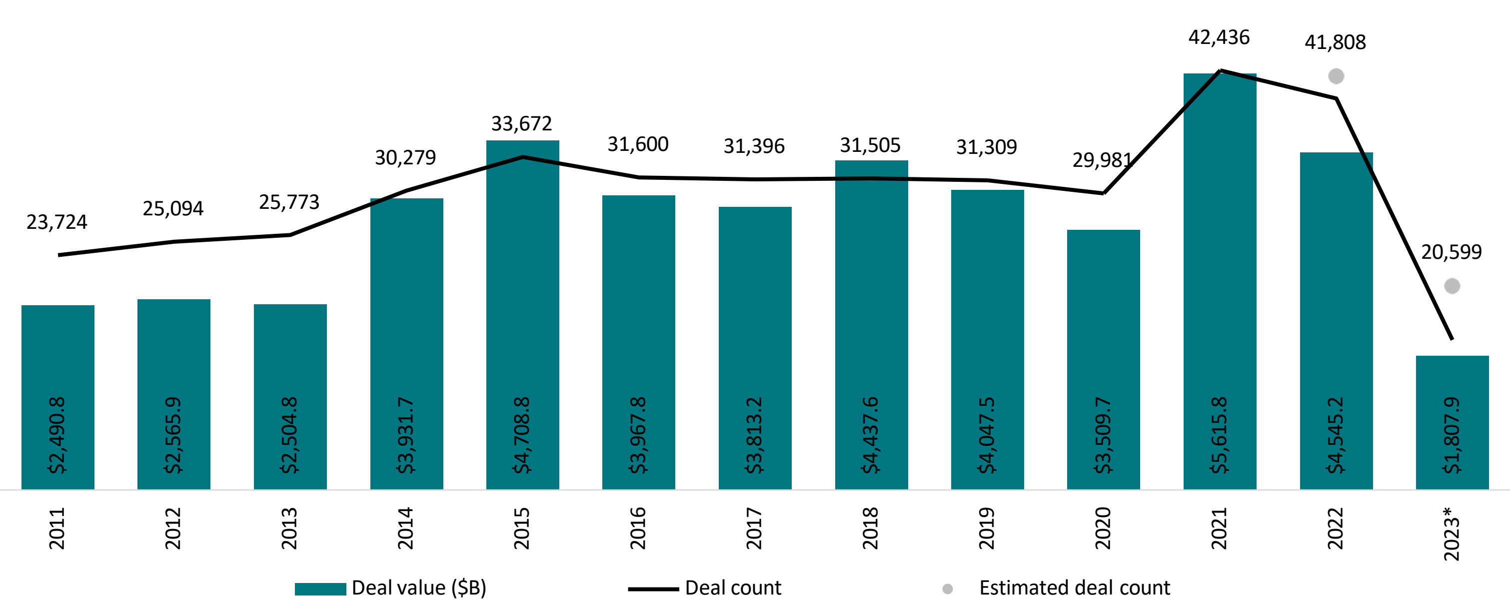
EXIT PLANNING

Conquering Your Exit: Wealth Preservation, Tax & Other Considerations

MARKET ACTIVITY

Global M&A Activity



Source: Pitchbook
*As of June 30, 2023

THE CHALLENGE

State of Owner Readiness

ONLY 20-30% OF BUSINESSES THAT GO TO MARKET END UP SELLING*

ABOUT 19% OF FAMILY-OWNED BUSINESSES SURVIVE INTO THE SECOND GENERATION**

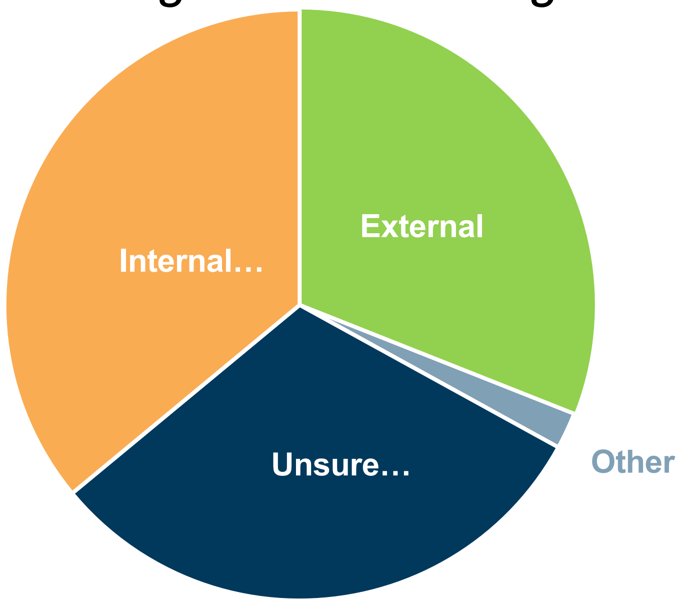
ONLY 56% OF OWNERS STATE THERE IS FAMILY ALIGNMENT ON COMPANY DIRECTION*** (WHY QUALITY ADVISORS ARE SO IMPORTANT)

Sources:
