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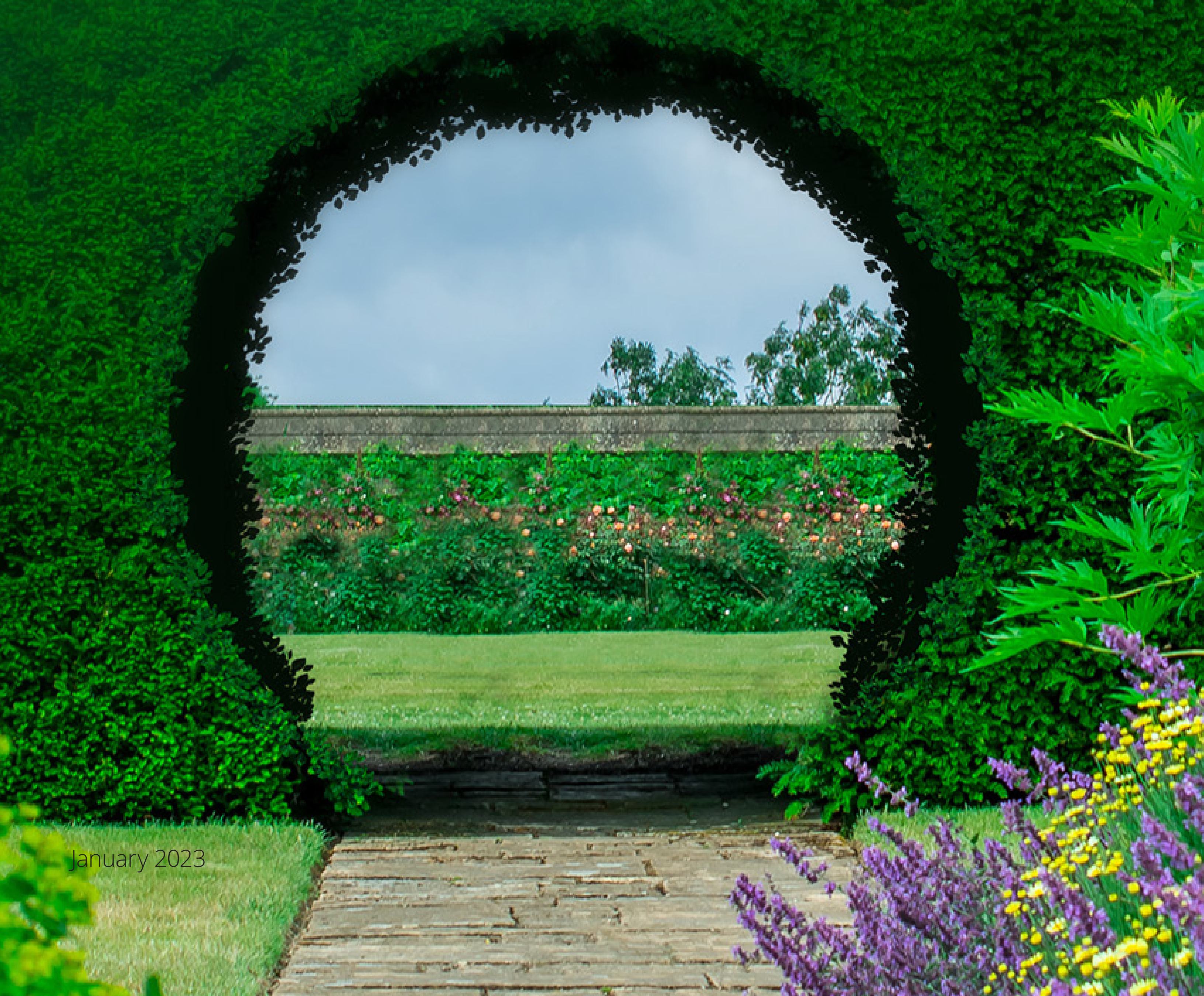
Pivotal moments for family enterprises
The future of the business: How to prepare for a sale and other exit strategy options



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EDITOR'S NOTE

Like a great work of art, family enterprises are unique, crafted over time, and highly valued. While no two family enterprises are the same, they are united by a series of pivotal moments—opportunities to grow, evolve, or transform—and preparation is essential for fully seizing those opportunities. This is the seventh article in a series exploring the eight foundational elements that can help family enterprises maximize the opportunities that arise. Because, with the right canvas, family enterprises can craft a business that supports its evolving vision, interests, needs, and values for generations to come.

