WELLS FARGO Wealth & Investment Management

Which Business Transition Option is Right for You?

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Which business transition option is right for you?

Key Considerations

- Most successful business transition outcomes start with clearly defined goals and objectives by the owner.
- Each transition option has its pros and cons. Understanding each option and how it aligns with your goals is key in determining which transition option to pursue.
- Business transitions are complex, so a disciplined process can help owners confidently plan and execute a successful business transition and maximize outcomes for all stakeholders.
- Every owner and their business is unique, and business transitions are not a one-size-fits-all solution. Invest the time to find the solution that is right for you, your family, and your business.



The most common business transition alternatives

Drivers	Alternatives	Are these priorities for you?	Practical Issues
What are your objectives? What are the industry dynamics and how is the company positioned? What are the mergers & acquisitions (M&A) and capital market conditions?	**Keep / Family transition**	☐ Continue growth and build scale ☐ Preserve your family legacy ☐ Maintain ownership and control value creation	• Postpones liquidity / future value uncertain • Ongoing business risk • Interest and capability of next generation
	Sale to strategic buyer	☐ Complete liquidity event for all owners ☐ Potential "spike" valuation from synergies with buyer ☐ Potential for near-term retirement	• Loss of control • Management roles and employees' future uncertain • Few motivated buyers
	Private equity recapitalization	☐ Partial sale providing potential for significant liquidity ☐ Retained equity providing potential upside ☐ Company receiving additional financial and strategic resources	• Significant involvement from investors • Likely giving up control even though ongoing participation may be required • Leverage increases financial risk
	Internal or management buyout (MBO)	☐ Capitalize on experience of existing management team ☐ Provide key managers with the potential for a significant financial return ☐ Generally less risk to management and employees compared to new ownership	• Management team may not possess “owner" skills • Retained business execution risk to the extent of seller financing • Liquidity available to owner depends on management equity and debt capacity
	ESOP (Employee Stock Ownership Plan)	☐ Tax benefits - deferral on capital gains, deductible contributions ☐ Opportunity to benefit all eligible employees ☐ Some liquidity plus managing the transfer of control	• Qualified plan subject to ERISA rules - ongoing complexity • Planning for repurchase obligation • Retained business execution risk

Keep / Family transition – Overview



Seller rationale?	• Owners not ready to walk away from business, either for personal or financial reasons • Allows owners to continue to drive the business to a higher value before a future transition • Owners' goal may be to transition business to family members, either now or in the future • Capable management team allows owners to step back from daily operations
Typical financial consideration?	• Ongoing cash flow from the business may be too attractive to give up • Family transitions can be structured in many ways – Gift with no consideration – Partial purchase or sale over time – Full market value • Funding of a family transition can also vary – Purchase paid for from business cash flows – Utilize bank financing – Institutional junior capital
Transaction structures?	• Key issues to address in a family transition include: – Timing of transition – Control of business during transition – Appropriate amount of consideration to be paid – Impact on family members, those both included and excluded from ownership – Coordination with overall wealth and estate plan

Keep / Family transition – Considerations



Positive indicators

- Owners can continue to use company cash flow to support lifestyle
- Owners can operate the company and move toward some financial, professional, or personal goal
- Anticipated value of long-term cash flows may exceed expected market value
- No change in company personnel or culture
- With additional time, owners may be able to bring in family members or train new managers
- Other transition options are all still available in the future

Potential challenges

- Without further planning, does not clarify path for owners who may be thinking about retirement or exit
- Owners may need to be involved with the company for an uncertain period of time
- While company can provide cash flow to owners, a cash windfall is unlikely without a transaction
- Ongoing risk of ownership of a private company
- May not solve issues / conflict among multiple owners
- Family may not be interested in or capable of running business