***Exit Planning Institute (EPI)**
****PwC**
*****PwC 10th Family Business Survey, October-December 2020**

REVIEW YOUR OPTIONS

Exit Options Analysis

"What best describes how you are planning on transitioning?"



GENERATIONAL TRANSFER
MANAGEMENT BUYOUT
PARTNER BUYOUT
ESOP

PRIVATE EQUITY
FAMILY OFFICE
STRATEGIC
FINANCIAL / INDIVIDUAL
GOING PUBLIC (IPO)

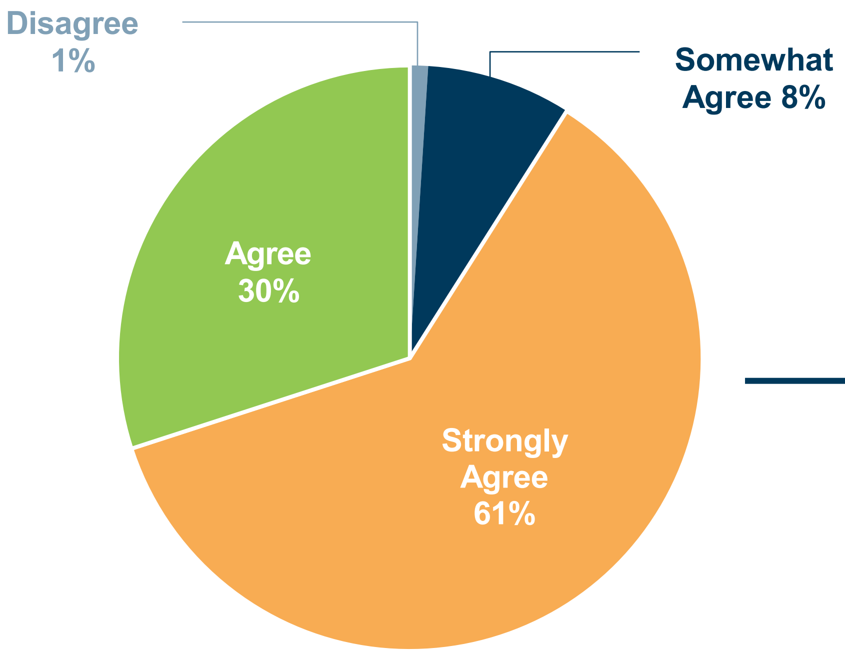
LIQUIDATION
BANKRUPTCY

UNSURE

Source: Exit Planning Institute (EPI)

99% of owners **agreed** with this statement:

*"Having a transition strategy is important both for my future and for the future of my business."**



And yet...