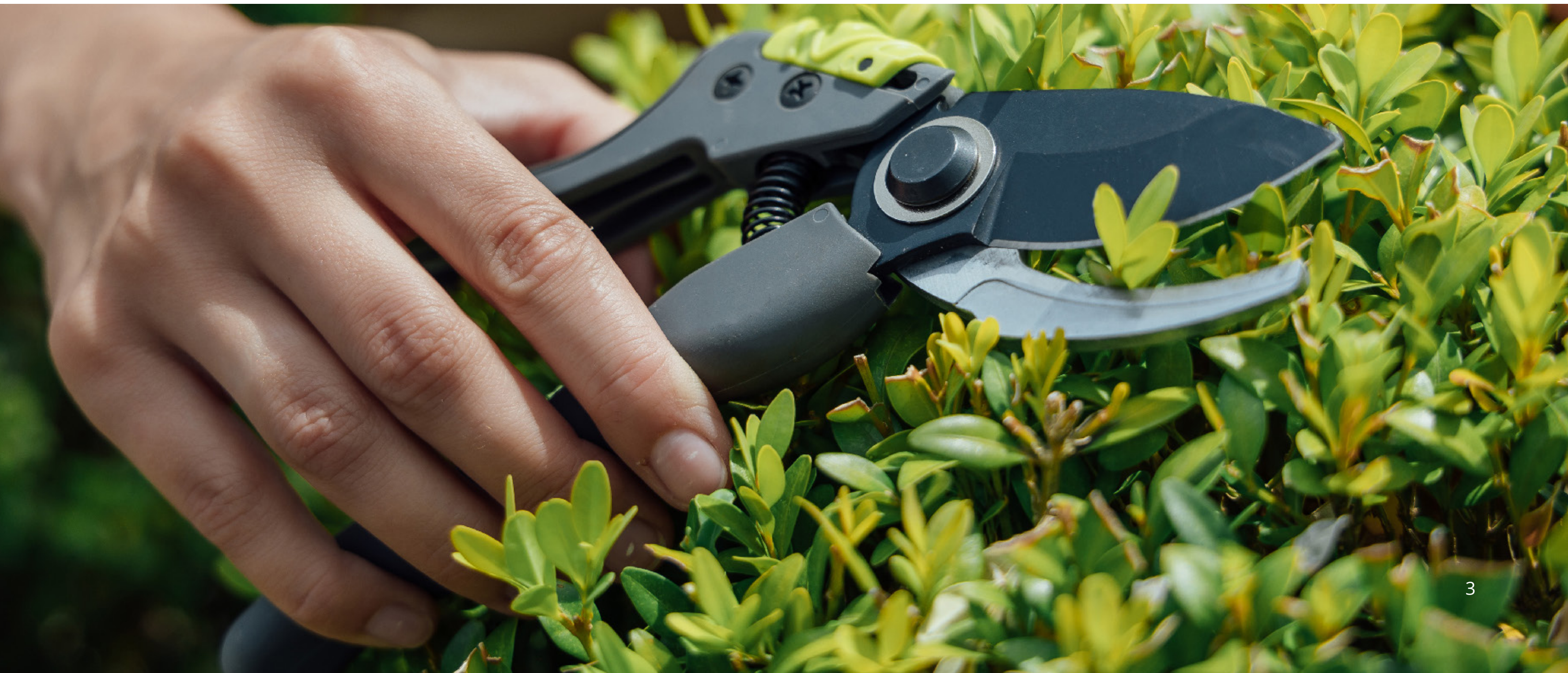
When you create something great, it can be tough to let it go. Many artists struggle with the thought of selling their work, and some have even gone so far as refusing to sell to someone they didn't think valued it as much as they did.

