

Financial Expert

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Business succession planning—better now than later

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Over the next 20 years, an estimated 8 million business owners will exit their businesses. The future of the business is at risk when founders fail to plan for the transfer of management, control, and ownership, or if they propose a plan that is unacceptable to the families and employees involved or have a plan that is out of date.

Exit planning typically involves dealing with the tough questions of estate planning, asset values, the age and health of current owners, and the passing of substantial management responsibility to the next generation. A good succession planner consultant will tackle these sensitive issues up front—while the business is still running smoothly and everyone is in a good position to discuss the options and opportunities.

Credentialed business appraisers have a valuable but often overlooked function—to serve as financial facilitators for privately held and/or family-run companies that are contemplating succession. Without a good sense of the value of a business, all other exit planning decisions become flawed. By bringing the entire process to fruition, the business appraiser can help the family avoid personal and financial disasters in the future.

The critical questions

In particular, business succession brings together traditional mergers and acquisitions or M&A planning with key employee and family considerations, along with buy-sell agreements and related appraisals. Exit planning strategies begin with the broad question: What is the business worth? The discussion branches out into three typical alternatives, each with its own specific issues:

1. Sell the business. What are the possible profit motives and value enhancement? What are the potential tax strategies and consequences?
2. Sell to employees. Smaller, professional service companies have different concerns—and different layers of organizational and administrative experience—than larger operating companies.
3. Family transfer. Gift and estate tax strategies are implicated here. Planning fundamentals include tax consequence, structured vehicles for gifting or transferring the assets, and potential valuation discounts.

In addition, business owners will face some version of the following questions as the process moves forward:

- > **What if the business has no significant value?** This is a disappointing conclusion, but a SWOT (strengths, weaknesses, opportunities, threats) analysis can help identify value-creating areas and places for improvement.
- > **Asset or stock sale—or does an installment sale make sense, to spread the tax consequences over time?** For an operating business, would a stock appreciation rights or SARS plan

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work? What about an Employee Stock Ownership Plan (ESOP)? What about recapitalizing the business by issuing more stock and then redeeming the founding shareholders' equity?

- > **Internal transfer?** If the owner wants to pass the business on to key employees, consider how they might structure a buy-in that will “incentivize” new partners while providing sufficient retirement funds for the owner/older partners, and how they might maximize retiring partners' return without burying the succeeding owners in debt.
- > **Family transfer?** How can the owner pass the business to the next generation at the lowest possible transfer/tax costs? How do specific gifting plans and estate options work? What about installment sales of minority shares? How do minority/marketability discounts come into play?

The paramount concern must be the continued economic viability and health of the enterprise. Appraisers' quantification of value will support the best approach that ultimately works to the advantage of all parties and their financial counselors.

Best outcomes in succession plans

Like taxes, most business owners don't want to think about death or divorce or other painful issues. Similarly, they don't want to discuss the “death” of their own businesses. A good business succession planner will do everything possible to ease the owner's pain all the way through the process. This means permitting the owners to:

- > Leave the company on their own terms and timetable and not as the result of external, unexpected pressures or sudden deadlines;
- > Realize the full value of the business and all their hard-earned wealth, minimizing the impact of transfer and estate/gift taxes;
- > Retain control of the situation by entertaining a variety of exit options;
- > Suffer the minimum of psychological stress and family conflict;
- > Watch a lifetime of work come to a fulfilling, profitable finish; and
- > Guarantee the continuity of the business and look after employees.

Proper exit planning can be time consuming, and most owners are buried in day-to-day operations and management. The planning process can appear complex and costly. But a financial facilitator can help owners understand the tremendous return on investment that solid exit plans provide. Nothing feels better than bringing an entire organization and family together in a unified plan, and knowing that your business will keep bringing them rewards long into the future. ■

The Baker Tilly team helps you prioritize your goals whether you wish to transfer ownership and management duties to your family, an outside party, or current employees. We can design a plan in coordination with your legal and other advisors and help make sure your plan effectively:

- > Ensures your financial security after retirement
- > Provides financial security for your family in the event of untimely death or disability
- > Maintains business success in your absence
- > Promotes family harmony by dealing fairly with all members, whether or not they work in the business
- > Identifies and prepares future owners

Cost of Capital

Treasury Yields¹

30-Day: 0.15% 5-Year: 2.55% 20-Year: 4.55%

Prime Lending Rate¹ 3.25%

Dow Jones 20-bond Yield² 4.22%

Barron's Intermediate-grade Bonds² 7.46%

Mean High Yield Estimate² 23.60%

Median High Yield Estimate² 12.80%

Dow Jones Industrials P/E Ratios²

On Current Earnings 16.1

On '09 Operating Earnings est. 15.8

On '10 Operating Earnings est. 13.1

Long-term Inflation Estimate³ 2.4%

Long-term Rate of Growth GDP³ 2.7%

Duff & Phelps' 2010

Premiums Over Long-Term Risk-free Rate⁴

Historical Equity Risk Premiums: Average Since 1963

Data for Year Ending December 31, 2009

Measure Used for Size ⁵	1st	13th	25th
5-Year Average EBITDA	4.7%	8.3%	11.3%
5-Year Average Net Income	4.5%	8.2%	11.5%
Sales	5.4%	8.5%	11.2%
Total Assets	4.5%	8.1%	11.2%

1 Federal Reserve Statistical Release April 5, 2010

2 Barron's, March 1, 2010

3 10-Year forecast; Federal Reserve Bank of Philadelphia, Livingston Survey, November 30, 2009;

4 Risk Premium Report 2010 © Duff & Phelps LLC

5 Each measure for size is organized by Duff & Phelps, LLC into 25 portfolio ranks, with portfolio rank 1 being the largest and portfolio rank 25 being the smallest. Smoothed average premiums are presented here because they are considered a better indicator than the actual historical observation for most of the portfolio groups.