66% OF OWNERS HAVE **NO** DOCUMENTED AND COMMUNICATED PLAN IN PLACE**

MANY OWNERS HAVE 80-90% OF THEIR FINANCIALS ASSETS BASED IN THEIR BUSINESS*

Sources:
*** Exit Planning Institute (EPI)**
**** PwC 10th Family Business Survey, October-December 2020**

THE SOLUTION

Exit Planning

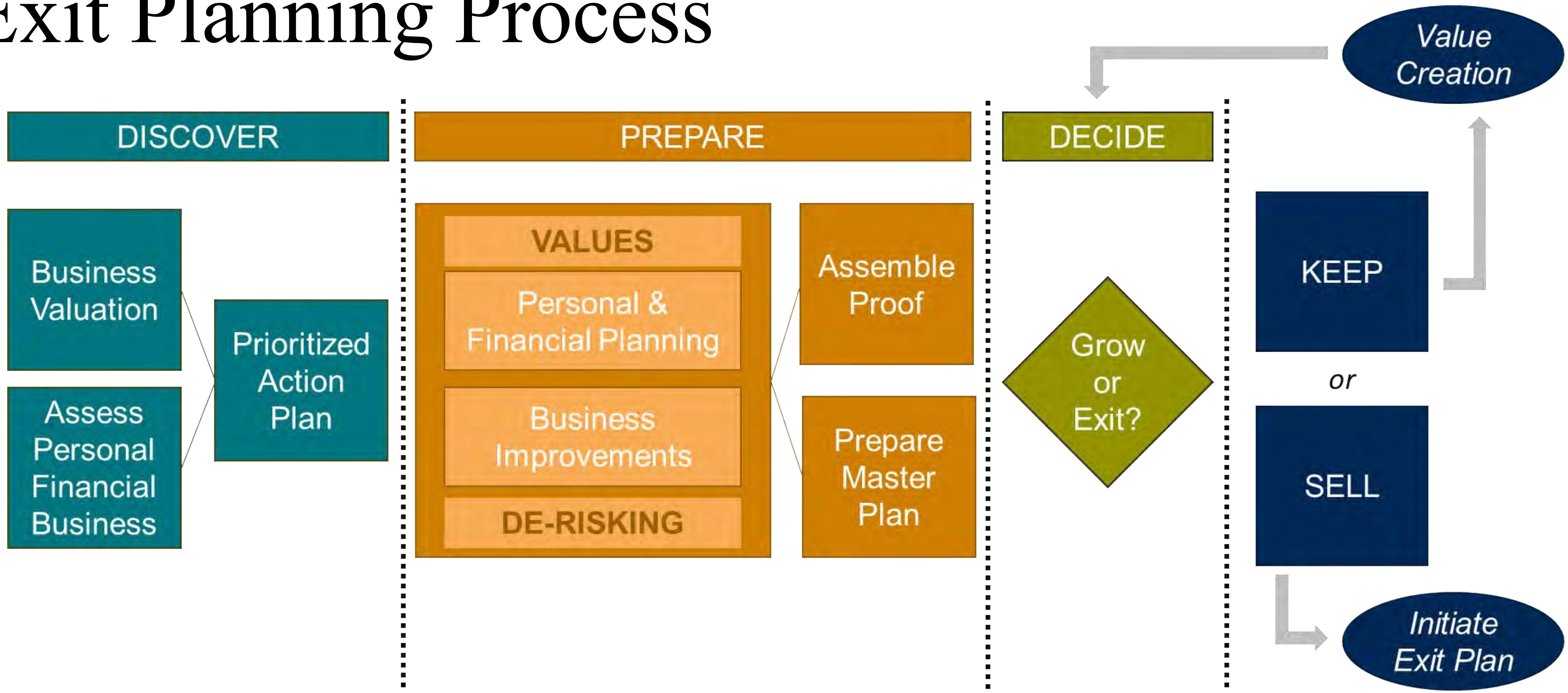
Exit planning combines the **plan**, concept, effort and process into a clear, simple **strategy** to build a business that is transferable through strong human, structural, customer, and social capital. The future of you, your family, and your business are addressed by exit planning through creating value **today**.

