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SMOOTH TRANSITIONS

Three Steps for Wholesaler Succession



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Over the next 15 years, the youngest of America's Baby Boomers will turn 65, and waves of small business owners across the country will get ready to cash out.

In fact, according to the Small Business Administration, half of small business owners are currently over the age of 50¹ and sales of Boomer-owned small businesses are expected to reach an apex by the end of the decade. Wholesalers are no exception.

Happily, wholesalers' revenues have begun to rebound from the recession — up 5.1% since 2013² — making now a good time for owners who delayed business transition to begin to think about succession.

Many small business owners believe they'll never fully retire. And finding time to plan for the future can be hard — especially for wholesalers, who face intense competition, market consolidation, and day-to-day operating pressures. Thinking 12 months ahead can feel uncertain, and planning for next-generation ownership can feel even more daunting.

But kick-starting the succession planning process is straightforward, and the rewards can be immense. For many wholesalers, their business represents their life's work, as well as their largest asset. Succession planning is a strategy designed to create a legacy, build wealth, and protect family members. It begins by enlisting a financial professional with the knowledge and experience to guide you through your options and assemble the right team of experts. With this team at your side, you will be able to put a plan in place to transfer skills, knowledge, relationships, and ownership.

Following are three simple steps to help get you on track for a smooth transition.



Step One: Have a Candid Family Conversation

Bring in an Outside Perspective

Consider having someone from the outside moderate and lead your candid family conversation. A wealth management firm that offers family governance assistance can guide your family through these conversations to get to the best solution everyone can agree on.

Because many wholesale businesses are family-owned, the first place to start is by asking a simple question: "Are family members interested in running the business?" Money and succession topics can be difficult for families to address. But talking openly about succession is a necessary first step to determine whether passing the business baton to the next generation is a viable option.

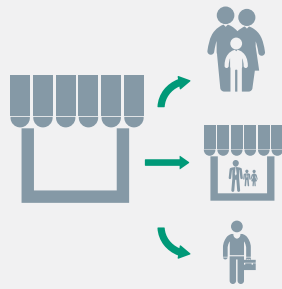
Family businesses often outlast their peers due to their long-term vision, resilience, loyalty, and shared values. An example of the power of "keeping it in the family" is Redco, a Bank of the West customer. Redco is a wholesale electrical distributor near Fresno, California, run by three generations of family members. Founded in 1985 as a joint partnership, the business went through two disappointing attempts at succession before the owner's son-in-law, Keith Hawkyard, joined the team. "The business had hired outside managers who turned out to be poor choices," Hawkyard recalled. "They ran the business into the ground and ran up debt." Seven years ago, Hawkyard's son showed interest in the business. Together they've diversified the business and turned it around. Today, all three generations are planning for succession. "Having my son in place makes it possible for us to transition the business confidently," Hawkyard says.

Transitioning the business to a family member can also have significant trust and estate advantages. Common transfer strategies include gifting, trusts, annuities, annuity trusts, family limited partnerships, and self-cancelling installment notes. Wealth transfer strategies, such as gifts or sales to certain trusts, can make use of discounted values. This allows significant estate reduction and gives the business owner a chance to transition larger actual amounts of the business than may be allowed using other techniques.



Step Two: Weigh Your Options

There are three primary choices a business owner has when thinking about succession:



1. Transfer the business to family members.
2. Sell the business to people within the organization (e.g., a partner, management team, employees).
3. Sell the business to an outside third party.

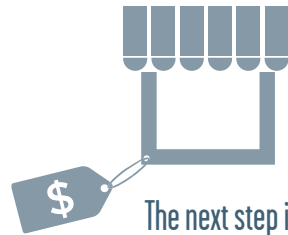
Tip: Start succession planning early. If you are planning on selling your business, the minimum amount of time it will take to find a buyer, sell and exit the business is about 18 months.

It's important to review these options with a trusted financial professional. "With family-run small businesses, a whole lot of history and emotion gets mixed into succession decisions," said Hawkyard. It's helpful to evaluate options and structure the process with an independent financial professional with expertise in succession planning. This person will then be able to bring in other experts as needed, such as an accountant or lawyer, to make the decision-making process fully informed and simpler.

It's also important to allow enough time for due diligence and preparation. That's because business succession is a process, not an event. By thinking ahead, owners can increase their options, and may minimize tax consequences and allow for the smoothest transition possible.

Business owner transfer options	Potential transfer strategies
Family	Gift, trusts, annuities, family limited partnership, self-cancelling installment notes
Employees	Employee Stock Ownership Plan (ESOP), management buyout (MBO), options, phantom stock and stock appreciation rights (SARs)
Charitable trusts	Charitable remainder trust, charitable lead trust
Co-owners or partners	Negotiate buy-out by co-owner or partners, new partner buys in
Third party	Sale, merger, recapitalization, private equity, partial purchase
Go public	Initial public offering (IPO), direct public offering (DPO), reverse merger

For illustrative purposes only. Not a recommendation of a specific strategy.



Step Three: Know Your Business's Value

The next step in the succession planning process is to understand what the business is really worth. Too often wholesalers overestimate the value of their business by focusing on annual revenues rather than the more accurate valuation metric of future earnings potential.

Owners need to ask themselves:

- How steady have my sales and profits been over the past five years?
- Once I retire, will long-term relationships remain?
- Does the business have transferable assets such as technology and real estate?
- How deep is my talent bench?

Tip: For do-it-yourselfers, using conventional methods such as book value or a multiple of EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization) can give you a rough estimate.³

Typically, these questions can be most easily answered by speaking with your advisor and arranging an appraisal if warranted.

Once a wholesaler pinpoints the value of the business, strategic adjustments can be made to enhance the company value, and the owner can begin to make informed decisions about how to transfer ownership (i.e., to whom, when, and using which structures and strategies).



