

# Parsec Financial

WEALTH MANAGEMENT

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## **Small-Business Succession Planning Guide**

A helpful resource for business owners who are starting the business succession planning process.

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## FIRST AND FOREMOST, CONGRATULATIONS ON BEING A SMALL-BUSINESS OWNER.

Entrepreneurship is an all-consuming lifestyle that brings highs and lows throughout the journey of establishing and growing the business.

It is easy for a business owner to view the value of his or her business subjectively close to the point of sale because of the owner's interconnected feelings and experiences with the business. This close association can breed significant biases within the owner, which may affect negotiations to sell the business. The valuation, terms of the transaction, employees and ongoing reputation of the business are some of the areas where a biased seller can struggle with letting go and entering a new phase of being a former owner.

Parsec advisors encourage owners of closely held businesses to plan their transaction years in advance of listing the business. This includes having company information benchmarked to industry averages, which will help the owner evaluate the business through a similar lens as a potential buyer. Having a firm understanding of various options for the sale transaction helps the owner plan for tax, legal and investment implications before listing. Additionally, gaining an understanding of what drives the value of the sale transaction critically informs the owner on how to run the business leading up to the sale.

Even though it might be difficult to carve out time to work on your succession plan with all of the immediate to-dos looming, it is imperative to start this process well ahead of time. This white paper will walk you through Parsec's own succession planning process, give other examples across several industries, and end with helpful tips and resources to further your knowledge in this space. When you are ready, Parsec financial advisors are happy to offer you a free, no-obligation meeting to discuss your unique situation and how Parsec can help.

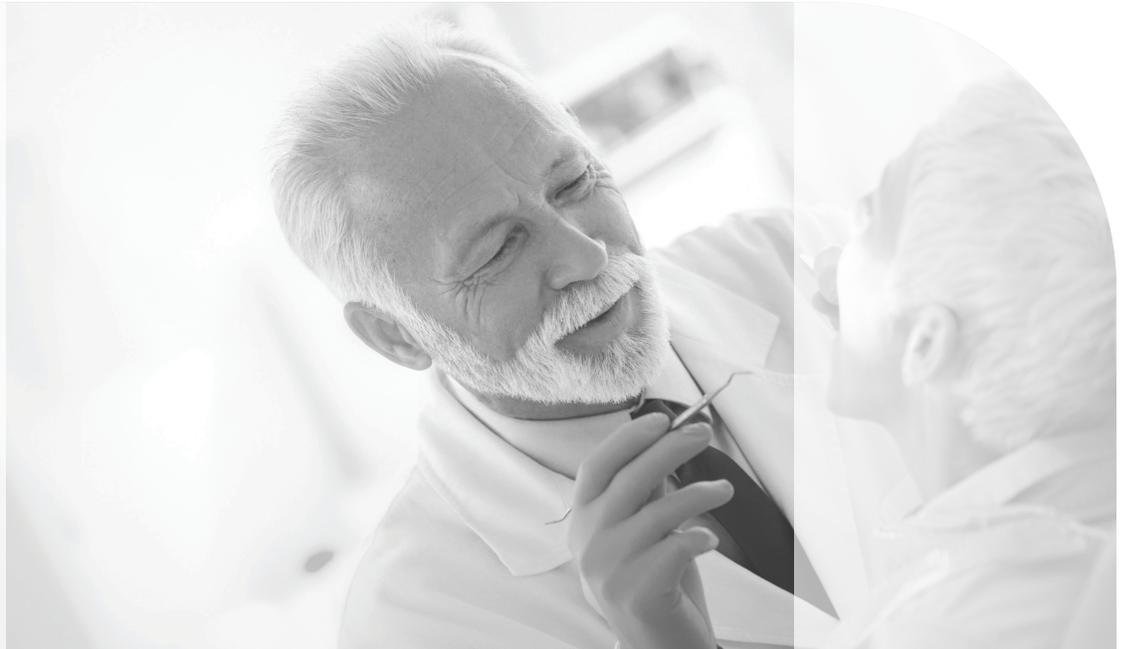
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Gaining an understanding of what drives the value of the sale transaction critically informs the owner on how to run the business leading up to the sale.

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## SUCCESSION PLANNING VARIES BY INDUSTRY, BUSINESS AND OWNER\*



One way to think through a succession plan based on the founder's impending retirement is to transition everything in-house. But what happens if existing employees are either unwilling or unable to take over? This occurs in some cases, particularly with dental practices.

