Wealth & Investment Management

Advice and Planning Update

8 best practices to prepare for a business transition

MARCH 2022

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Advice and Planning
Offered through Wells Fargo Bank, N.A.

Key takeaways:

- While every business and transition is different, there are eight best practices that most businesses should address as part of the transition process.

What this may mean for you:

- While planning for business transitions can be complex, following a disciplined process can help owners plan and execute a successful business transition.

At some point, almost every business owner will face a business transition. While every business is unique and different types of transitions emphasize certain considerations, addressing the eight key items below can aid you in executing a successful business transition.

1. **Organize your financial statements**

A buyer is relying on the accuracy of your company's financial statements to run their own analyses and ultimately determine what price they are willing to pay for your business. If a potential buyer has doubts as to the accuracy of the statements, this can hold up a potential transaction while the buyer performs additional due diligence by having an accounting firm review your company's financials.

Generally speaking, there are three levels of financial statements: company prepared, reviewed, and audited. Most buyers will accept reviewed financials, but audited financials are preferred. Most business owners do not get audited financials due to the cost and time that it takes to create an audited financial statement. Buyers tend to have little to no confidence in company prepared financials. This situation is where the buyer will perform additional due diligence and it may slow down the process. A buyer may request that a CPA firm create a reviewed or audited financial statement before a deal proceeds forward.

Financial statement preparation should also address moving personal expenses (for example, cell phones, cars, and gas) and assets (such as cars, homes, and real estate) off of the company's financial statements to the owner. This may occur prior to a transition or may occur as part of the transition. Consult with your CPA and attorney on how to move these assets based on your situation.

2. **Evaluate your management team**

As an owner, what is your role in the company? What are your day-to-day responsibilities? The more significant your role and the more responsibilities you have, the longer it may take you to transition out of the business. Buyers want a smooth transition, and this may potentially include your continued involvement for a number of years. Having a strong management team in place may help reduce your involvement in the business. While individual situations vary and it may not be possible to turn over operations to your management team, this should be a point of consideration and conversation with your advisors and maybe even your management team.

3. **Document your company processes**

In his 2008 letter to shareholders, Warren Buffett wrote, "Long ago, Ben Graham taught me that 'price is what you pay; value is what you get.'"

Many think of things like customer lists and contacts, products, and physical assets as what gives the business value. However, part of what you can provide to a potential buyer is the value of your company's processes and policies in a written format. If these are documented, it can provide a buyer some level of comfort with how the company operates and how smoothly the transition of your company will go.

4. **Review your agreements and contracts**

Many business owners also own related entities as part of their business. A few examples of these might include real estate that the company operates out of, an entity that owns assets the company uses in the production of their products or services, or another business unit. These entities should all have agreements with the entity you are transitioning. In preparation for a transition, it is a best practice to review these agreements and ensure the terms of the agreements are up to date and at market terms. You can also identify which entities should be transitioned with your core business and which you want to retain.

Additionally, your external contracts with suppliers, customers, and financial institutions should be reviewed in preparation for a transition. Some agreements may need to be renegotiated to strengthen your position ahead of a transition. Careful consideration should be taken to review your agreements and contracts for language around a transition. While not all agreements address a transition, many do, and there may be restrictions or terms that change.

5. **Create your transition team**

How you are planning to transition will impact who you need as part of your transition team. For example, to complete a transition to the next generation, you usually will have your CPA, estate planning attorney, and financial advisor as your transition team. To sell your company to a third party, your team will generally consist of an investment banker, merger and acquisition attorney, CPA, and financial advisor. Each transition path will require a different team of professionals to assist you and your company transition. Identifying this team well in advance of a transition will enable you and your team to spring into action when the time is right. Additionally, committing the resources necessary to meet with your team early to identify your goals and reviewing your company specifics can help best position your company for the transition path you have selected. We recommend having this team assembled at least a year in advance of the start of a transition. While this may not be possible in all situations, the formation of and planning by this team can be invaluable for you as a business owner in your preparation for a transition.

6. **Diversify suppliers and customers**

One area that most buyers will focus on is your lists of suppliers and customers. Most buyers are interested in not only who is on each list but the percentage of your overall business that is done with each of those on these lists. The rule of thumb is that there is a concentration if a supplier or customer makes up 10% or more. On the supplier side, this is 10% or more of the product supplied to your company. On the customer side, this is 10% or more of overall revenue from a particular customer. If there is a concentration, this can present additional risk to a buyer, especially if the supplier or customer does not want to do business with the new owner. Concentrations can lead to the owner receiving less cash from the transition. For example, a buyer may require a greater portion of your deal to be paid as an earn-out tied to retention of customers and suppliers or may require you to continue on with the company to ensure a smooth transition of these key relationships.

The current pandemic has created several supply chain issues for businesses. As a result, many business owners have been working to diversify their suppliers to the extent that they are able. The silver lining is that it is helping business owners strengthen their list of suppliers, which is ideal from a transition perspective.

If you have any concentration on the customer side, we recommend you and your management team review your specific situation and determine how appropriate it would be for you to focus on reducing these concentrations in preparation for a transition.

7. **Review personal finances and goals**

As you prepare for a business transition, we recommend reviewing your cash flow planning and determining how much you may need post transition. Additionally, consider your personal transition goals, such as charitable intents and estate planning opportunities. Consider what life will look like after the business. How will you fill your time? For some business owners, they find some of their personal worth tied to the business and what they created and built. How will this value be replaced? While there is no “silver bullet” to address this and it is very individual for each owner, it is an important point of consideration as you prepare for your transition.

8. **Create a Plan B**

Not all transitions are successful on the first attempt. Only about 30% of businesses that go to market and attempt a third-party sale are successfully sold. This is why having a “Plan B” is important. This is a step many business owners miss in their transition preparation. Ensure that this is a part of your transition team’s discussion and that you have a backup option that is suitable to you.

Regardless of your transition path, consider these best practices to address as part of your transition process. At Wells Fargo, we can help you address these items as well as others that are specific to your individual situation. Contact your advisor to be connected with a Business Owner Advisory Specialist.

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 CAR-0322-03681