Exit planning is
BUSINESS STRATEGY

"You really only have 2 choices, you can plan for your exit or not plan, but eventually you are going to exit"

GETTING STARTED

Exit Planning Process



State of the Estate

- Initial Questionnaire – this is to gather an initial understanding of what's important to you and what you want to accomplish with your estate plan
- Estate/Trust Summary
  - This compiles a concise list of all assets and liabilities and what is "in" and "out" of the Estate in order to determine any projected Estate tax and what assets will get an adjustment to basis at death
  - Review of titling of all assets, all beneficiary designations (retirement accounts, life ins etc.), review the "health" of life insurance policies, annuities etc.

State of the Estate

- <u>Diagram of legal documents</u> – this provides a “picture” of what your current documents say:
  - Last Will and Testament and any Codicils along with Durable Power of Attorney and Health Care Directive
  - Revocable Living Trust and any Amendments
  - Other Irrevocable Trusts
  - LLC/Partnership agreements
  - Stockholder’s agreement, Buy/Sell agreement
  - Other pertinent legal documents
- <u>List of follow up's and recommendations</u>

How Much Is My Business Worth?

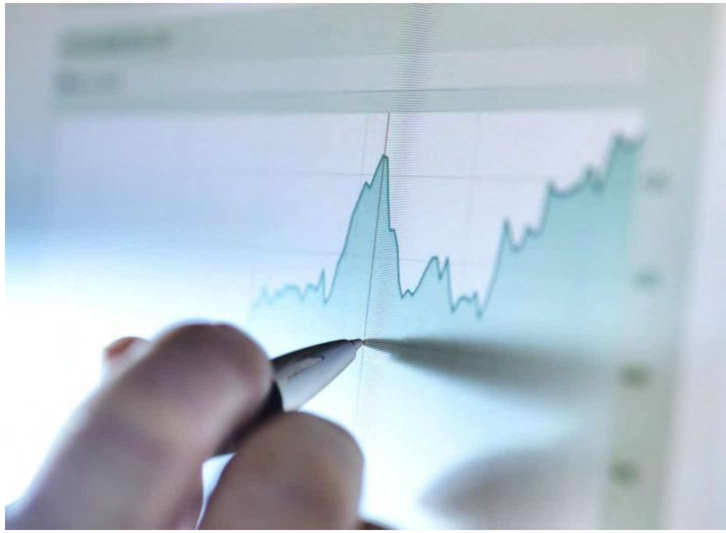
versus

How Much Will Someone Pay for My Business?

VALUATION

The Purpose of Valuation

- Is the business salable and what should it sell for?
- Determine a starting point for negotiation
- Determine characteristics that “add” and “detract” from value



VALUATION

The Process of Estimating Value

- Review 3 years of monthly financial statements
- Analyze the company's operations
- Research the company's industry
- Estimate the company's adjusted cash flow
  - High level adjustments
- Search for industry valuation multiples
  - Deal Stats, Capital IQ, BRG
- Consider "value drivers" specific to the company
- Apply market-based multiple to subject company metric

MAXIMIZING YOUR METRICS: IT'S ALL ABOUT DRIVERS

Value Drivers & Other Important Items

Value Drivers

- Competent, autonomous management teams
- Contracts in place with key customers and suppliers
- Key employees covered under non-compete agreement
- Proven track record of revenue and profit growth
- Clean and comprehensive books and records
- Assets are in good operating condition

Other Important Items

- Valuation should be performed very early in the process
- Valuation should only include the assets intended to be sold
- Strategic buyers often pay a premium over financial buyers

Preparing for an Exit – The Financials

THE WHY

Why Prepare Financial Statements for a Sale?

- Financial statements are the key driver of valuation in a sale
- Poor quality financial statements can lead to a lower valuation
- Do you want the buyer to know more about your financials than you do?
- What is the best way to go about preparing your financials?