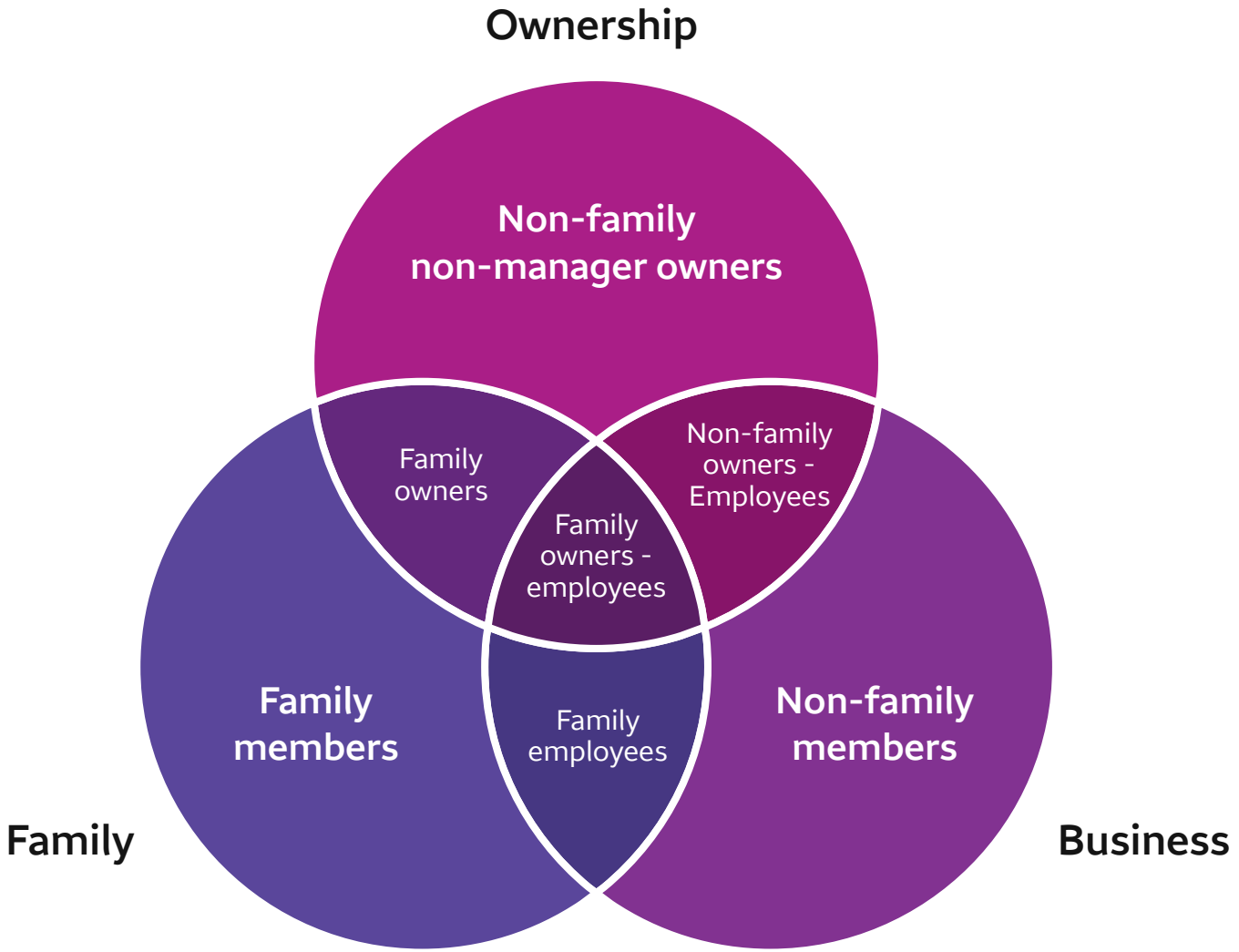
Additional considerations

- Does the company have the next generation of management in place? If not, how will successors be identified and recruited?
- Will the company's value in the future be greater or less than the current value?
- Can the company successfully navigate disruptions in the industry and economy?

Keep / Family transition – Considerations

Three circle model of the family business system

Consider the interests, desires, and concerns of all stakeholders to develop the best approach to a family transition



Source: Adapted and used with permission from the Three-Circle Model of Family Business System, Tagiuri and Davis, 1982.

