VALUE MANAGEMENT INC.

Investment Banking + Advisory Services

ISSUES + UPDATES FALL 2017

Succession Planning Options for Family-Owned Businesses

Succession planning options for the family business walk hand in hand with liquidity options for family business owners. Who will run the business and take it to the next level? How will the current owners cash out their equity interests?

There are many options for family business owners to consider when contemplating transferring the business. The starting point should be establishing the business owner's objectives. Then, examine the various options to determine which course will accomplish these objectives. Presented below are the most common exit strategy options.

Family First, Of Course

It should come as no great surprise that the option of first choice for many family businesses is to transfer the control and ownership of the company to the next generation. This can be done by sale or gift to children and/or other family members. When this is possible, advance preparation for efficient transfer and ongoing attention to business and familial issues are essential for a successful outcome.

This option is desirable to family business owners because it keeps the family in the business. Also, it enables the owners to control the pace and nature of changes made at the business.

Often, this option is not viable. Family members may not be interested, or they have interests or talents not suited for the family business. Also, it is unlikely that parents will maximize their value by selling or transferring to their children. Additionally, owner financing is common.

Management is Near and Dear and Has No Fear

If you are looking for the next leaders of the family business, trusted managers and directors are a logical choice to consider. Who knows the business better than its current management? Who knows the company's potential and what must be done to achieve it?

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VMI Highlights:

VMI would like to welcome Jonathan Hart, MBA, to our team! Jon joins us as a Financial Analyst. He has an MBA in Corporate Finance from St. Joseph's University. Please join us in welcoming Jon!

Value Management Inc. sponsored the Bucks County Estate Planning Council's first dinner meeting of the year in September. VMI will be sponsoring the Philadelphia Estate Planning Council's first luncheon meeting of the new year on January 9, 2018. The topic will be "Business Succession Planning." If you are interested in attending as our guest or would like more information, please contact Susan Wilusz.

Greg Kniesel spoke at the Las Vegas National ESOP conference on November 8th. His topic was, "Current DOL Issues and Investigations."

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This is often seen by owners as an easy option, as company managers/directors are already intimately familiar with the business and often eager for the opportunity to become owners. Similar to transferring/selling to family members, transferring/selling to existing management can help to ensure consistency of business operations.

While management is often eager to assume control, questions may remain about overall leadership ability – i.e. they are good at what they do but can they run the whole business successfully. She may be an excellent CFO, but how well can she deal with employee issues? The GM has a firm handle on operations, but does he have the financial savvy to understand the implications of the numbers? How much money does management have to buy out the current owners? Is owner financing likely in a sale to management and does this fit in with the owner's goals?

Our Employees Are Family, So How About An ESOP?

Many family business owners attribute the company's success to their "business family," or their employees. Some owners want to sell/transfer all or a portion of the business to its employees through an Employee Stock Ownership Plan (an "ESOP"). An ESOP is a defined pension plan that enables employees to become company shareholders.

An ESOP can provide liquidity to selling shareholders, and offers potential tax benefits to them under certain circumstances. An ESOP enables management and employees to become actual owners of the business, and they need not pay for it out of their own pockets. Tax deductible contributions made by the company are used to pay for the shares bought from the owners. ESOP-owned companies often promote and leverage employee ownership for enhanced company morale and performance.

While the ESOP does offer many benefits, an ESOP cannot pay more than the fair market value of the interest being sold and cannot pay a synergistic value. Additionally, there are initial and ongoing expenses (legal, administration, valuation) associated with an ESOP. The funds for a sale to an ESOP can come from the company or can be borrowed (from the bank, from the company, or from the selling shareholders).

New Horizons and Deep Pockets Would Be Nice

If an influx of new capital is a high priority and if some new blood is needed to reinvigorate the business, finding an outside investor may be the desired choice. If the next generation does not want to or is not capable, and if management is not ready or capable of seeing the big picture, the family business owner may choose to bring on/sell their interest to outside investors.

There are many strategic investors. It is possible to find investors that bring financial and operational resources. Often, injecting an objective, professional point of view into a business, coupled with the resources to finance growth, can help take a company to the next level. In the right situations, it is possible for owners to partially cash out and to participate in the growth and possibly future sale proceeds.

Family business owners take pride in their corporate independence and personal freedoms of being an owner. Sometimes it is difficult if not impossible for some owners to take on active partners, and/or to remain at the business in a reduced role. Many owners would not want to relinquish control to an "outsider,' even if paid well for it. Conversely, it may be very difficult to find an investor willing to buy a non-controlling interest in a privately-held business.