It's a conundrum familiar to many family business founders, who have worked so hard to realize their vision and can't imagine it in the hands of someone outside the family. In our global survey of family enterprises,[1] only one in 10 respondents saw an outright sale to a third party or an initial public offering as preferred options for executing their company's leadership succession.

But the lifecycle of family business ownership is complex, and decisions to exit, in whole or in part, are often driven by individual family members' wants and needs. The next generation may not be interested or prepared to take over. There may be multiple partners or family members involved, many with different aspirations. Some might want to keep growing the business, while others seek to cash out their stakes.

If a sale is in a family enterprise's future, its level of preparedness to sell will likely impact the level of interest, valuation, and terms it receives. Fully understanding the options and opportunities can put shareholders in a position to choose the route that is best for the business and their individual needs.

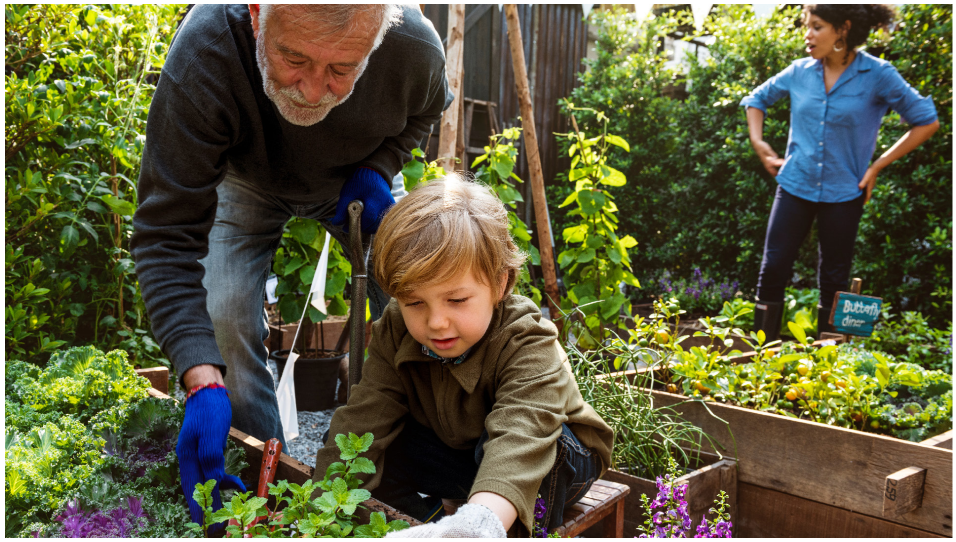
[1] https://www2.deloitte.com/content/dam/Deloitte/lu/Documents/strategy/lu-family-business-survey-2019.pdf



Balancing liquidity and control

In past publications, we have underscored the importance of building internal alignment[2] between the family strategy and the business strategy to create a shared view of the future. This process may become even more complicated when considering succession[3] along with a liquidity event. There are often only a few candidates from the family who are realistically able to move into leadership and sustain multi-generational success. Understanding who is ready and willing to step up well ahead of time can help the family start the succession process by developing future family leaders.

But it's also valuable to consider if non-family partners will likely be needed one day, whether it's to provide liquidity to a family founder, infuse cash into the business to accelerate its growth, or help the family diversify its investment portfolio. There are a host of reasons why a family enterprise might need access to outside capital—and plenty of options for accessing it without ceding control.



Understanding who is ready and willing to step up well ahead of time can help the family start the succession process by developing future family leaders.

"Family business owners who balk at the idea of selling their businesses might find there are other options that enable them to access the capital or liquidity[4] desired with far less dilution or even no dilution," says Max Hughes, managing director of Deloitte Corporate Finance LLC. "You're limited only by your ultimate goals and imagination." For example, family leaders wanting to retain control might consider taking on additional debt, with investors receiving a fixed return and only board observation rights or limited board representation.