Sale to strategic buyer – Overview



Seller rationale?	• Strategic sale often alternative with highest near-term value and least continued involvement in company • Strong alternative for owners who would like to cash out and walk away • As part of transaction, seller may be able to negotiate a variety of non-monetary details
Who are the buyers?	• Companies in your sector or market • Public, family-owned, or private equity-owned “platform” companies • Likely to come from competitors, customers, suppliers, or geographic / product adjacencies
Buyer rationale?	• Strategic buyers typically purchase 100% interest to fully control and integrate business post-closing • Expand into new geographic market, customer segment, or product offering • Capture economies of scale • Integrate vertically up or down supply or distribution chain • Eliminate a competitor • Acquire technology, know how, brand, or other rights (i.e., exclusive licenses or distribution rights) • Gain beachhead access to key customers • Buy instead of build infrastructure (i.e., production capacity, distribution network, or sales force)
Typical financial consideration?	• Bulk of proceeds received at closing, with some amounts held back to ensure various representations and warranties • Often 100% cash payment from larger buyers • May include equity consideration or seller financing if needed to finance transaction • Earnouts used situationally: in smaller transactions and transactions with low competition among buyers (i.e., strong buyer leverage), to bridge valuation gaps, or to ensure ongoing seller involvement
Transaction structures?	• Stock purchases or asset purchases most common • Tax consequences and liability management for both parties typically dictate transaction structures

Sale to strategic buyer – Considerations

Positive indicators

- Typically, opportunity for higher payout at close due to:
  - Potentially highest valuation alternative
  - Buyers often buy 100% of interest
  - Buyers often pay in cash
- Often leaves seller with less retained risk
  - Minimal retained equity risk
  - Minimal retained payment risk
- Commonly the most likely alternative to allow seller to quickly retire, walk away, and not look back

Potential challenges

- Sale process can be stressful with an uncertain outcome
- Seller fully relinquishes control over business
- Ownership change may impact company culture
- Younger generations may be excluded from ownership or participation
- Risks associated with seller financing or earnout if part of transaction funding

Additional considerations

- Will buyer need / want seller to continue working after closing?
- Is seller able or willing to transition from owner to employee?
- A highly structured sales process can help optimize terms of sale and probability of closing
- Seller may want to consider working with an investment banker with strong experience and industry knowledge

Sale to private equity (PE) - Overview

Seller rationale?	• Sale to a private equity investor generally brings relatively high near-term proceeds • Usually, owners continue to operate the company under the direction of the private equity investor and can drive the business toward a higher valuation and a second liquidity opportunity • Allows owners to cash in some chips and reduce their personal financial risk but stay involved in the business • As part of transaction, seller may be able to negotiate a variety of non-monetary details
Who are the buyers?	• Private equity firms seek a financial return – they set up vehicles that collect funds from investors, use those funds to invest in attractive companies, operate and grow the company toward a future sale, and then return proceeds to investors
Buyer rationale?	• Private equity firms seek a financial return • Investors may view the target company as having considerable growth potential and may benefit from additional expertise • Private equity investors may already own "platform" companies – that is, they may already own firms in the same or related industries or upstream or downstream segments
Typical financial consideration?	• Private equity investors typically utilize new debt on the company to buy the interest from the sellers • Large up-front cash payment with remainder rolled into equity in the new private equity-controlled company • Earnouts used situationally: in smaller transactions and transactions with low competition among buyers (i.e., strong buyer leverage), to bridge valuation gaps, or to ensure ongoing seller involvement
Transaction structures?	• Stock purchases or asset purchases most common • Tax consequences and liability management for both parties typically dictate transaction structures

Sale to private equity (PE) - Considerations



Positive indicators

- Typically, good opportunity for high payout at close with potential for additional return upon a future sale
- Often the selling owner continues to be involved with the company
- Potential for relatively lower retained risk due to receipt of proceeds from the initial transaction
- May be an attractive option for owners who want to cash in some chips while continuing to grow the company

Potential challenges

- Sale process can be stressful with an uncertain outcome
- Private equity investor likely will have control over business
- Continuing owner effectively works for the private equity investor for at least some period of time
- Ownership change may impact company culture

Additional considerations

- Private equity investor likely will want the selling owner to continue to operate the company for some period of time
- Company will have some amount of additional debt after initial transaction
- Seller may want to consider engaging an experienced investment banker; process likely would consider a sale to a strategic buyer as well

