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Family Business Succession Planning - Who's Next?

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One of the most important and often most neglected aspects of family business ownership is succession planning. The daily demands of running small and medium-sized companies typically push succession planning into the ever-growing "to-do" pile. Aside from deciding how much ownership to transfer to whom (family, executives, third parties), a business owner must also consider the right course of action to ensure that the company and its employees are set up for future success. There is a multitude of options available to an owner regarding the transfer of ownership in a family business and having access to knowledge and experience is key to making an informed decision. Assembling a quality succession planning team to assist in the transition process is essential. Such a team often includes legal counsel to the company, a CPA, a financial advisor, a CEO or business coach, and a qualified business appraiser. This appraiser should hold a professional credential based on rigorous

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education and work experience requirements. One such credential is the Accredited Senior Appraiser (ASA) of the American Society of Appraisers, which qualifies business appraisers based on valuation experience, technical proficiency, and professional ethics. A business appraiser can help the succession planning team not only understand the value of the business, but also assess the economic benefits of the different succession options and provide a level of confidence for all parties involved in the transaction.

This article briefly highlights three ownership succession options that are available to business owners. Each option has its advantages and disadvantages and should be carefully analyzed and discussed with the entire succession planning team.

Gifting - Keeping it in the Family

Keeping ownership and control of the business within the family is often the preferred succession option for family business owners. If there are children or grandchildren that are knowledgeable and qualified to run the family business, transferring ownership interests to them may be the best option for continuity and longevity of the business. Gifting of small ownership interests can be spread over several years or done all at once, depending on specific transition goals. The drawback of this ownership transition option is that gifting, by definition, does not provide the "selling" owner compensation for the transferred interest. However, gifting can be used as a tool to reduce estate taxes.

The American Taxpayer Relief Act of 2012 set the lifetime gift tax exemption at $5.25 million (indexed annually for inflation). Any estate above this level is subject to estate taxes as high as 40%. Business owners can reduce their estate (and possibly avoid estate taxes) by gifting equity ownership of a family business out of their estate. By making gifts of minority interests in the family business, an owner may be able to transfer a large share of equity out of his or her estate without utilizing the entire gift tax exemption. Since minority interests do not have control over business operations and are less marketable than full company interests, discounts may be applicable. Typically, a discount for lack of control is applied to account for limited control possessed by a minority interest in a business. A discount for lack of marketability is typically applied to reflect the limited market and difficulties related to transferring a minority interest

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in a business. A business appraiser will be able to analyze the gifted interests and determine the appropriate discount for the transaction. Depending on the facts and circumstances of the case, gifting interests may provide business owners flexibility with regards to both estate planning and maintaining company ownership within the family.

ESOP - Employee Ownership

Another option is to transfer business ownership to the employees of the firm through an Employee Stock Ownership Plan (ESOP). Again, this can be done in part or in whole. Aside from several federal income tax benefits for the firm, the ESOP allows the business owner to sell a portion or all of his or her ownership interest to a trust set up for the benefit of the company's employees. In essence, the ESOP creates an immediate market and buyer for the company's stock. Oftentimes, a business owner can also retain partial (or full) control of the company by acting as a trustee of the ESOP trust. An ESOP allows the employees to share in the success of the company and incentivizes management and staff to increase firm value.

Since shares of family owned businesses do not trade in an active market, the fair market value of the company stock must be determined on an annual basis. The annual valuation prepared by a qualified business appraiser informs employees of the fair market value of their ownership interest in the company. Additionally, the initial valuation to set up the ESOP, as well as subsequent annual valuation can act as a tool for management to assess annual performance as it relates to firm value. Fluctuations in business value year-over-year can act as a barometer for how management and the business are performing.

Third Party Sale

A third party sale of the company may be the best option. Buyers may include individuals, private equity firms, competitors, or synergistic acquirers. Moreover, myriad transaction types such as asset purchases, equity sales, leveraged buy-outs, recapitalizations, and public offerings afford options for a seller liquidation event. Regardless of the buyer and type of transaction, you can be sure that the potential buyer will perform a thorough review and valuation of the business. The value that each type of buyer may place on the business can vary depending on each individual buyer's goals. For example, a competitor may pay more for a family business than its fair market value due to perceived strategic benefits or synergies. Knowing not only the fair market value of a business but its perceived strategic and synergistic value can place a business owner on level footing during transaction negotiations.

Prior to entering into any sale negotiations, a business owner should have a solid understanding of the fair market value of the company, as well as the current market environment within the business' industry. A business owner should retain a business appraiser who will be able to research recent market transactions, analyze guideline public and private companies, and compare industry financial ratios to those of the subject business. Using this combined analysis, a business appraiser can determine the appropriate valuation multiples for the subject business. As many transaction prices are determined based on a multiple of earnings, knowing these market multiples, the business' value and current market conditions is key. Moreover, understanding how these factors contribute to the business' strategic or synergistic value to a potential buyer will give the business owner a powerful tool in deal negotiations.

Plan Ahead

Regardless of which succession plan a business owner chooses pre-sale planning is essential. It takes time to determine the right path for all parties involved. A preliminary valuation with limited appraisal work can be a great first step to inform the team of advisors of the best succession options. Once a path is selected, additional valuation work can be used as one component for considering tax implications, planning for future business growth, and finalizing a liquidity event.

Along with the entire team of transition advisors, a qualified business appraiser can be an invaluable tool in the transition process. In addition to determining the fair market value of the owner's interest, an experienced business appraiser can act as an independent consultant and resource for the client. Whether it's understanding the mechanics of an ESOP, determining the appropriate minority interest discounts, or analyzing a purchase offer, a qualified business appraiser can help maximize value for the client and remove the valuation aspect of succession planning from the business owner's "to-do" list.

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Astrum is currently working on its 2nd deal and for more information about the deal and investing in Astrum please contact John Hartman, Managing Director at 310/571-3400 or via email at *jhartman@astruminvest.com* to arrange a meeting.

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Quote of the Day

"Innovation distinguishes between a leader and a follower."

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