Having quality financials won't necessarily increase the value of your business, but having poor financials can negatively impact the value of your business and increase the risk the sale doesn't go through.

THE WHO

Who Needs to Prepare Seller-Ready Financials?

- Everyone can benefit from preparing their financials for a sale process
- A quality of earnings ("QofE") analysis helps to identify key issues and quantify risks as it relates to the transaction since many issues may not be uncovered until diligence is performed
- A QofE analysis can also identify items that will end up driving value through the process

THE HOW

Process & Preparation Steps

- Getting your accounting in shape
- Applying the tools of finance to improve your performance and boost your value
- Robust, multi-year forward looking forecast model
- Understanding the metrics that matter in your exit
- The sale/partial buyout process itself
- Don't forget about communication!

Quality of Earnings Analysis $000s	FY 21	Rolling Sep-22	YTD Sep-21	YTD Sep-22
Reported Revenue	45,019	45,967	34,633	35,580
Diligence Adjustments				
2 Project Revenue & COGS Recognition	NQ	NQ	NQ	NQ
3 Bill and Hold Adjustment	NQ	NQ	NQ	NQ
Diligence Adjustments (+/- NQ)	-	-	-	-
Diligence Adjusted Revenue (+/- NQ)	45,019	45,967	34,633	35,580
EBITDA Reconciliation				
Net Income	3,873	4,228	3,073	3,428
Depreciation & Amortization	370	432	242	304
Interest Expense	12	19	7	14
Taxes	1	3	1	3
Reported EBITDA	4,257	4,682	3,324	3,749
% of Reported Revenue	*9.5%*	*10.2%*	*9.6%*	*10.5%*
Management Adjustments				
1 Owner Compensation & Personal Expenses	298	353	209	264
Management Adjustments	298	353	209	264
Management Adjusted EBITDA	4,555	5,036	3,533	4,013
Diligence Adjustments				
1 Owner Compensation & Personal Expenses	(13)	(13)	(10)	(10)
2 Project Revenue & COGS Recognition	NQ	NQ	NQ	NQ
3 Bill and Hold Adjustment	NQ	NQ	NQ	NQ
4 Pro-forma Rent Expense	(37)	(14)	(30)	(7)
5 Transaction Related Expenses	9	20	6	17
6 Business Consulting Expense	18	27	15	24
7 Non-operating Income	(39)	(40)	(14)	(15)
8 Commission Expense Normalization	NQ	NQ	NQ	NQ
9 Employer 401k Match	(140)	(10)	(130)	-
10 Bonus Expense Normalization	(9)	23	(53)	(21)
11 Workers Compensation Normalization	(144)	(81)	(115)	(51)
12 Unrecorded Accruals	NQ	NQ	NQ	NQ
Diligence Adjustments (+/- NQ)	(356)	(88)	(330)	(62)
Diligence Adjusted EBITDA (+/- NQ)	4,199	4,947	3,203	3,951

QUESTION

What is Quality of Earnings?

- Financial accounting analysis of a business to report its recurring rate of earnings.
- Focuses on Earnings Before Interest, Taxes, Depreciation & Amortization, not GAAP earnings.
- Analyzing the sustainability of historical cash flow.

Tax Implications of an Exit

CONSIDER THIS

Deal Structure & Entity Type

- Sale of Equity?
- C Corporation
- Cash at Closing
- Sale of Assets?
- S Corporation
- Seller Financing
- Net Working Capital
- Partnership
- Earnout
- Purchase Price Allocation
- Limited Liability Company
- Rollover Equity
- Gross Up

TRANSACTION TAX SERVICES

Tax

Tax Due Diligence and Disposition/ Acquisition structuring– Whether it's an acquisition or an investment into a business venture, it is important to evaluate the tax consequences of the optimal transaction structure. Our experts provide advice before, during and after the transaction.