Keys to Success

Successful transitions require preparation and a willingness to answer hard questions. Some of these questions are technical and are rooted in accounting, law, estate planning, retirement planning, and business modeling. Others are deeply personal, shaped by family dynamics, values, career goals, and a desire to leave something of value to family members.

Among the questions to consider:

- 1. Are there successors I trust within my family who want to run the business?** If the answer is "yes," it's important to develop what Keith Hawkyard calls a "learning plan" to teach successors how to run the business. "My son prepared," Hawkyard said. "He studied for his electrical certificate. He's built strong relationships with customers and vendors over the past seven years. He took business classes at night school. Now he's the knowledge center of the business." Hawkyard acknowledges that it's hard to put aside time for training. "But you have to do it," he said. "Taking advantage of vendor training and software training can really help. I don't think you can run a strong business without keeping abreast of change."
- 2. Do I want to leave my business in the hands of my employees?** If so, how do I motivate them to stay with the business? Are there incentive plans, such as an employee stock ownership plan (ESOP), or ownership options that make sense for my business to help retain the current workforce?
- 3. What are the trust and estate implications of my succession plan?** Because family businesses are forms of concentrated wealth, the eventual transfer of the business should be addressed in an estate plan. If some children have been active in the business while others have not, owners must decide how to divide the estate fairly — and how to transition the business to the active child(ren) if it represents a disproportionate percentage of family assets.
- 4. Am I thinking clearly about my succession options?** When you're planning for the next iteration of the business and family dynamics are involved, decisions can be more complicated. Separating from a business that's a core part of your family history or that you worked tirelessly to build and pass on to the next generation can be an emotional experience. But, as Keith Hawkyard suggested, "Don't put it off. You'll want as much time for succession planning as you can possibly get."
- 5. How quickly do I need to monetize the business to generate retirement income?** It's important to consider cash flow and the liquidity you'll need to both pay potential estate taxes and replace your salary during retirement. If near-term liquidity is important, how do I structure the transfer to generate income? When does an earn-out or partial transfer make sense? Are there insurance options that can help me meet my liquidity needs?

The Benefits of a Buy-Sell Agreement:

- Guarantees a buyer
 - Ensures a fair selling price to match business valuation
 - If funded, provides the necessary liquidity for purchase
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- 6. Have I accurately determined my income replacement needs?** What personal expenses may go up or down post-succession, and have I pre-planned for that? How will I fund all of my personal expenses in retirement? Distinguishing between personal and professional assets, liabilities, expenses, and income will be a necessary step when preparing for succession.
- 7. Is my business structured the right way for succession?** A business's legal structure has implications for succession and tax planning. Common structures are C-corporations, S-corporations, an LLC, a partnership, and a sole proprietorship. In an S-corp or partnership, the company's income or losses are passed through to shareholders to report on their individual tax returns. Talk to your tax professional to determine the best structure for your business, given your needs.
- 8. Do I have the right buy-sell agreements in place to maximize the value of the transfer?** Buy-sell agreements are critical documents that provide a plan in case of a triggering event, such as death, disability, or retirement. Many are funded through life insurance policies, but the business purchase may also be funded in cash, by taking on debt, by liquidation, or through investors. There are three basic types, and each has implications for succession and estate planning:
 - a. The cross-purchase:** Here, two partners own insurance policies on each other so that if one dies the other can be bought out.
 - b. The entity purchase agreement:** If one of the parties dies, the family is required to sell the shares to the business, and the business is obligated to buy. These are usually funded through a life insurance policy.
 - c. A hybrid:** This may work when there is one insurance policy on each owner, held in trust. Premiums are paid by bonuses awarded to owners.
- 9. Do I have insurance in place to cover unforeseen events during the succession process — and beyond?** One benefit of succession planning is being prepared for the unexpected. Many wholesalers have been so consumed running the business that they haven't taken the time to put protection policies in place for the business (e.g., key person insurance) and/or family members (e.g., disability or long-term care insurance). As part of the succession process, evaluate the need for core protection products, so that there is a plan in place if the business owner were to unexpectedly die or become unable to manage the business.
- 10. How important is it to leave something of value to my family and/or co-workers?** Liquidation may provide a near-term gain, but business transfer can be more emotionally and financially rewarding. Careful strategizing with the help of a professional with experience in succession planning can allow you to transition ownership and leave something of value to the next generation.



Bottom Line

While letting go of your business and stepping aside can be an emotional and complex process, many wholesalers eventually make some decisions about business transfer. Those who make informed choices — and consider a full range of family, tax, estate, and retirement issues — will have the best chance of achieving a smooth, rewarding transition.

At a time when a growing percentage of U.S. businesses are privately held — and many owners are approaching retirement — the lines between retirement planning, succession planning, and family wealth have blurred. In the wholesale sector, where consolidation is rampant and a disproportionate percentage of retirement assets are invested in the business, smart succession planning is particularly important. It starts with family conversations, a comprehensive review of transition options, and a business valuation. Handled correctly, it may end with tax savings, retirement income, and a legacy of family wealth.

1. "Demographic Characteristics of Business Owners and Employees: 2013," SBA Office of Advocacy, no. 6 (2013), 2, URL: <https://www.sba.gov/sites/default/files/advocacy/Issue_Brief_6_Demographic_Characteristics_2013.pdf>

2. Alan Beaulieu, "State of the Wholesale Distribution Industry," National Association of Wholesaler-Distributors, 2014, URL: <<https://www.naw.org/about/industry.php>>

3. "3 Ways to Value a Business for Sale," NFIB, 2013, <<http://www.nfib.com/article/3-ways-to-value-a-business-for-sale-35826/>>

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