Is It Time To Sell? (If Not Now, When?)

People are surprised to hear the statistics about the relatively low percentages of family businesses that successfully pass ownership and/or control to second and third generations (typically cited as 30% and 10%, respectively). Truth is, it is hard for some businesses to survive long enough to be transferred or sold to anyone. If you then factor in the succession planning options and obstacles other than sale to a third party, the low estimates of second- and third-generation business ownership make more sense.

Having options is good. However, some options will not achieve the owner's objectives. The more successful the business, the more likely it is to be actively sought. More demand typically creates more value. A sale may create the largest liquidity event.

When is the right time to sell? It is first necessary to assess value and determine if any adjustments are required to increase its marketability. If the owner is ready, is the business ready? Is the state of its industry going to help or hinder a sale? Does the economy favor high prices? Are there ready buyers? In short, is it a seller's or a buyer's market?

The best situation for an owner is one where they are not compelled to sell. If they understand what they have, and their goals are reasonable/achievable, and the market is right, and the buyers are anxious, it may be the time. The trouble is, some companies and their owners may never experience the "stars being aligned" – the perfect time to get a great deal. Factors at the company – dependency on the one or two people or on a key customer, delayed capital expenditures, loss of a significant supplier, etc., can detract from value.

The owner and company must be prepared for a sale. The market conditions should be ripe (decent interest rates, competitive lending environment for buyers, public markets on the rise, investable cash on corporate balance sheets). The seller-to-buyer ratio should favor good demand (i.e. plenty of buyers drives up value).

It's Not Hitting the Lottery, But Going Public Feels Like It!

If your family business is good enough and has enough potential, going public can mean tremendous returns. If this is an option, the rewards often outweigh the downsides.

Observations On Succession Planning Options

To summarize, the succession planning options discussed are:

1. Transfer/sell to family
2. Transfer/sell to management
3. Transfer/sell to an ESOP
4. Partial sale to an investor
5. Sell the company
6. Take the company public

Family control tends to decrease with each option. Conversely, the financial value to the family owners tends to increase with each option (i.e. selling or going public will most likely produce the highest prices for the selling owners). The choice is yours!

Many Small-Biz Owners Don't Want to Retire

The tidal wave of baby boomers selling their small businesses may be a little later in coming than many people thought. Many owners want to keep working in their business in some capacity as long as they are able. The Wells Fargo/Gallup Small Business Index finds that, if money were no object, over one-half (53%) of the nation's small-business owners would continue working in a full- or a part-time capacity. Only about one in four say they would retire completely.

Surprising Estimates of Private-Company Cost of Equity

Over half (59%) of privately held business owners believe their cost of equity is less than or equal to 12%, according to the "2017 Private Capital Markets Report" from Pepperdine University Graziadio School of Business and Management. What's more, half of the 1,034 respondents say it is no higher than 10% and almost a third (31%) say it is less than or equal to 8%. The survey was released in January 2017. Their method is simple: They ask private capital market players what returns they project. The players are divided into six segments aligned with the major institutional arms of the private investment world, each with different return, investment, and research characteristics. The segments are: bank lenders, asset-based lenders, mezzanine lenders, private equity groups, venture capital, and angel investors.

Proxy Gave 'Fair' Summary of Valuation Work, Chancery Says

Several decisions in the Delaware Court of Chancery have focused on the use of the business judgment rule to defeat breach of fiduciary duty claims. Under the rule, the court does not second-guess a deal where a majority of disinterested, informed shareholders approved the transaction. In the most recent case, the plaintiffs argued the vote was uninformed because of disclosure violations regarding the financial advisor's fairness opinion, but they failed to persuade the court.

The plaintiffs sued in connection with the 2015 sale of a healthcare software developer to IBM. Goldman Sachs (Goldman) was the financial advisor for the transaction. Goldman performed a discounted cash flow analysis and prepared a fairness opinion that pronounced IBM's offer "fair from a financial point of view." Because Goldman worked on a contingency-fee basis, it stood to earn $13 million if the merger went through. A majority of the disinterested shareholders approved the transaction.

