strong enough to handle running the company without the owner.

The exit strategy will be the catalyst to determine whether the company is ready for some other entity to assume ownership. Are the books and records, processes and systems, management and employees, business model, brand, public image and reputation desirable enough for someone else to pay to acquire it? If the answer is yes, the next question is would the acquirer be external or internal?

Exit Options

The owner's external exit options are sale to a strategic buyer or sale to a private equity group. Internal transfer options include a management buy-out, a sale of shares through the Employee Stock Option Plan (ESOP), or



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gifting of shares, usually to the next generation of the owner's family. Each of these five exit options has a different valuation range, with external transfers generally having higher values. The owner will also relinquish control of the firm after the external transaction, giving up the ability to subsidize his or her lifestyle through internal expenses. The external exit option also eliminates the owner's control over his or her legacy, so the owner must determine his or her financial and emotional readiness to exit the business.

If the owner is emotionally ready to leave the business, but needs the highest financial return, as the financial advisor you can

recommend that a sale to a third-party strategic or third-party financial buyer should be considered. Under these arrangements, it's important to calculate investment banking and legal fees, as well as taxes, because all will be subtracted from the amount of the check the owner will cash at the end of the day. Due diligence by the third party buyer will be thorough. If there are family members working in the business, their employment may be at risk if the current owner is not calling the shots. The owner may be required to bridge any financing or value gap with seller notes or earnouts over time.

A management buyout (MBO) creates a different risk to analyze: is the management team capable of continuing to generate enough cash to pay out the owner over time? Some industries lend

themselves to MBO's better than others, such as construction. Such a deal will require outside financing from a bank or another source, and management may be required to pledge personal assets to support a bank loan. Seller notes will also likely be part of the financing. After the buyout, the owner may still be involved and may retain some financial expense benefits under the deal. The further in advance this option is considered, the better the owner can prepare the team for the execution.

An ESOP is a tax-advantaged, though administratively complex, way for the owner to take some money off the table by selling shares to employees and management. Under a buyout or transfer through an ESOP, the owner will likely remain in control if less than 50% is sold, and will continue to have some personal

expenses paid by the company.

Gift-giving is also a tax-advantaged way to transfer ownership, usually to (hopefully capable) family members. The owner can stay in control and have expenses paid for by the firm. This option will cause complications in relationships, especially as you get deeper into the second and third generations of the family. Capable outside consultants with experience in family business issues should be considered to help smooth out issues.

All the options that financial executives can suggest for exit strategies carry different valuation ranges, with external transfers having higher valuation ranges (and higher tax impacts). However, a clear awareness of each will help the owner and the company mitigate risk and prepare for the future.