EXIT STRATEGY 101

AN INTRODUCTORY GUIDE TO SELLING YOUR BUSINESS

crr CPA

WHAT'S YOUR EXIT STRATEGY?

Selling your business is a process, not an event.

We meet many clients who have successfully managed their business for many years, but have no real plan when it comes to cashing in their life's work. As a business owner, you're focused on day-to-day profitability—and rightly so—but it's equally important to have an exit strategy plan that will allow you to realize the value of your investment.

There are many strategies for exiting your business when the time comes, but this guide will focus on one in particular—the sale of a business to a third party.

EXIT STRATEGY 101

In this guide, we'll discuss:

- Initial Considerations
- Pre-Sale Tax Planning
- Deal Structure
- Tax Considerations in Selling
- The Legal Process

INITIAL CONSIDERATIONS

MAKING THE EXIT DECISION

The first step, of course, is making the decision to sell your business. But where do you go from there? Start by asking yourself an important question:

- What, exactly do you want out of this transaction?

It's important to begin with the end in mind, so that you can formulate a comprehensive financial plan that will align with your goals.

DEFINE YOUR PRIORITIES

Knowing your priorities ahead of time, and the relative importance of each priority, will go a long way towards crafting a deal you can live with.

For example:

- Do you want **all cash** with a full exit?
- Do you envision yourself having a **role in the business** after the sale?
- What's the **bottom line number** you'd be willing to accept?

PRO TIP:

Make a list of any stipulations that are critical to the sale, and then rank those in terms of importance. This list will give you a great starting point when it comes time to negotiate.

INITIAL CONSIDERATIONS

TIMING THE SALE

You may not be quite ready to sell yet. But if you're thinking about it, now is the right time to start planning.

The best strategy is to prepare for an eventual sale early, so that you are able to take advantage of better conditions, and drive internal factors that will maximize the value of your business.

PREPARING EARLY

Here are some early steps you can take to get your affairs in order, ensuring that when the time comes, your business is in the best position for a sale:

1. Make sure all records are formalized and all transactions are clearly documented. Consider documenting your company policies and procedures.
2. Examine your supplier and customer contacts.
3. Review any real estate leases and make sure that they will not expire or require renegotiation within the time frame of your sale.
4. Determine whether material contracts can be assumed by a buyer.
5. Review your arrangements with any business partners.
6. Conduct an intellectual property audit, or financial audit, if necessary.
7. Ensure that you are in compliance with all laws and regulations.
8. Lock in key employees and consultants.

Many of these steps are simply good business practice, and should be reviewed on a periodic basis anyway, regardless of whether you intend to sell. But keeping on top of these items will also pay dividends when it comes time to plan for the sale of your business.

INITIAL CONSIDERATIONS

BUILDING THE TEAM

The sale process begins as soon as you get a call from an interested buyer—and you can't always predict when that will happen.

Having a team of experts in your rolodex that you can assemble when the time comes will help you confidently dive into the stages of the sales process, and avoid delays that could result in a lost opportunity.

Here's who you'll want on your team:

- Lawyer - preferably one with significant transactional experience.
- Accountant - with M&A tax experience.
- Investment Banker/Business Broker - to provide critical advice on strategic alternatives, positioning the company, identifying potential buyers, and act as an intermediary.
- Financial Planner - to quantify potential options and map out life after the sale of your business.

By taking these steps in advance, you'll ensure that you are ready when the opportunity presents itself, able to take advantage of market conditions, and positioned to maximize the value of your business.

PRE-SALE TAX PLANNING

BUSINESS OWNER GOALS

When performing pre-transaction tax planning, your CPA can help you evaluate your financial situation, alongside your personal needs and goals, to minimize your potential tax burden and stay on course in the sale of your business.

FAMILY + CHARITABLE GOALS

Your CPA can also help you evaluate the tax implications of transferring "excess" financial resources, especially when it comes to family and charitable gifting.

- Consider gifting:
  - Outright gifts to children and other individuals
  - Leverage gifting through discounting

- Consider setting up trusts

- Charitable Remainder Trust
  - Avoid income tax on sale
  - Generate charitable income tax deduction
  - Potential use of wealth replacement trust

- Grantor Retained Annuity Trusts
  - Annuity payments go to the grantor
  - Remainder goes to the beneficiaries

- NH "Asset Protection Trust"
  - If properly structured, grantor's assets can be protected from creditors

- Irrevocable Life Insurance Trust
  - If properly structure, insurance proceeds will not be subject to estate tax

DEAL STRUCTURE

WHAT ARE YOU SELLING?

There are a few types of sales, including:

- Stock Sale (what the seller typically wants)
- Asset Sale (what the buyer typically wants)

Also, whether your business is an LLC (partnership) or Corporation (S or C Corp) will also affect the transaction. We'll talk more about sale types in a few pages!

PURCHASE PRICE ALLOCATION

A few items to keep in mind:

- Capital assets generate capital gains
- Depreciable assets can generate some ordinary income
- Goodwill generates capital gain
- Hot assets, such as accounts receivable and inventory, create ordinary income

Also, consider whether your business has any of the following:

- Employment agreements
- Consulting agreements
- Covenants not to compete

DEAL STRUCTURE

NET WORKING CAPITAL

What is Net Working Capital?