Is your expert a Star Wars' light saber...or a badminton racket?

Chuck Esser, CPA, CFF, CBA, ABV

It goes without saying, the selection of the right financial and valuation expert in a family law matter may have significant impact on the economic outcome for your client. While choosing the right expert may be difficult, taking the time to thoroughly research the credentials and track records of your top choices can help you avoid terrible endings, such as the case studies below.

Lemmen v. Lemmen, 2010 WL 454959 (Mich. App.)(Feb. 9, 2010)

In this Michigan divorce case the husband owned a 25 percent interest in a privately held oil and gas business. The husband's expert valued his fractional interest in the company at \$5.5 million (using a capitalization of dividend method), while the wife's expert said it was worth \$17.5 (using a combination of methods). In addition to her own expert, the wife also retained a rebuttal expert to challenge the methodology applied by the husband's expert. At trial, the rebuttal expert testified that the capitalization method employed by the husband's expert was simply wrong and without any support in the business valuation community. He showed that the stream of income capitalized (dividends) and the source of developing the capitalization rate (Build-up Method using Ibbotson data) were inconsistent with one another. In addition, the attorney for the wife further impeached the husband's expert with text and treaties that further supported the rebuttal testimony. Ultimately the trial court rejected the husband's financial expert stating that it was not the "product of reliable principles and methods." Oops!

Marriage of Theurer, 209 WL 382 (Cal. App.) (Nov. 17, 2009)

This California divorce case involved the valuation of a successful and well established orthodontics practice. The practice employed approximately 14 people, was technologically up to date, grossed \$2.6 million annually, and produced annual income to the husband of approximately \$1.3 million pre tax. While the wife retained a single valuation expert, the husband hired a valuation expert and a business broker.

The wife's financial expert utilized an "excess earnings" method (a hybrid method of combining asset and income approaches) in valuing the husband's interest. Setting a reasonable compensation rate for the husband at \$500,000, the wife's valuation expert produced a goodwill value of approximately \$2.5 million and overall practice value of \$3.0 million. Similarly, the husband's first expert used an excess earning method, but set the reasonable compensation level at a higher rate of \$776,000, and, using a higher capitalization rate, computed a goodwill value of \$900,000. He then deducted from his value patient prepaids as a liability (more than \$1.1 million), for a final practice value of \$126,905.

The husband's second expert (the business broker) valued the practice based on two rules of thumb. The first was a multiple of net income and the second was a multiple of gross revenues. During his examination, the broker testified that the excess earnings method is generally not used in connection with the sale of a professional practice. In addition, he testified that the number of new starts for an orthodontics practice is relevant in determining fair market value but explained he had not received this information. When he learned that the new starts were 866 in

the most current year, he testified, "I think it would be wonderful to have 866 starts. Great Scott, that's a lot...The buyer would clap his hands...I would think it would be positive. The more the merrier."

The trial court found that the husband's two experts effectively impeached each other on the use of an appropriate methodology and patient pays. Oops!

Helper v Helper, Inc., 2009 WL 3644001 (W. Va.) (Sept. 9, 2009).

In this West Virginia divorce case, the husband also retained two experts to value his solo chiropractic practice. The first was to be the primary witness and the second used in rebuttal. The husband's first expert used an excess earning approach and valued the practice at \$41,000 excluding goodwill. The court will ultimately accept this value.

The wife also retained an expert to value the practice. Using the same method as the husband's expert (excess earnings method), the wife's expert calculated a value of the practice including some practice goodwill at \$388,000. During examination, the husband's rebuttal witness testified that the valuation prepared by the wife's expert had several problems. In arriving at his conclusion of value, the wife's expert relied on the wife's estimate of value for the tangible assets and did not have the assets appraised or apply an alternative approach to valuing them. The wife's expert also failed to consult comparative salary data, and instead relied on the financial studies of small business in arriving at a reasonable compensation level. Finally, the wife's valuation expert adjusted rent to \$10 a square foot – a rate which appeared to be materially below market – despite testifying how valuable the location was. Oops! ■

Upcoming and recent events

- > **May 15, 2010:** Tom Harjes co-presented on the topic of "Update on Non-Marital Claims and Tracing" at a seminar sponsored by the Minnesota State Bar Association in downtown Minneapolis for family law attorneys.
- > **June 17-20, 2010:** Baker Tilly is a proud sponsor of the American Bankruptcy Institute's 17th Annual Central States Bankruptcy Workshop at the Grand Traverse Resort and Spa in Traverse City, MI.
- > **July 15-18, 2010:** Chuck Esser and Jason LeRoy will speak about hot topics in valuation and family law at the State Bar of Michigan's Family Law Section Mid-Summer Seminar that Baker Tilly is sponsoring at The Homestead Resort in Glen Arbor, MI.



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