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Wealth Planning Update

Four Mistakes Business Owners Can Make When Transitioning a Business

APRIL 2021

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Key takeaways:

- Avoid common missteps—which may marginalize outcomes when transitioning a business through a third-party sale.
- Understand cash flow needs for retirement in the context of contemplating a sale.
- Don't limit your expectations to an all-cash deal.
- Speak with multiple prospective buyers.
- Prepare your business for sale before going to market with the objective of business performance, price, and likelihood of closing the sale.

What this may mean for you:

- While planning for business transitions can be complex, following a disciplined process can help owners plan and execute a successful business transition.

At some point, nearly every business owner faces a business transition. As the business often represents the single largest asset on many owners' personal balance sheets, its value can represent a lifetime of focus, energy, and work. While every owner, business, and transition is unique, there are four common mistakes we typically see business owners make, particularly when selling the business to a third party.

Mistake #1: Not understanding after-tax cash flow needs for retirement

When weighing the complex topic of transition and exit planning, many owners focus heavily on receiving liquidity (or a headline transaction value) as a result of the transition but not necessarily on how the timing of the transition or the amount from the proceeds will affect their retirement picture and long-term standard of living. This step can be especially critical because after-tax cash flow can actually decline post-transition, particularly for owners who have paid themselves a handsome wage or significant dividends or distributions.

As a business owner, gaining a clear understanding of your personal balance sheet, sources and usage of cash flow, income tax liability, and risk and liquidity profile—both on a pre- and post-transition basis—can give you powerful insight as to when (or whether) you should keep or sell your business. This understanding goes beyond an overview; a decision this significant should be based on well-developed projections of the sale transaction on your personal wealth and cash flow, as it is key to evaluating your transition timing and options. This may be particularly important when selling a business during a strong economic or market cycle. Many owners plan to invest their sale proceeds into a diversified portfolio of stocks and bonds; yet, many marketable securities may be at all-time highs. Work with your tax and investment advisors to prepare a sensitivity analysis—does your post-sale wealth plan address your needs if you invest at the peak of the market and it subsequently declines?

Suggestion: Review your cash flow and retirement income needs considering both pre- and post-transition scenarios.

Mistake #2: Expecting an all-cash deal

Contrary to what many business owners may think, business transitions are not typically conducted as all-cash transactions. Many business transitions involve seller financing, earn-outs, and escrow/holdback arrangements—meaning that while an owner may receive some cash at closing, he or she may also receive a significant portion of the purchase price over time.

These different approaches to a business sale can have important retirement planning and risk management implications for business owners who are not receiving a full payout at closing. Business owners may carry a level of risk until the terms of the promissory note or earn-out are completed because future payments may be at risk if the acquiring company faces a financial reversal or downturn. An after-tax cash flow analysis that reflects anticipated transaction terms can better position owners as they negotiate the timing, amount, and security of contingent consideration in a deal. In some instances, such an analysis may even save an owner from entering into a deal that may have had calamitous long-term retirement planning implications. We recommend working with your relationship manager or a transition planning professional to understand how the sale of your business likely will affect your financial future and personal wealth plan.

Suggestion: Engage an advisor who can help determine what deal terms can be achieved realistically in the current market environment.

Mistake #3: Only speaking with or seeking one prospective buyer

Oftentimes, many owners receive unsolicited offers from competitors, strategic buyers, or private equity groups. These offers may materialize at various times throughout the year, leading to a scenario where an owner is essentially evaluating one offer at a time. Furthermore, it can be tempting to take a do-it-yourself approach to a sale, as business owners know their business well; such an approach provides control, plus the possibility of fee savings. Adopting this approach, however (even if an unsolicited offer ultimately leads to a sale), may create uncertainty regarding whether they maximized the amount of money they could have received for their business. We've found that rarely does a single buyer offer the highest purchase price or most advantageous terms to the seller, simply because there isn't a need. Absent a disciplined and broad marketing approach led by a merger and acquisition professional, the buyer does not have to compete with other buyers for the business. The result can be a sub optimized process and transaction.

Further, companies that have prepared to go to market—and do find a buyer—do not always close the deal. One of the biggest reasons given for deals not closing is the inability of the selling owner and the prospective buyer to overcome differences in how each party viewed what the business was worth (that is, the expected purchase price). Lack of a cultural or strategic fit, which is often discovered during due diligence, between a selling company and its strategic or financial buyer also may present a significant impediment to consummating a deal.

Just as business owners should not limit themselves to considering only one prospective buyer, they also should not consider only one transition option. Many owners, in fact, face a predictable set of strategic alternatives for the transition of their business. In addition to intergenerational family business transfers, businesses can also be transferred in other ways:

- Selling to management (management buyout)
- Selling to an employee stock ownership plan (ESOP)
- Sale of equity in an initial public offering (IPO)

When appropriate, pursuing a sale through a disciplined auction environment, whereby multiple prospective bidders all review the same information at the same time, may help enhance the probability of finding the right cultural and strategic fit for the company at a purchase price and terms that may best meet the owner's long-term transition (and retirement) planning goals and objectives.

Suggestion: Be aware of all your transition options to help enhance your outcomes.

Mistake #4: Lack of preparation

Finally, business owners should honestly assess the readiness and attractiveness of the business prior to going to market. A helpful step in this process can be deliberately thinking like a buyer, which entails appraising the company's strategic positioning, weaknesses, and business risks across the competitive landscape, in much the same way that a prospective buyer would when evaluating an acquisition target. Owners also could conduct preliminary operational, financial, and cultural due diligence on their company, perhaps engaging a business consultant or a transition advisor to provide an objective evaluation.

Whether the business owner intends to keep the business in the family or position it for a sale to a third party, this exercise, in our experience, often results in improved company performance pre-transition, better positioning the company for an internal buyout or a more favorable price and terms in an external sale.

Finally, a comprehensive review provides business owners time during the pre-sale window to resolve any business or legal issues that might arise during the actual sale process, not only helping owners determine a realistic timeline to go to market but also increasing the probability of a deal's closing and transition success.

Suggestion: Conducting due diligence on your company could improve performance and sale outcomes.

Planning for a business transition

Mindful of these four business exit planning potential mistakes, business owners may be able to achieve the following benefits with advance planning and preparation:

1. Identify, assess, and compare multiple transition options to help ensure your exit achieves your financial objectives and personal priorities
2. Enhance the probability of a closing on favorable terms and at an attractive value
3. Minimize or resolve negative issues that may interfere with a sale process
4. Improve performance, which should lead to a more attractive sales price

While planning for business transitions can be complex, following a disciplined process can help owners plan and execute a successful business transition and improve outcomes for all stakeholders. To learn more about these strategies that could potentially enhance transition success, please consult with a Wells Fargo relationship manager.

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