ACTIVITIES

- Advise on best structure to acquire the business, while assessing all tax risks and future issues.

M&A Tax Services
(Buy & Sell Side)

- Tax Due Diligence and Agreement Review
- Waterfall Calculation, Tax Exposure & Gross Up Analysis
- Transaction Structuring and Purchase Price Allocation
- 409A & 280G Compensation Consulting

DELIVERABLES

- Slide deck depicting alternative structures to acquire (buy side) or dispose (sell side) the entity.
- Advise on proper representations and warranties in the share purchase agreement.
- Negotiations of terms in light of the facts.
- Assess any unused tax benefits that can be acquired and limitations on the use of such benefits.
- Comprehensive model for waterfall calculation, gross up calculation and purchase price allocation.

POST DEAL

After-Tax Cash Proceeds

A tax "waterfall" estimates the seller's net cash after payment of taxes, transaction fees, and debt.

The purpose of this exercise is to educate the seller on how purchase price compares to net cash.

	Asset Sale Scenarios		Stock Sale Scenarios	
	Purchase Price $45,000,000	Purchase Price $80,000,000	Purchase Price $45,000,000	Purchase Price $80,000,000
Gross Cash Proceeds	$ 45,000,000	$ 80,000,000	$ 45,000,000	$ 80,000,000
Debt Paydown	(29,257,040)	(29,257,040)	(29,257,040)	(29,257,040)
Unpaid Transaction Fees @ Closing				
IB Success Fee	(900,000)	(2,350,000)	(900,000)	(2,350,000)
Advisor Fees	(240,000)	(240,000)	(240,000)	(240,000)
Executive Bonuses	(730,148)	(2,407,648)	(730,148)	(2,407,648)
Before Tax Proceeds	13,872,812	45,745,312	13,872,812	45,745,312
Taxes				
Federal Ordinary Income Tax from Sale	(1,561,300)	(1,135,699)	-	-
Incremental Medicare Tax from Sale	(59,883)	(43,579)	-	-
Federal Capital Gain Tax from Sale	3,000	(6,560,805)	(994,629)	(7,369,129)
Pirmary State Tax from Sale	(279,910)	(2,196,574)	(296,349)	(2,208,699)
Incremental State Tax from Sale	(15,947)	(125,144)	(16,884)	(125,835)
Tax from Continuing Operations	(3,065,198)	(3,065,198)	(3,065,198)	(3,065,198)
Estimated Tax Payments	615,000	615,000	615,000	615,000
After-Tax Proceeds	$ (4,364,239)	$ (12,511,999)	$ (3,758,060)	$ (12,153,861)
ETR	*36.7%*	*28.9%*	*32.2%*	*28.1%*
Seller net cash	**$ 9,508,573**	**$ 33,233,313**	**$ 10,114,752**	**$ 33,591,451**

Estate, Gift and GST (Generation-Skipping) Law

- **2018 to 2025 – Tax Cut & Jobs Act of 2017** signed 12/22/2017
  - New Tax Act doubled the Estate, Gift & GST exemption from $5,000,000 to $10,000,000 per person, adjusted for inflation.
    - For 2023 the amount is **$12,090,000** per person
  - **The current law "sunsets" after 2025** and on 1/1/2026 reverts back to $5,000,000 per person, indexed for inflation, projected to be approximately $7,000,000

Installment Sale

- Seller can defer overall gain and buyer can defer cash outlay
- Risk of potential increase in capital gains rates, but seller can elect out

Pre-Sale Estate Planning if Goal is to Move Some Value of the Business to Future Generations

- It may be more tax efficient to transfer assets before sale
- Transfers or sales to IDGT – Intentionally Defective Grantor Trusts
- Other various planning techniques
- Asset Protection planning

Post-Sale Ideas/Issues

- Protect your Proceeds
- Review your liability protection
- Diversify your holdings

Qualified Small Business Stock Requirements

Section 1202 provides that a non-corporate taxpayer can potentially exclude part or all of the gain arising from the sale or exchange of "qualified small business stock("**QSBS**").

