Business Succession Evaluation

Protecting Your Family by Protecting Your Business

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Current Plan vs. Optimized Plan

	Current	Optimized
Buy-Sell Agreement	Entity Purchase Buy-Sell	Cross Purchase Buy-Sell
Buy-Sell Funding Method	Life Insurance	Life Insurance
Current Business Value	$10,000,000	$10,000,000
Buy-Sell Funds Available	$2,000,000	$10,000,000
Risk to Family/Business	**$8,000,000**	**$0**

	Current	Optimized
Alleviate the burden and expense of locating a buyer	✓	✓
Relieve loved ones of stressful negotiation during emotional time	✓	✓
Guarantee your loved ones receive a fair price	✗	✓
Ensure immediate payment of the full purchase price	✓	✓
Assure employees and creditors that the business will continue	✓	✓
Prevent your co-owners spouse from becoming your business partner	✗	✓
Ensure you retain control of the business if your business partner dies	✗	✓

Action Plan

- ☐ Meet with a qualified business planning attorney to review buy-sell agreement and update as needed
- ☐ Apply for life insurance coverage to properly fund buy-sell agreement
- ☐ Evaluate the impact of the loss of a key employee on the business through the Key Person Evaluation process
- ☐ Evaluate current estate plan to ensure planning objectives are being met through the Estate Evaluation process

Optimized Business Succession Plan

Suggested Agreement Structure:

Cross Purchase Buy-Sell Agreement

Funded By:

Life Insurance

John Client

Policy Owner & Beneficiary:	Robert Client
Policy Insured:	John Client
Death Benefit Amount:	$5,000,000
Type of Policy:	15 Year Term

Robert Client

Policy Owner & Beneficiary:	John Client
Policy Insured:	Robert Client
Death Benefit Amount:	$5,000,000
Type of Policy:	15 Year Term

Buy-Sell Agreement Review

1	Identifies entity name, entity type and ownership	✓
2	Provides for endorsement of stock certificates (corporations only)	✓
3	Provides for inability to transfer ownership interest except under agreement	✓
4	Provides for required sale of deceased owner's interest upon death	✓
5	Provides for required sale of disabled owner's interest upon disability	✘
6	Provides for required sale of owner's interest upon voluntary termination	✓
7	Provides for involuntary transfers of owner's interest upon bankruptcy, etc.	✓
8	Provides for valuation based on certificate of agreed value	✘
9	Provides for valuation based on appraised or book value if not agreed upon	✓
10	Provides terms of sale with life insurance proceeds upon owner's death	✓
11	Provides terms of sale when no life insurance proceeds available	✓
12	Provides for covenant not to compete by departing owner	✘
13	Provides for protection of confidential information by departing owner	✘
14	Releases and indemnifies departing owner from indebtedness	✘
15	Provides for company's default of payment on note given to shareholder	✘
16	Provides for purchase of life insurance and/or disability buy-out insurance	✓
17	Provides for amendment of agreement by all parties	✓
18	Provides for termination of agreement by agreement of all parties	✘
19	Provides for termination of agreement upon dissolution of entity	✘
20	Provides for termination of agreement upon simultaneous death of all owners	✘

Important Notes

5 The agreement does not require the sale of a disabled owner's interest. A disabled owner could earn the same revenue as healthy owners without contributing to the success of the business.

8 The agreement does not provide for valuation by a certificate of agreed value. Use of this method helps ensure the buyout amount will keep up with the business' fair market value.

12 The agreement doesn't prevent a departing owner from competing directly with the business. Such a provision helps ensure a departed owner's knowledge will not be used against the business.

13 The agreement doesn't prevent a departing owner from taking confidential information. Such a provision helps ensure the departed owner's knowledge will not be used against the business.

14 The agreement does not provide for a departing owners's indemnification from company indebtedness. Such a provision helps ensure a departed owner won't be liable for company debts.

Buy-Sell Agreement Review

Important Notes Continued

15 The agreement does not provide for remedies upon the company's default on a promissory note. Such a provision outlines a departed owner's remedies against the company and it's owners.

18 The agreement does not provide for termination upon agreement of all parties. Such a provision clearly indicates under what circumstances the agreement can be terminated.