Management buyout (MBO) – Overview

Seller rationale?	• Sellers may see a management buyout as a way to reward employees and preserve company culture by transitioning the company to employees who are familiar with the business and may have contributed significantly to its growth and value • Attractive alternative for owners who want to benefit employees, maintain culture, and reduce involvement
Who are the buyers?	• The buyer is a group – often one or more managers, though outside investors are possible – interested in taking over ownership of the company
Buyer rationale?	• In a management buyout, the interested buyer group can transition toward ownership of the company • While buyers can purchase interests directly from the sellers, buyers can also finance the purchase of seller shares by financing the transaction using the cashflow of the company, usually with some combination of senior debt and seller debt
Typical financial consideration?	• Owner may be bought out by management group in one or more transactions that likely involves bank debt and / or a seller note • Depending on deal structure, sellers can receive a portion of proceeds upon closing, with future proceeds often consisting of interest and principal on a seller note • Amount of cash paid to seller at closing will depend on buyer resources and borrowing capacity of company
Transaction structures?	• A management buyout may entail a single 100% sale or a transaction in stages in which the management group obtains shares over time

Management buyout (MBO) – Considerations

Positive indicators

- Sellers typically consider a management buyout as a method to reward key employees who may have been instrumental to the company's success
- By turning key managers into owners, the company is positioned for the future
- Although the owners may exit the company, the transition may have less impact on company culture than other alternatives

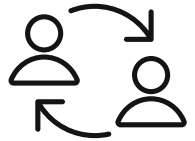
Potential challenges

- Retained risk:
  - Sellers may need to wait several years before receiving all proceeds
  - Risks associated with seller financing if part of transaction funding
- Seller relinquishes control over business at some stage
- Depending on makeup of management group, younger generations may be excluded from ownership or participation

Additional considerations

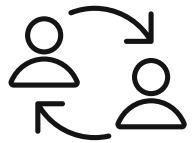
- Will the management group be able to operate effectively as owners?
- At what stage will the sellers be able or willing to give up control of the company?
- How long will exiting owners continue to work after the initial stage of the transition?

Employee stock ownership plan (ESOP) – Overview



Seller rationale?	• An Employee Stock Ownership Plan (ESOP) represents a ready buyer with flexible transaction structure options • An ESOP transaction provides exiting owners with some near-term value, potentially enhanced through a 1042 tax deferral election, and an ongoing payment stream, either from continued ownership in the business or the ESOP purchasing additional shares • Attractive alternative for owners who want to benefit employees, maintain culture, and reduce involvement
Who are the buyers?	• The buyer is an employee stock ownership plan (ESOP) that acts as trustee for participating employees
Buyer rationale?	• Shares purchased by ESOP are allocated to employees • As company value increases, so does the value of the shares held by the ESOP • ESOP is a tax-exempt entity, which can provide an economic advantage to the business and owners
Typical financial consideration?	• Amount of cash paid to seller at closing may depend on borrowing capacity of company • Seller may be able to elect 1042 treatment, thereby deferring capital gains taxes • If transaction entails a seller note, seller may receive interest and principal payments over some years
Transaction structures?	• Transaction may entail a single 100% sale or a transaction in stages in which the ESOP purchases shares over time

Employee stock ownership plan (ESOP) – Considerations



Positive indicators

- Typically viewed by sellers as best method to:
  - Preserve company culture
  - Reward employees
  - Set up company for future success
- Under certain conditions, company can operate free of taxes, potentially providing competitive edge
- Can be structured in stages, thereby allowing the owner to realize a liquidity event and maintain control of the business

Potential challenges

- Retained risk:
  - Sellers may need to wait several years before receiving all proceeds
  - Risks associated with seller financing or earnout if part of transaction funding
- Seller may relinquish control over business at some stage
- Younger generations may be excluded from ownership or participation
- Not all companies are good fits for an ESOP

Additional considerations

- Will selling shareholders continue to work after closing? Are sellers able or willing to give up control of company?
- Ongoing structure maintenance to comply with regulations

Let’s talk

- I’m ready to listen and start the planning process with you
- Schedule a confidential session to discuss your next steps



WELLS FARGO

Wealth & Investment Management

Thank you

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