Generally, the gain exclusion is greater of
(i) $10M or (ii) 10 times the aggregate adjusted bases of QSBS issued by the corporation and disposed of by the taxpayer during the taxable year.

Main Requirements for QSBS:

- Stock of domestic C- corp during "substantially all" of holder's holding period of such stock
- Generally, five year holding period
- Stock must have been originally issued for money, other property, or services
- The aggregate gross assets of the corporation (or any of its predecessors) must not have exceeded $50M at any time on or after August 10, 1993 and before the issuance of the stock for which preferential treatment is sought;
- Qualified trade or business. Service businesses (i.e., in health, accounting, law etc) do not qualify
- Active Business Requirement: 80% (by value) of assets are used in qualified trade or business during the entire holding period.

Section 1202(d)(2)(A) defines the term "aggregate gross assets" as the amount of cash plus the aggregate adjusted bases of other property held by the corporation. Section 1202(d)(2)(B) further states that contributed property **is treated as having as basis equal to its fair market value immediately after the contribution**.

Life Management Thoughts for Business Owners Considering Selling their Business

Selling your business is one of the most important business decisions you will ever make. Once you make the decision to sell, you need guidance from your professional advisors regarding the exit process and the financial and tax implications.

In addition to strategic ***Financial and Tax Management***, you should also carefully look at the strategic ***Life Management*** side of the equation.

Life Management involves the emotional and psychological components that are inextricably intertwined with the growth and development of the business enterprise which has become part of the business owner's life journey.

Exiting the business and reaping the rewards of years of hard work can be the fulfilment of a dream and represents the closing of an important chapter of a business owner's life. It is also a new beginning which should also be addressed.

What's next for a business owner and their family personally and professionally? Most business owners spend the majority of their time building their business and growing their net worth. The sale of the business presents a new, and challenging time for them to now focus on life worth, family, and legacy and their next chapter.

It's critical that every business owner have a Financial Management *exit* strategy combined with a Life Management *entrance strategy* to make the successful transition to their best and brightest future.

Working Capital

The Overriding Concept

Working Capital represents what is needed to run a business at a normal operating level throughout the year

Working Capital = Current Assets less Current Liabilities

Adjustment Mechanism

- Rationale: Protection for Buyer and Seller for the economic impact of movements in working capital between signing and closing
- What is included in the definition of Working Capital and the Target Working Capital must be defined in the SPA
- Working capital adjustment = actual working capital at closing less target working capital ("normal" level as agreed in the SPA)

Key Steps

Step 1
Setting the Target

Step 2
Negotiating Basis of Presentation of Actual Working Capital

Step 3
Negotiating Form of the True-up Mechanism

Step 4
The True-up Process

Polling Question

Would you like to connect with someone from Armanino regarding exit planning?

a) Yes
b) No
c) N/A

Q&A

Thank you for attending

Additional Questions?