19 The agreement does not release parties of purchase obligations upon entity dissolution. Such a provision ensures the parties have no obligation to purchase if the entity has been dissolved.

20 The agreement doesn't provide for termination of purchase obligations upon simultaneous death of all owners. Such a provision terminates all purchase obligations if no current owners remain.

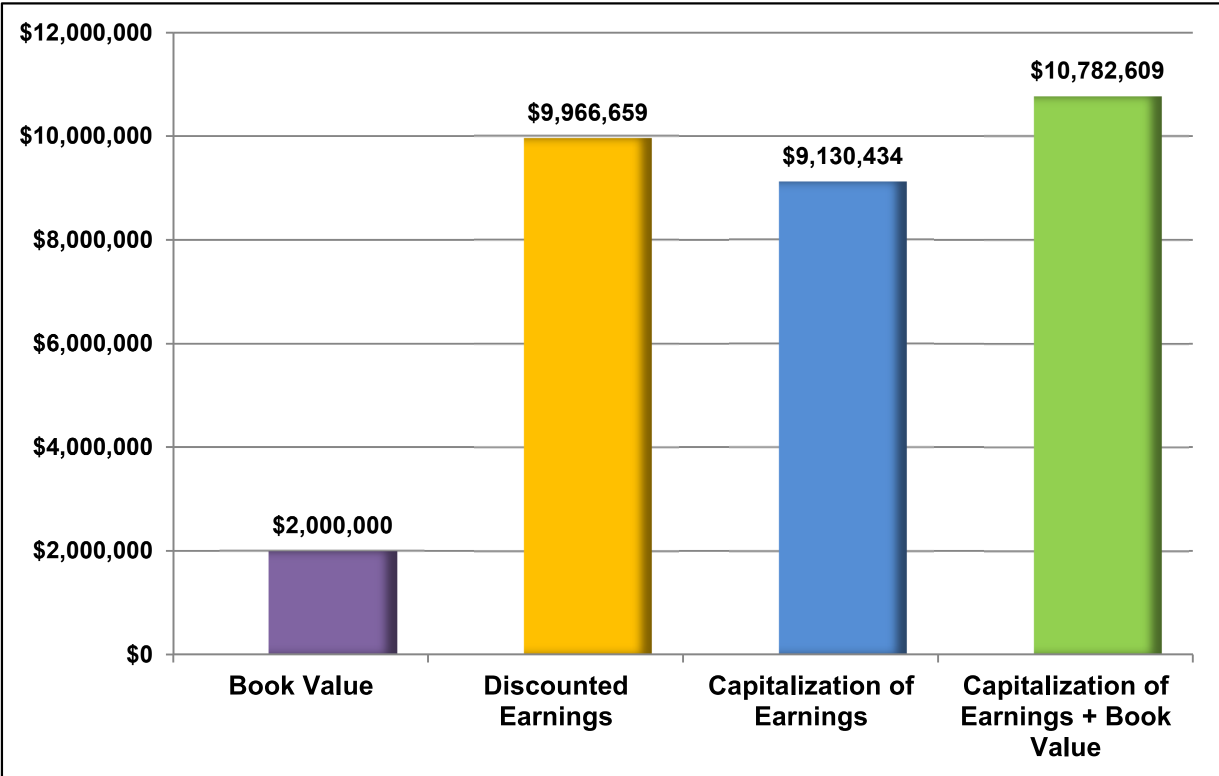
Business Valuation

Business Information

Assets:	$8,000,000
Liabilities:	$6,000,000
Earnings (average 3 years):	$1,400,000
Owner Compensation & Bonuses:	$700,000
Projected Growth of Earnings:	4%
Rate of Return on Capital Assets:	4%
Discount Rate:	25%
Long-Term Growth:	2%
Capitalization Rate:	23%

Results

Book Value	$2,000,000
Discounted Earnings	$9,966,659
Capitalization of Earnings	$9,130,434
Capitalization of Earnings + Book Value	$10,782,609



This calculation is meant to provide a valuable starting point in helping you determine the value of your business. This valuation,however, is not a substitute for a formal valuation nor does it establish avalue for tax or underwriting purposes. A formal valuation should be obtained with the guidance of your legal and/or tax advisors.