Even when it comes to equity investments, there are different ways to structure the transaction (e.g., convertible preferred, participating preferred, or minority equity) which can allow the family to retain control while raising capital for growth or family liquidity.

When family members express an interest in divesting the company or just their stakes, it's beholden on the rest of the family to better understand their reasons for wanting to sell. Sometimes, a third-party intermediary can help the family explore their individual needs, look across the capital structure, and offer a perspective of what could be possible based on the amount of liquidity everyone needs.One of the most difficult stages of this process tends to be balancing larger and smaller distributions among shareholders, which typically requires reallocating equity relative to the unequal distribution of the proceeds. This could be why many families in this situation often have buy-sell agreements in place that designate prices for the internal transfer of equity.

[2] https://www2.deloitte.com/us/en/pages/deloitte-private/articles/pivotal-moments-family-governance.html

[3] https://www2.deloitte.com/us/en/pages/deloitte-private/articles/family-business-succession-planning.html

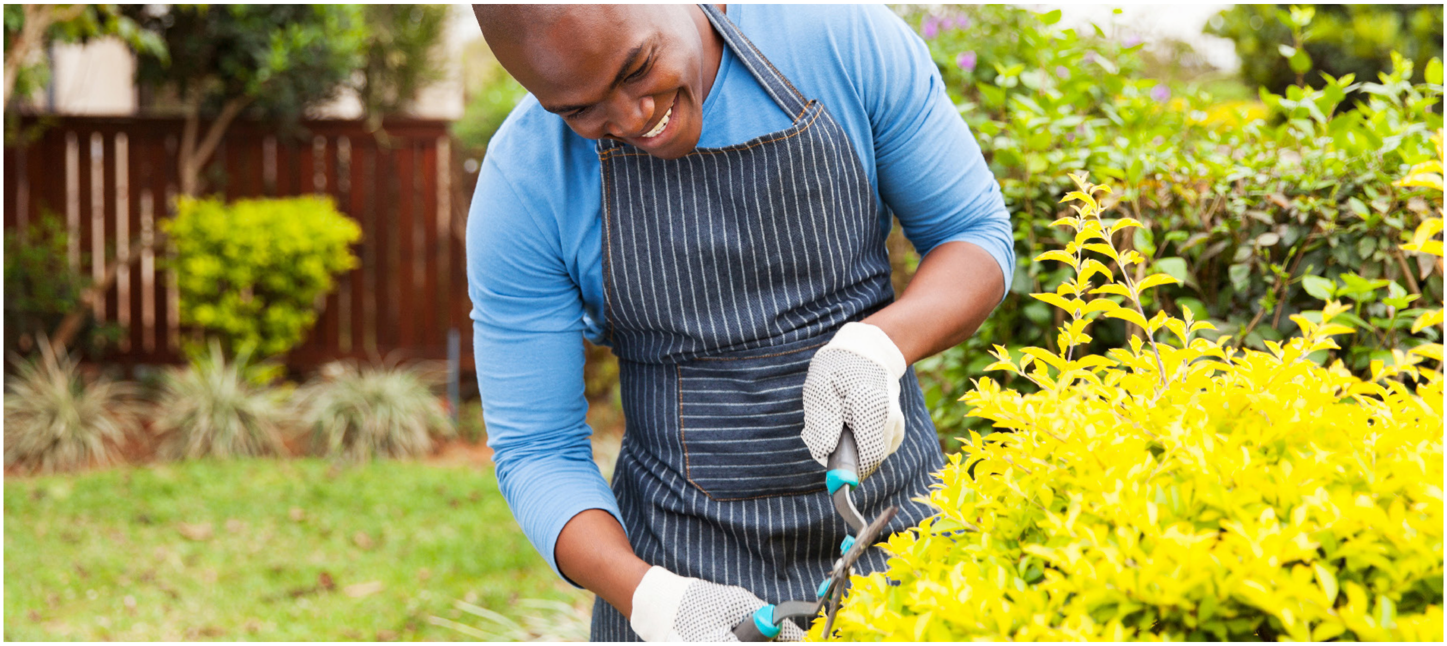
[4] https://www2.deloitte.com/us/en/pages/deloitte-private/articles/new-capital-options-can-create-new-opportunities-for-family-enterprises.html