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stevebeyer PRODUCTIONS

has been sold to its

Employee Stock Ownership Plan (ESOP)

VALUE MANAGEMENT INC.

served as financial advisor to the ESOP trustee

PACHILD.ORG PACHILD

has been sold to its

Employee Stock Ownership Plan (ESOP)

VALUE MANAGEMENT INC.

served as financial advisor to the ESOP trustee

MARSHALL INDUSTRIAL TECHNOLOGIES

has been sold to its

Employee Stock Ownership Plan (ESOP)

VALUE MANAGEMENT INC.

served as financial advisor to the ESOP trustee

Marshall Financial Group

has been sold to its

Employee Stock Ownership Plan (ESOP)

VALUE MANAGEMENT INC.

served as financial advisor to the ESOP trustee

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The plaintiffs filed a complaint contending the board was conflicted and its members acted in bad faith by disseminating "materially misleading and incomplete information" to the stockholders and providing a proxy that omitted material information. The defendants filed a motion to dismiss, arguing the business judgment rule applied. Since a majority of disinterested shareholders approved the merger, the stockholder vote would have a "cleansing effect" on the transaction to the extent there were conflict-of-interest issues.

To show the vote in favor of the merger was uninformed, the plaintiffs alleged the proxy: (1) did not accurately disclose how Goldman's DCF analysis treated stock-based compensation; and (2) inadequately described the present value of the company's net operating losses. All of this information was material to providing shareholders with a "fair" summary of Goldman's work, the plaintiffs claimed.

The court noted the proxy gave many details about Goldman's work, including projections for revenue, gross profit, EBITDA, EBIT, net income, earnings per share and cash flow. Combined, this information provided a fair summary of Goldman's work. Because the vote was fully informed, the business judgment rule applied. The court dismissed the complaint.

The case is In re Merge Healthcare Inc. Stockholders Litig., 2017 Del. Ch. LEXIS 17 (Jan. 30, 2017).

What's the Value of a Laugh?

How do you put a price on a punchline? We may get an idea if a case against Conan O'Brien makes its way through the courts. The comedian has been charged with copyright infringement by a writer who said he plagiarized punchlines about Caitlyn Jenner, Tom Brady, and the Washington Monument, according to a report from the Associated Press. The judge in the case refused to dismiss the case, so we may get to glean some insight into the value of laughter.

While this case involves comedy, it's a serious matter. Years ago, a once-famous comedy film writer/director committed suicide after being hounded by charges of improperly reusing gags from films he had worked on in his heyday.

New Jersey Ruling Cements Use of DLOM to Sanction Oppressing Shareholder

You may remember last year's controversy over the Wisniewski v. Walsh case, in which the court used the marketability discount to punish bad behavior. A trial court decision (Parker v. Parker) in a forced buyout follows the same approach. The oppressor had created an "extraordinary circumstance which requires this court to apply a marketability discount" in order to achieve a "fair and equitable" outcome, the court said.

Two brothers, Richard and Steven, formed two separate companies, Plant Interior Plantscapes (PIP) and Parker Wholesale Florists (PWF), in which each brother had a 50% interest. The companies did business from the same location and shared overhead

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but were otherwise independent enterprises. Decades later, each brother filed suit, claiming he qualified as an oppressed shareholder. As the court put it: "Both litigants seek to have the court remedy every injustice they perceive has befallen them over the last 25 years at the hand of the other. This, of course, cannot be done."

The court found Steven had engaged in shareholder oppression by allowing PWF to incur huge losses over 20 years and by "continually" withdrawing funds from PIP to cover the losses, without obtaining Richard's consent. It ordered Steven to sell his 50% interest in PIP to Richard.

Conduct unbecoming: Under New Jersey law, courts tasked with determining fair value in a forced buyout have "substantial" discretion to adjust the purchase price to reflect a marketability discount. The resulting value must be "fair and equitable." The state Supreme Court has held that in "extraordinary circumstances" a DLOM may be appropriate to ensure the shareholder instigating the problems does not receive a windfall as a result of his or her conduct.

In this case, the court found that Steven's wrongful conduct created an extraordinary situation. To calculate the price of Steven's interest in PIP, both sides' experts relied primarily on a discounted cash flow analysis and looked to IRS Revenue Ruling 59-60. Richard's expert used a 25% DLOM and a 15% minority discount, saying he believed Richard to be the oppressed shareholder and discounts "needed to be applied." The court found this was a legal conclusion the expert was not qualified to make.

However, the court generally accepted the expert's analysis, including the application of a 25% DLOM. Steven's actions "were the cause of the lawsuit," the court said. At the same time, the court noted that, while exceptional circumstances in this case justified a DLOM, they did not "automatically" entitle Richard to a minority discount.

The case is Parker v. Parker, 2016 N.J. Super. Unpub. LEXIS 2720 (Dec. 22, 2016).

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