Business Valuation

Definition of Terms

Assets: Business assets adjusted to reflect fair market value, or the liquidation value of the business, as opposed to the depreciated value for income purposes.

Capitalization Rate: The capitalization rate quantifies the rate of return required by an investor to take on the risk of operating the business. The riskier the business, the higher rate of return required. For the purposes of this calculator, the capitalization rate is determined by subtracting long term growth from the discount rate.

Discount Rate: The discount rate reflects the expected rate of return from another investment opportunity with a comparable level of risk. For the purposes of this calculator, a build up method for determining discount rate has been utilized. The build up method takes the current risk free rate (i.e. long-term return on treasury bonds) and adds to it a large cap premium and small cap premium obtained from a third party source. Finally, an industry and company risk premium is added to the above to obtain the discount rate. This calculator uses a default industry and company risk premium that does not take into consideration a specific industry or company profile.

Earnings: Earnings refers to earnings before interest, tax, depreciation and amortization (aka EBITDA). EBITDA is essentially net income with interest, taxes, depreciation, and amortization added back to it, and can be used to analyze and compare profitability between companies and industries because it eliminates the effects of financing and accounting decisions.

Goodwill: Goodwill refers to intangible assets that relate to a company's business practices which increase the value of the business but can be difficult to quantify. Examples of goodwill include brand recognition, customer loyalty, and employee happiness.

Liabilities: Liabilities of the business.

Long Term Growth: This rate is the growth rate for the business, expressed as a percentage, used to project growth on a long-term horizon. This rate should be more conservative than the projected growth of earnings rate used.

Projected Growth of Earnings: This rate is the growth rate for business earnings, expressed as a percentage, used to project future earnings for five years based on current and/or historical earnings.

Rate of Return on Capital Assets: This rate represents the earnings produced by corporate assets, which may include stocks, bonds, real estate, and other assets or accounting methods.

Owner's Compensation & Bonuses: Owner's compensation and bonus income.

Business Valuation

Your business may be the most important asset you own. A business valuation can help you protect that asset by providing a measure of the worth of your business on the open market. Understanding the value of your business can help you plan for future events that might otherwise threaten its success, such as:

- Death
- Divorce
- Retirement
- Bankruptcy or insolvency of an owner
- Transfer to the next generation
- Estate Taxes

Business Valuation Methods

This information is provided to introduce you to different methods that could be used to help value your business. It is not a substitute for a formal valuation performed by a professional with knowledge and experience in that area, and does not apply to any business where there is insufficient history to support the modeling methodologies. It is designed to demonstrate how different valuation methods produce different results and provide a starting point for you to have a conversation with your professional valuation advisor regarding your business.

The four methods considered in this presentation are:

Book Value Method. This method is the simplest valuation method. It takes the fair market value of all the assets of a business and subtracts its liabilities to determine the value. This method does not take into account goodwill or earnings capacity of the business. It is most appropriately used when goodwill is limited or may disappear quickly.

Discounted Earnings Method. This method uses projected future earnings and a discount rate to determine the value of the business. The discount rate used is generally the rate of return that an investor would want to receive from another investment with a similar level of risk. The projected future earnings are discounted by the chosen rate and then added together to determine the value of the business. This is the most common form of business valuation and is often used for valuing services businesses (whose asset bases are often small) and for companies experiencing high growth rates.

Capitalization of Earnings Method. This method looks at the current and historical earnings generated by the business to determine its value. It calculates the capital required to generate those earnings, adjusted for the risk level of the business relative to other investments. This method assumes that the earnings will be stable and does not take into account the book value of the business. It is generally suitable for service oriented businesses with limited capital.

Capitalization of Earnings + Book Value Method. This method combines the Book Value and Capitalization of Earnings methods. It attributes a portion of the earnings to the return on corporate assets and subtracts those earnings from the total earnings to determine the “excess” earnings. It then applies the capitalization method to the excess earnings and adds that value to the book value to determine the total value of the business. This method is helpful when the capital assets of the business are important to income production.

What could your business be worth?

While it is important to implement a business succession plan, it is equally as important to regularly review your buy-sell agreement and any associated funding. Agreements and funding can quickly become outdated due to increased business value. The chart below illustrates the potential growth of your business in future years.