Overview of equity alternatives

Examples of equity investments and "typical" terms utilized in today's market

	Debt	Structured debt	Convertible preferred equity	Participating preferred	Minority equity
Overview	Typically a fixed return (limited to no dilution for shareholders)	Provides a largely fixed return and less dilution for shareholders	Provides a minimum fixed return and upside through conversion to common equity	Provides a minimum fixed return and upside through equity participation	Traditional form of minority equity
Security	Senior to common equity	Senior to common equity	Senior to common equity	Senior to common equity	Pari passu with common equity
Valuation	Valuation less relevant	Valuation less relevant unless warrants are attached (can be penny warrants or have a strike price)	Equity value at investment generally dictates the percent of converted common equity ownership	Valuation less relevant to fixed portion, but determines amount of equity partici-pation or warrants (penny warrants or strike price)	Equity value at investment determines percentage ownership
Terms	Cash interest with potential for payment in kind (PIK) option (L+6% to 14%) depending on pricing/structure	Preferred PIK dividend of 12-16% plus possible warrants (penny warrants or strike price)	Preferred PIK dividend of 8%-12%; payout is higher of principal plus accrued interest or percent of converted common equity	Preferred PIK dividend of 8%-12% plus equity upside through warrants (penny warrants or strike price based)	No preferred / accrued dividend, payout is determined by equity value at exit
Warrants	Warrants less common for senior debt	Warrants likely / balanced with other terms (e.g. PIK)	None (due to convertible feature)	None (due to participating ownership)	None (due to common ownership)
Covenants	Debt covenants (potential financial)	More debt-like; may have some covenants that align with lenders	Negative covenants	Negative covenants	Negative covenants
Term	5-7 years	5-7 years	5-7 years	5-7 years	5-7 years
Governance	Potential for observer rights or limited board representation	Basic minority rights and potential for board representation or observer rights	Customary minority shareholder rights and board representation; more involved than structured equity	Customary minority shareholder rights and board representation; more involved than structured equity	Customary minority shareholder rights and board representation consistent with ownership percentage

Less dilutive vs. more dilutive



Readying for a transaction

Once the possibility of a sale is on the table, the next step is putting the company in the best possible position to receive a strong offer. Many family businesses have experience as acquirers but may not have as much on the other side of the table, says Jake Wise, managing director at Deloitte & Touche LLP. "This might be the first time they've gone through the selling process, so they may not know what they should know," Wise says.

Specifically, family enterprises need be prepared to address any issues that might have an impact on the valuation prior to the transactional due diligence and consider how the proceeds can build multi-generational wealth for the family. Here are four preparatory steps family business leaders may want to take before considering a whole or partial sale.

No. 1 — Adopt a buyer's perspective

A good real estate agent will assess the home you're selling for its strengths *and* its weaknesses. Companies need the same kind of advance work so there's ample time to highlight value-enhancing advantages and address correctible inadequacies. Bringing in an outside perspective can help pinpoint improvements that will lead to better offers.

"You need to be able to put yourself in the buyer's shoes and come up with a short list of things that are likely going to be issues for you in a sale," says Ryan Stecz, an M&A tax partner with Deloitte Tax LLP.

No. 2 — Focus on quality of earnings

Many entrepreneurs achieve success through a blend of smart financial management and gut instinct. When it comes time to selling, buyers will likely be far more interested in the former.

This is where the quality of earnings report comes in—it tells them what aspects of the company's financial performance are repeatable and which are non-recurring. It's one of the first data points most buyers will want to examine, and just a handful of items that are deemed unsustainable can reduce the perceived earnings before interest, taxes, depreciation, and amortization potential of the business and may translate into a lower valuation. The potential buyer will also likely be looking for justification for growth targets, particularly in new business forays that don't have much of a track record.