Net Working Capital is defined as current assets less current liabilities. In other words, Net Working Capital is the short term liquidity needed to run your business.

The Net Working Capital is typically calculated using the average working capital over the preceding 3 to 6 months prior to the sale date.

This amount is expected to be left behind on the date of the sale (a buyer will likely require you to leave behind a healthy company that can pay its bills and employees week one).

ADJUSTED EBITDA

EBITDA is Earnings Before Interest, Taxes, Depreciation, and Amortization.

Many deal values are multiples of adjusted EBITDA, so it’s critical to understand what this is, and how to arrive at it. Every dollar increase in this number could yield 8x more in transaction price! Your CPA can help you determine some acceptable adjustments to your financial statement EBITDA.

PRO TIP: REMEMBER TO THINK ABOUT...

- **Timing of payments** - do you want a lump sum, or installment payments?
- **Earn-outs** - terms and conditions can impact installment payments.
- **State tax issues** - are there business operations in multiple states?

TAX CONSIDERATIONS

TAXABLE STOCK SALE

- Seller recognizes gain or loss equal to the difference between basis in the stock and the amount of consideration received.
- Gain recognition may be deferred until the consideration is actually received by using an installment sale.
- Target corporation itself will recognize neither gain nor loss and its assets will retain their historic basis.
- If the target stock is "qualified small business stock" (which must be stock of a C Corp), individual target shareholders may be able to exclude a portion of their gains.
- It is possible for the buyer to elect a step up in basis of the assets to reflect the price paid for the stock, which would require the target corporation to recognize any gain inherent in its assets.

TAXABLE ASSET SALE

- Selling shareholders (and partners) usually recognize gain or loss equal to the difference between their basis in the assets (partnership interest), and the amount of consideration received.
- Target company recognizes gain or loss on the transfer of its assets.
- Ordinary income, short- and long-term capital gain.
- Buyer takes a basis in the assets (including any goodwill or going-concern value), based on the price paid.
- This structure generally favors the buyer, and is less favorable for the seller.

TAX FREE STOCK SALE

- Stock of the target corporation is acquired in a tax-free reorganization, and the seller recognizes no gain, to the extent that the seller receives stock of the buying corporation as consideration.
- The stock that the seller receives takes a basis equal to the target stock given up, so the seller may ultimately recognize gain when he disposes of the stock received.
- The target corporation itself recognizes neither gain nor loss, and retains its historic basis in its assets.
- Generally, the seller must take all of his consideration in the form of voting stock of the buying corporation. Many times shareholders of the buying corporation are unwilling to cede a degree of control and ownership.
- Some selling shareholders are unwilling to accept such an interest.

TAX FREE ASSET SALE

- Assets of the target corporation are acquired in a tax-free reorganization, and the seller recognizes no gain, to the extent that the seller receives stock of the buying corporation as consideration.
- Target assets retain their historic basis in the hands of the buying corporation.
- Similar business considerations and issues exist in this form of transaction as with the tax-free stock reorganization.

THE LEGAL PROCESS

LETTER OF INTENT

A letter of intent is usually prepared once the broad terms of the transaction have been hammered out, and includes the general terms of the deal, as well as due diligence, confidentiality, and "no shop" clauses. This is a valuable step to guiding both parties into a definitive agreement.

Typically, the letter of intent is non-binding, except for any provisions relating to clauses and confidentiality. Depending on the transaction, the letter of intent may call for the buyer to make an "earnest money" deposit.

Having experienced legal council on your team will help you strike a balance between getting broad terms hammered out and dealing with the minutiae of terms.

DUE DILIGENCE

Following the letter of intent, there is a specified period for due diligence—during this period the buyer has access to your financial and other records to investigate prior to closing the deal.

PRO TIP:

- **Do your own due diligence on yourself.** Look at your business through the eyes of a buyer to identify and resolve possible issues—it will help you avoid delays and future expense.
- **Never try to hide anything**. Smart buyers will find it!
- **Do your own due diligence on the buyer.** It's always good to have some background knowledge of who you're doing business with.

THE LEGAL PROCESS

BUSINESS PURCHASE AGREEMENT

The devil is often in the details, and purchase agreements can often be the subject of intense negotiation. Typically, the buyer's council will insist on drafting the agreement, which includes:

- Provisions on transfer and sale of assets or stock.
- Seller representations and warranties.
- Pre-closing covenants of the buyer and seller.
- Conditions for closing.
- Indemnification and remedies.

Once you've hammered out all of the details of the purchase agreement, you'll finally move on to...

THE CLOSING!

The closing is arguably the most exciting part of the sales process—you're almost at the finish line! Although, if you've done all of the proper preparation, the closing should actually be pretty anti-climactic. However, you should always be prepared to deal with any last minute issues that could come up.

The closing can be done face to face, or with the help of modern technology, via email or fax.

KEY TAKEAWAYS

1. BEGIN WITH THE END IN MIND
2. CLEARLY DEFINE GOALS + OBJECTIVES
3. PREPARE EARLY TO ENHANCE VALUE
4. BUILD YOUR PROFESSIONAL TEAM
5. UNDERSTAND YOUR TRANSACTION OPTIONS

Congratulations! You're now ready to embark on the process of selling your business!

Questions? Contact our expert:

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As always, it's our pleasure to be your trusted advisor.