Assumed Current Business Value

$10,000,000

Assumed Average Annual Growth Rate

4%

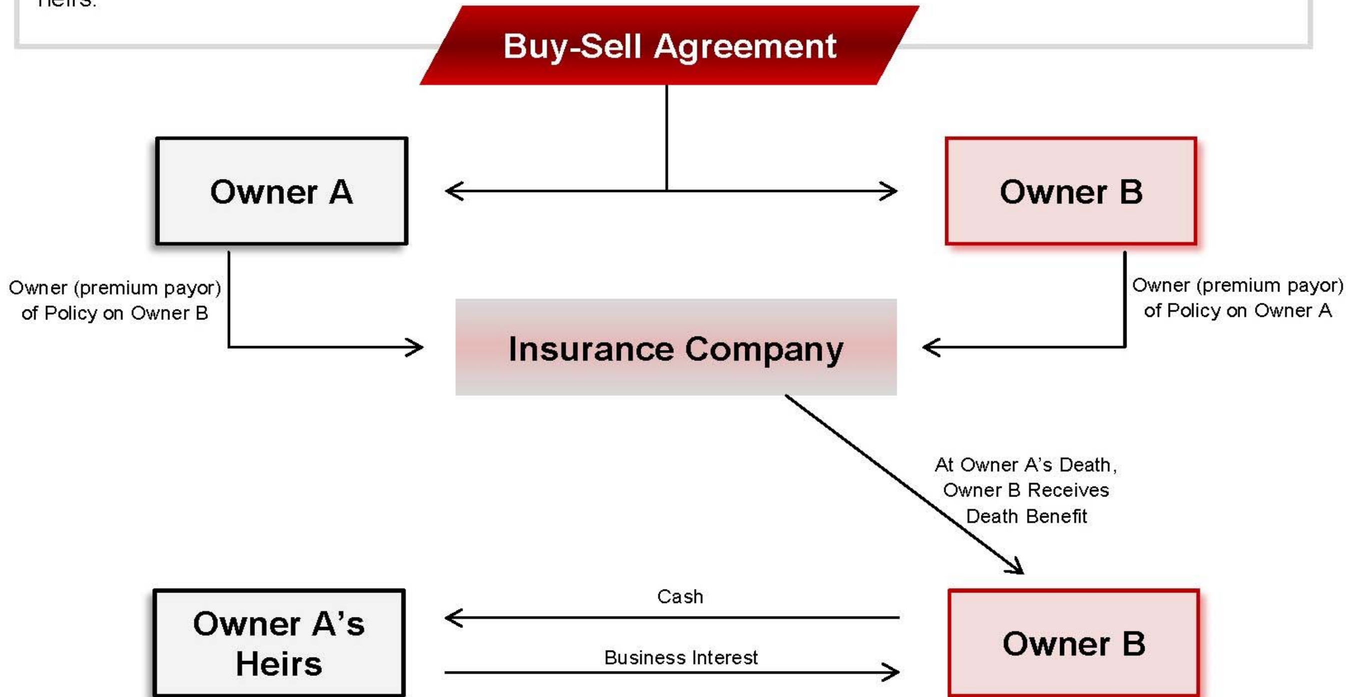
Projected Business Value in Year 2030

$18,009,435

Year	Beginning of Year Assumed Value	Projected Business Growth	End of Year Assumed Value
2016	*$10,000,000*	*$400,000*	*$10,400,000*
2017	$10,400,000	$416,000	$10,816,000
2018	$10,816,000	$432,640	$11,248,640
2019	$11,248,640	$449,946	$11,698,586
2020	$11,698,586	$467,943	$12,166,529
2021	$12,166,529	$486,661	$12,653,190
2022	$12,653,190	$506,128	$13,159,318
2023	$13,159,318	$526,373	$13,685,691
2024	$13,685,691	$547,428	$14,233,118
2025	$14,233,118	$569,325	$14,802,443
2026	$14,802,443	$592,098	$15,394,541
2027	$15,394,541	$615,782	$16,010,322
2028	$16,010,322	$640,413	$16,650,735
2029	$16,650,735	$666,029	$17,316,764
2030	$17,316,764	$692,671	$18,009,435

Cross-Purchase Buy-Sell Agreement

A buy-sell agreement identifies a buyer for a business in the event of an owner's death. In a cross-purchase arrangement, surviving owners are obligated to purchase the interest of a deceased owner. To fund the buyout, owners purchase life insurance policies on the lives of each of the other owners. Upon an owner's death, surviving owners receive the death benefit and purchase the deceased owner's interest from his or her estate. Surviving owners retain control of the business and the non-liquid business interest is converted to cash for the heirs.