This means the business will need to ensure that its reporting systems are accurate and provide the kinds of insights a potential buyer would need to better understand the business. There may also be time to follow in the footsteps of an increasing number of companies that have invested in sophisticated forecasting tools[5] that enable their businesses to improve financial reporting and analysis.

[5] https://www2.deloitte.com/us/en/pages/finance/articles/getting-ahead-how-cfos-can-align-minds-and-machines-to-reinvent-forecasting.html

Just a little preparation can go a long way to helping family businesses paint the picture they envision.

No. 3 — Get ahead of tax issues
Tax matters can have a significant impact on value in a transaction. Sellers should fully understand and be able to clearly explain the business's legal entity and tax structure, tax filing profile and potential tax issues to a potential buyer.

For instance, a business that may not have been filing returns in several states where it should have been may result in adding previously unreported tax costs. A thorough review might also uncover potential tax-specific value drivers (e.g., opportunities to obtain a step-up in tax basis or attributes that may be available to offset future taxable income) connected to the business or the assets being sold, thereby boosting the value for an acquirer.

To help spot these potential issues and opportunities, family enterprises should consider preparing a "tax fact book"[6] that describes the tax profile of the business being sold. Further, this exercise might also prompt a consideration for mitigating potential tax risks (e.g., amended return filings, voluntary disclosure agreements or method changes) or could give rise to potential structuring alternatives that may be mutually beneficial to seller and buyer.

No. 4 — Take steps to protect your proceeds
Wealth planning may seem less important than getting the business ready for sale and closing the deal when it happens, but there are steps family business owners can take in advance to potentially reduce their tax exposure from a sale and pass on more wealth to their heirs.

One popular vehicle for multi-generational wealth transfer is a grantor-retained annuity trust (GRAT), which business owners often use to gift business equity to their spouses, children, or grandchildren ahead of a transaction. A GRAT effectively freezes the value of those interests, which is likely to be lower before any sale, thus limiting future transfer taxes.

In addition, families may want to evaluate whether a family office structure will be required after the transaction closes. If an outright sale is being considered, someone will need to manage the family's new wealth and determine where to invest it in line with the family's goals and values (look for more on that topic in our final upcoming article in this series on family office creation).

Telling the right story

All this preparation will help the family present the business in the best light to ensure they ultimately realize as much value as possible and achieve all their objectives in a sale. "It's really a question of how you can best position yourself for the process and put your best foot forward when presenting to buyers," says Wise.

A sale is a big decision for any enterprise, but for families running a business together it can be especially emotional. For many, there's a deep and rich history that got them to this point, and the prospect of stepping away from their creation can be distressing. This makes it that much more important to bring a fact-based, disciplined evaluation to the process. Just a little preparation can go a long way in helping family businesses paint the picture they envision.

Questions to ask when considering a sale or other capital-raising transactions

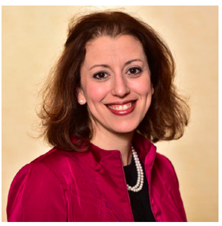
- Are we aligned as a family to handle the capital needs related to ownership succession?
- What have we tried to present as options to any family members who are unclear about the merits of selling the family business?
- Have I or another family member considered selling a minority interest in the company to meet the enterprise's liquidity and/or growth needs?
- Do we have a firm grasp of what aspects of the company's earnings are repeatable and which will be viewed by a buyer as likely nonrecurring?
- How confident are we that our financial reporting and analysis capabilities would be able to generate the kind of information we would need to furnish to a seller?

[6] https://www2.deloitte.com/us/en/blog/mergers-acquisitions-insights-news/2020/how-tax-fact-books-boost-deal-value.html

NEXT UP IN OUR SERIES

"Family office creation" *will explore the considerations for starting a family office—such as operating costs, partnerships, proper controls and investments, and roles and responsibilities—and how to form a family office that meets your family enterprise's needs.*

GET IN TOUCH



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