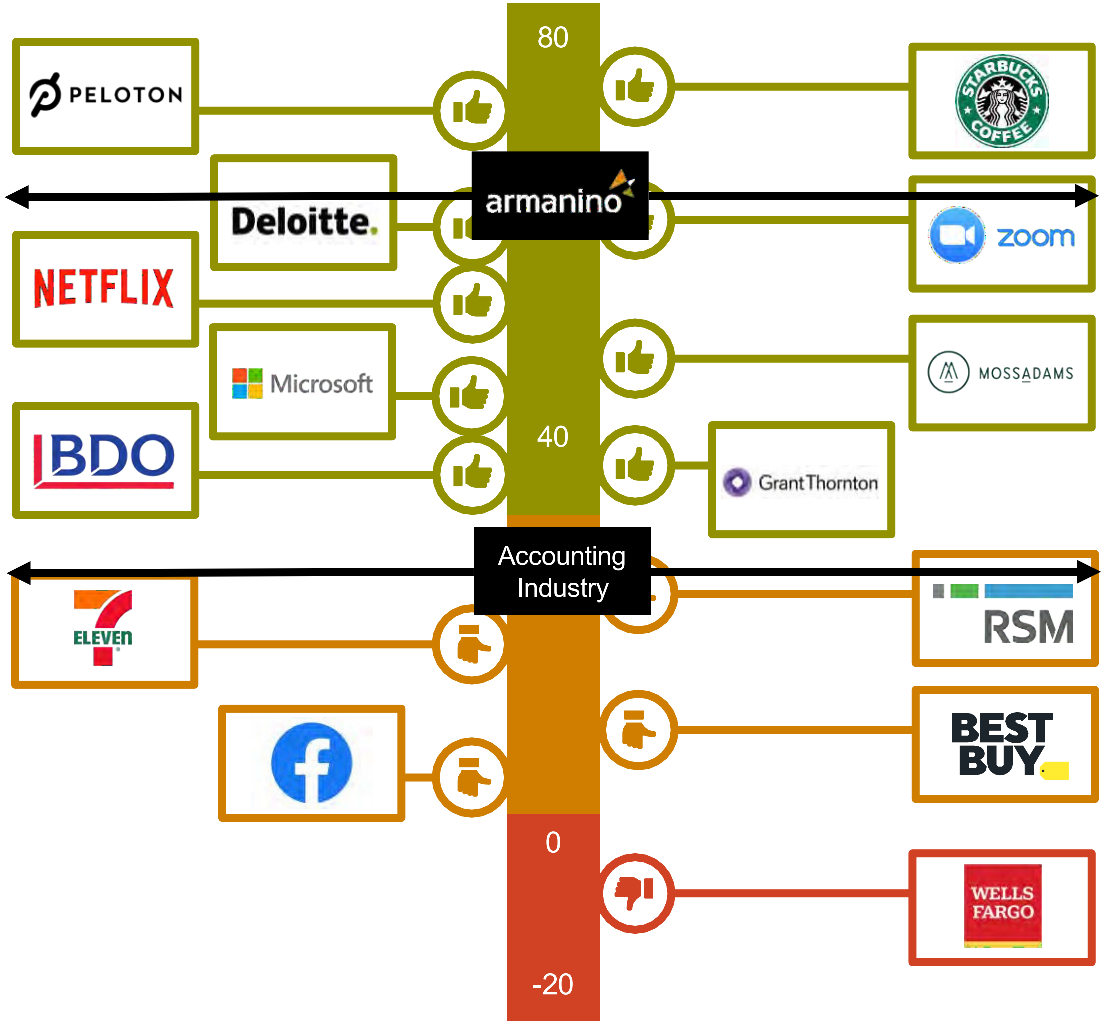
Reach out to us at

Experts@armanino.com

OUR CLIENTS' VIEW

We Know You'll Love Us

A Net Promoter® Score (NPS) is used by more than two-thirds of Fortune 1000 companies. **Armanino's NPS (68) is almost two times higher** than the accounting industry average (38), and it places the firm scores closest to household name brands such as Starbucks, Peloton and Zoom.



5 YEARS DIAMOND AWARD 2017 - 2021

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Equipping you with the insights and tools needed to succeed today, and in the future

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- Trust & Estate
- SOX
- Contract

ASSURANCE & ADVISORY

- Cybersecurity
- SOC
- Restructuring
- Revenue Recognition

STRATEGY & PLANNING

- Corporate Strategy
- Strategic Advisory
- Benchmarking
- Business Transformation

STAFFING & DEVELOPMENT

- Payroll
- Health Benefits
- Executive Search
- Interim Placement

TECHNOLOGY SYSTEMS

- ERP
- CRM
- Business Intelligence
- Managed Services

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- Bookkeeping
- Budgeting/Forecasting
- Account Receivable
- Accounts Payable


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