Client Profile

- Business with multiple (typically two) owners

Why it is used

- Guarantees a market for future sale of the business
- Guarantees business passes to other current owners
- Provides fair market value for deceased owner's heirs
- Provides liquidity for the family of a deceased owner

Advantages

- Guarantees a purchaser for the business
- Provides liquidity to meet purchasing obligations
- Surviving owner(s) retain control of the business
- Terms of sale negotiated prior to death
- Heirs of deceased owner receive fair market value
- Family of a deceased owner receives cash to pay estate taxes and/or to meet family needs
- Assurance of continued operation for creditors and employees

Disadvantage

- More owners require more life insurance policies

Role of Life Insurance

- Provides liquidity for surviving owner(s) to meet purchase obligation
- Provides immediate full funding of the purchase price
- Less costly funding method than borrowing the funds or using the company's working capital
- Leverages premium dollars

Tax Considerations

- Death benefit received income tax free
- Premiums not income tax deductible
- Deceased owner's estate receives a step-up in basis
- Surviving owner receives step-up in basis on share purchased from deceased owner's estate
- Not subject to Alternative Minimum Tax (AMT)

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Funding a Buy-Sell Agreement

A buy-sell agreement obligates surviving owners, the business or a third party to purchase the business interest of an owner upon that owner's death. These transactions generally require the purchaser(s) to pay a significant sum of cash to the deceased owner's heirs or estate. "Funding" the agreement refers to the method of financing the purchase price for the deceased owner's business interest. The various options for funding a buy-sell agreement are discussed below.

Life Insurance

Advantages

- Generally considered the least costly method of funding
- Cash is available precisely when needed
- Life insurance proceeds are received income-tax free
- Minimizes financial strain on the buyer at time of business interest purchase
- Cash value accumulations can be used as a substantial down payment in the event of other triggering events, i.e. disability or retirement
- Life insurance cash accumulation is generally not available to buyer's creditors

Disadvantages

- Availability/cost depends upon insurability
- Premium payments are not a deductible expense
- Increases in future value of business may require additional purchases of insurance

Installment Payments

Advantages

- Seller may spread capital gain tax consequences from living buyout over time
- Allows flexibility for buyer

Disadvantages

- Seller or seller's heirs bear risk of business failure and resulting default on installment payments
- Total sales price may be included in seller's estate but transaction does not provide immediate liquidity to pay estate taxes
- Interest in addition to principal must be paid
- Payments reduce cash available for business cash flow
- Obligation may affect buyer's ability to borrow for other business needs
- Lacks certainty for seller or seller's heirs

Borrowed Funds

Advantages

- Cash can provide necessary funds in the event of any triggering event such as death, disability or retirement if business or surviving owner(s) can secure loan

Disadvantages

- Dependent upon buyer's ability to secure credit (death of an owner may make this especially difficult)
- Interest in addition to principal must be paid
- Payments reduce cash available for business cash flow
- Obligation may affect buyer's ability to borrow for other business needs
- Collateral and personal guarantees are generally required

Sinking Fund

Advantages

- Necessary cash will be available if owners have sufficient time to save full amount
- Cash can provide necessary funds in the event of any triggering event such as death, disability or retirement
- Owners can access cash if buy-sell agreement is terminated

Disadvantages

- May take significant time to save necessary funds
- Deposits made with personal or business after-tax dollars
- Earnings on the fund may be taxable
- Additional funds must be set aside to provide for increases in business value
- Fund may be subject to buyer's creditors
- Payments into fund are not tax deductible
- Funds must be managed and must achieve adequate rate of return to accumulate to required sums
- Access to funds could result in an unfunded agreement