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MoneyTalk

Business Succession Planning

Part 2: Business Succession Planning Options

While this article focuses on some technical tools that could fit into the final plan, remember that any good plan must begin with the clearly defined goals of the owner. Too often, planning begins with the question "How can I avoid paying taxes?" rather than "What do I want for my future, my family and my business?" The former question may deliver a tax-free pass to dissatisfaction, whereas the latter leads to a well-designed succession plan.

When considering technical alternatives for the succession plan, keep in mind that many alternatives can be combined to achieve the desired results.

Management buy-out

Management buy-outs are an excellent way to keep the business independent and insure that it will continue operating. This personal legacy to years of hard work and success is extremely rewarding for many entrepreneurs. In implementation, a management buy-out can take a variety of forms; the most common include buy-sell agreements and stock options.

Once it is clear who should own how much stock, a price needs to be arrived at. This could be based on a reasonable formula by considering company assets and performance or an outside estimate of the company value. The sale price is negotiable, especially when the sale is among colleagues. Sometimes owners create continuing compensation agreements. These commit the company to pay the former owner for a specified number of years. This obligation reduces future earnings and can reduce the value of the company, making the sale easier. After a mutually agreeable price is arrived at, it is necessary to arrange financing.

A wide range of possibilities exist for financing management buy-outs. The first question is how much can the managers purchase immediately. They can use cash, savings or take out loans. It is up to the managers to determine how they will purchase the stock. After the managers have planned to buy stock personally, they must figure out how the company can buy the rest. A number of alternatives exist to do this.

Loans or notes from banks are often used to purchase stock from an owner. This type of leveraged buy-out is attractive for its simplicity, but it has a few drawbacks:

1. It requires the commitment of future profits to pay for the purchase of stock.

2. It will probably force the company to pledge assets as collateral for the loan.

3. It will require that payments on the stock be made in post-tax dollars.

Together, the taxes and financing costs may raise the cost of this purchase.

Notes or loans from the seller extend payments over a number of years. This "seller financing" may reduce costs and make the transaction easier. But the payments are still in post-tax dollars and reasonable interest must be paid. Further, extending payment terms has a number of negative implications for the selling owner.

1. The selling shareholder must pay the capital gains tax for the full purchase amount, while receiving only some of the cash to pay the taxes.

2. The business owner will not be able to diversify his or her investment to reduce risk, often the primary goal of "cashing out" the business.

3. If the owner wants security, the assets used as collateral cannot be leveraged for other business purposes.

While seller financing looks a lot like bank financing, the terms can be better because the owner has more confidence in the management team.

An installment purchase of stock is similar to seller financing and is attractive, as the management team and company can purchase the stock over a number of years. However, tax rules may make it difficult to implement. Fortunately, other tools, including trusts can be used to hold

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the stock until the company and/or management team can buy it.

Employee Stock Ownership Plans (ESOPs) can be used to finance part of the stock purchase on more favorable terms, while retaining control among the chosen management team. (See next section.) Inevitably, leveraged buy-outs, by management or anyone else, strap the business with substantial debt which may get in the way of other business plans.

Selling to the employees

A partial sale to an ESOP can make management buy-outs easier. The ESOP can purchase any amount of company stock on highly preferential terms. The effect is to reduce the total cost of the stock purchase, while retaining closely-held control among the primary shareholders.

Essentially, the ESOP is a retirement plan for the employees. The stock is held in a trust under the control of a trustee appointed by the board of directors. Administration of the ESOP requires annual valuations by an outside party. The first valuation is more expensive, but the annual cost is often around a few thousand dollars.

In the right situation, a sale of some or all of a business to an ESOP can give everyone involved significant tax breaks. ESOPs can make a management buy-out easier for the company and beneficial to the selling shareholder. Further, it will continue the business as an operating entity, controlled by chosen management and may have a positive impact on employee motivation.

Selling to an outsider

Selling to someone outside the business or family means the new owner may change or close it, but sometimes a "strategic buyer," a competitor or related business, can offer the highest price.

The business could be of greater value to the new owner if he or she takes the customer list, product name and sells the other assets. For some owners, this prospect is undesirable, but the benefits to the selling owner may outweigh that drawback.

The process of selling to an outsider begins with hiring a business broker. Often, the next step is to "clean up" the company financials and prepare them for the buyer's package. Much like cleaning up a house which is being put on the market, this process is necessary to make the most valuable parts of the business stand out. It can mean paying any notes or loans made by the business or to the business by the owner or managers. The broker will then assess the value of the business. After the buyer's package is written and circulated, the broker will talk to others in the industry to explore the level of interest in the business.

Once prospective buyer's surface, negotiations begin. The negotiations end in the signing of a letter of intent. The letter of intent outlines the terms of the sale and the price. Once the letter of intent is signed, the purchaser arranges financing and the deal is closed. The dealer's fee will usually come out of the final sale.

Liquidation

Liquidation of the company is not usually considered an alternative in succession planning because the business ceases operation. Thus, no one succeeds the owner in running the business. Sometimes, though, liquidation of the assets is the best way for the owner to get the highest price for his or her business.

The assets are valued, put on the market and sold. Proceeds from the sales are then used to pay off liabilities along the way. Unfortunately, in some businesses, environmental liabilities can greatly reduce the value of the business and property -- even reducing it to a negative value. This leads some business owners to sell the equipment and abandon the property.

In summary

Succession planning is about taking control of the inevitable. Eventually, every business owner will leave the business. If no planning is done, lawyers and the government will control the process. But if the owner plans for an orderly transfer, he or she can reduce the taxes paid, get the maximum value out of the business, leave it in the hands of chosen successors and avoid family and business crisis.

This article is extracted from the World Wide Web at: http://dept.kent.edu/oeoc/spp/articles/options.htm , and adapted for the SA environment.

February 06