WELLS FARGO Wealth & Investment Management

Advice and Planning Update

Three keep/sell pivot points

JANUARY 2022

Tracey Gillespie
Senior Business Transition Strategist
Wells Fargo Bank, N.A.

Key takeaways:

- Understanding the risk of the asset you own (your company) is a first step in evaluating your keep or sell options.
- External dynamics such as tax, industry, or economic shifts may have a significant impact on your exit timing.
- Determining who will be the next owner of your enterprise may be the most important decision you make.

What this may mean for you:

- Business owners often struggle with the keep/sell "what-if" scenarios; narrowing your focus to risk, timing, and control can help bring clarity.

Is it the time to keep or the time to sell? It's a difficult choice we make often when considering our next car, home, or even a new cell phone. The analysis is straightforward: Determine the economics, evaluate the variables, weigh the pros and cons, make a choice, and move on.

With all this lifetime practice, why do business owners struggle with a similar choice: Do I keep the business or sell it? Is it better to continue to live off the annual cash flow (and perks of ownership) or take the lump sum? But unlike the similar decision a lottery winner must make (receiving the winnings as an annuity or lump sum), a business owner's decision matrix is much more complicated and complex.

Investment and Insurance Products: ▶ NOT FDIC Insured ▶ NO Bank Guarantee ▶ MAY Lose Value

Why? Because the most challenging variables to evaluate are not concrete: risk, timing, and control. I have seen owners struggle with each of these keep/sell decision points, dragging out the evaluation process and weighing them down in "what-if" scenarios. A sure path to keep/sell clarity is objective and thoughtful evaluation of these top considerations.

Evaluating the risk

A perplexing challenge for most owners is evaluating the risk of the asset you own versus the risk of an alternative asset class. Often, the owner has become so accustomed to the risk of owning a business that it is difficult to perceive, and yet it is a key factor in prioritizing objectives.

However, there is a way to measure risk: Understand the discounted cash flow value of your enterprise. This valuation method considers the future cash flow of the business that would accrue to the owners, adjusted (or discounted) for the risk in that cash flow. For example, a software licensing company with multiyear subscription contracts has very stable, and typically high-margin, cash flow that can last years. The risk of this cash stream declining is mitigated by the multiyear and fixed-price nature of the contracts. Owning this cash flow could be very attractive because of this predictability. Contrast this with a company that sells snacks to sports venues: very seasonal, with demand impacted by the popularity of the sports team, weather, cost of tickets, etc. Without a multiyear contract, this cash flow could be very unpredictable, thus higher risk and less valuable to own. To evaluate which cash flow stream is the better investment, adjusting for risk is critical.

Once you understand the risk and reward of the asset you own, it becomes much easier to compare it with other assets you could potentially trade it in for, such as cash or a diversified investment portfolio. As a shareholder of publicly traded equities, you might expect an annualized return on investment of a moderate growth and income portfolio of 7% and a risk, or standard deviation, of 10%. What if you discovered you are generating a return in your company of 7% but were taking 20% risk to achieve that return; how would you view your continued investment?

Timing is everything

Well, maybe not everything, but when choosing between keeping your business for a few more years or selling to the next owner, timing is a pivotal factor. Typically, timing your departure as an owner or operator from the enterprise is a top priority, often driven by personal objectives such as lifestyle, health, or leadership succession preparation.

Often overlooked, but more significant economically, are the external dynamics that can affect the timing of the decision to transition and the execution of the transaction. Principal external factors that can impact your preferred outcome include tax law changes, economic cycle dynamics, cost of capital and valuation trends, and future lifestyle cost escalation.

In a changing tax environment, special attention to changes in capital gains and ordinary income tax rates can influence your decision to sell now or later. For example, if ordinary income rates rise faster than capital gains rates, then keeping your enterprise to maintain current compensation and distribution levels may not be the most advantageous choice. Your incremental annual cash flows may be offset by your additional tax liability, reducing your net cash flow.

Industry and economic trends influence timing of an exit as well. Buyers prefer to acquire companies when the prospects for the future are still on the upswing. Predicting performance to repay acquisition debt or distribute profits to investors is more easily justified in a growing economy with favorable industry trends.

Finally, the options available and the structure of your transaction can be impacted by these factors. If you hope to sell your business to employees through an employee stock ownership plan, to a small group of key managers

through an installment sale, or to a financial buyer such as a private equity group, market trends are further influenced by availability and the cost of capital, especially debt.

Financial modeling of different scenarios can help you decide which path forward makes the most sense under a given fact pattern. Evaluating your options and understanding how they translate into net proceeds, after taking into account taxes and any retained risk, is important in order to make a fair comparison.

Relinquishing control

Almost all owners value control and are reluctant to relinquish making strategic decisions for the company. Yet, the most pivotal ownership and leadership decision is: Who is the next best owner and leader for the company you built? Would you want to be in charge of that decision? This is the crux of the keep/sell decision.

The best outcomes are a function of the owner's input into the decision, timing, and structure of an ownership transition. If exiting to a third party, who is best to tell the company story, extoll the merits of the enterprise, and mitigate the risks? If selling to internal buyers, who is best to advise on a structure that is compatible with the company's need for capital or operating risk profile?

Proactively considering a keep or sell scenario is best done by the current owner rather than heirs or remaining managers should the owner be unable to guide this decision. This ensures economic objectives are attended to appropriately and noneconomic goals can be addressed simultaneously. Most owners have a point of view on who the next best owner should be. Why not be in control of that decision based on your timing and circumstances?

Clarity is the goal

Although a complete evaluation of these top three factors is not an easy task, investing the time to address them brings clarity to your decisions and the confidence to move forward. Knowing what you have chosen to do, as well as what you have chosen not to do, brings peace of mind to many owners.

The complexities of risk, the timing of the transition, and your ability to control the outcome warrant a comprehensive keep/sell analysis. If you would like to evaluate your business ownership path forward, contact your Wells Fargo relationship manager to learn more about our resources and how we can help you.

Disclosures

Wells Fargo & Company and its affiliates do not provide legal or tax advice. In limited circumstances, tax advice may be provided by Wells Fargo Bank N.A. Please consult your legal and/or tax advisors to determine how this information, and any planned tax results may apply to your situation at the time your tax return is filed.

Wealth & Investment Management offers financial products and services through bank and brokerage affiliates of Wells Fargo & Company. Bank products and services are available through Wells Fargo Bank, N.A., Member FDIC. Brokerage products and services are offered through Wells Fargo Advisors, a trade name used by Wells Fargo Clearing Services, LLC, and Wells Fargo Advisors Financial Network, LLC, Members SIPC, separate registered broker-dealers and non-bank affiliates of Wells Fargo & Company.

Wells Fargo affiliates may be paid a referral fee in relation to clients referred to Wells Fargo Bank, N.A. Wells Fargo Bank, N.A. (the Bank), offers various advisory and fiduciary products and services, including discretionary portfolio management. Financial Advisors of Wells Fargo Advisors may refer clients to the bank for an ongoing or one-time fee. The role of the Financial Advisor with respect to bank products and services is limited to referral and relationship management services. The Bank is responsible for the day-to-day management of non-brokerage accounts and for providing investment advice, investment management services, and wealth management services to clients. The Financial Advisor does not provide investment advice or brokerage services to Bank accounts but does offer, as applicable, brokerage services and investment advice to brokerage accounts held at Wells Fargo Advisors. The views, opinions, and portfolios may differ from our broker-dealer affiliates.

© 2022 Wells Fargo Bank, N.A. Member FDIC. CAR-0122-01699