In one instance, a dentist who had been practicing for more than 30 years was eager to retire yet could not bring on partners with the intention of selling to them, largely due to monetary factors. The dentist was having trouble coming up with a suitable valuation but was not aware of what he would need to get from the practice in order to maintain his current lifestyle. Thus, Parsec advisors ran several "what if" scenarios based on different ages of retirement and various valuations of total investable

assets after assumed sale of the practice. This helped him focus on what he needed in assets to sustain his standard of living regardless of what the real value of the practice was. Shortly thereafter, he received a cash offer that allowed him to cut ties from the practice on the closing date. After running the analysis to determine if the cash offer was enough to maintain his lifestyle (using various portfolio allocations to determine his required rate of return in conjunction with his ability to assume market risk), he agreed to the sale and retired four weeks later. Even though he did not receive what he thought the valuation should be because of his emotional ties to the practice and the staff he had cultivated over the years, he received enough to live comfortably, with proper management of his assets.

\*Client stories: Our stories are based on a composite of real client stories, each of which had a particular set of goals and objectives. The services described in these stories may differ from services provided to other clients, and the results achieved may not be similar, as every client's goals and objectives are unique.

Medical doctors often have unique situations to work through depending on existing partnerships with local hospitals.



Sometimes a clean break isn't feasible. In one instance, the owner of a successful industrial storage business was eager to pursue other endeavors. He determined a value for the company and implemented a marketing strategy to attract buyers. He identified a buyer, and they agreed on a valuation. The owner received cash in the transaction but also provided financing in the form of a promissory note. Two years after the sale, it was apparent that the new owner was having trouble operating the business and was missing payments on the promissory note. The prior owner was able to make an offer to repurchase the business at very favorable terms and has since returned the business to profitability. Parsec advisors are now working with him on estate planning

strategies as the business valuation exceeds the federal estate tax exclusion limits.

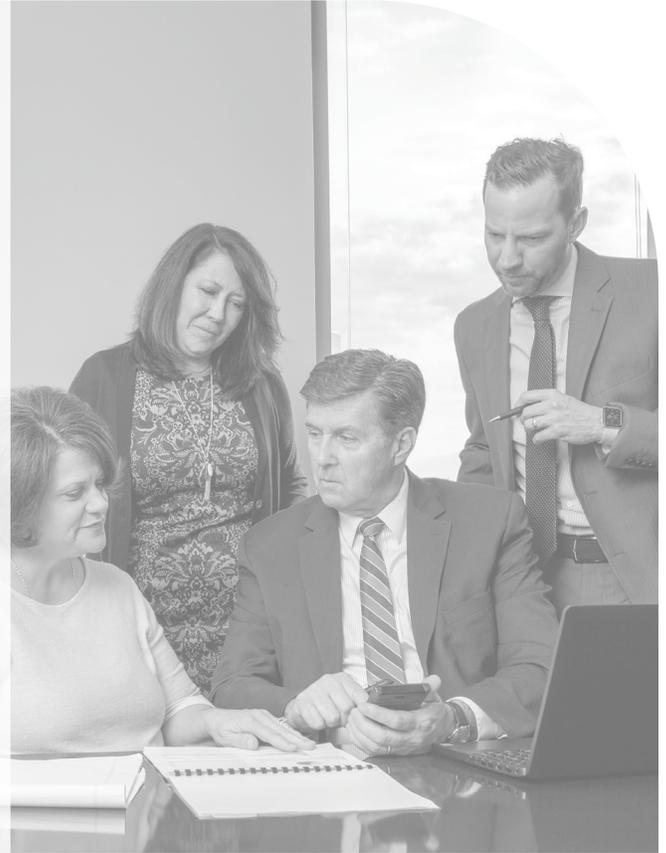
Medical doctors often have unique situations to work through depending on existing partnerships with local hospitals. One doctor who decided not to sell to his local hospital instead set a fair market price for goodwill and his practice's value. He found a buyer and formulated the buyout to be a steady stream of income, which in his case was over half of his final year's receivables paid over the following three years. This allowed him to have a reliable income for the short term before he was able to tap into his savings with his IRA.

## SEVEN STEPS TO SUCCESSION PLANNING

Having a team of trusted advisors can help with many aspects of a business transaction or succession plan. The legal, tax and financial ramifications of a small-business transaction have huge implications, some of which are ongoing. Most business owners have spent a lifetime growing their business, and the value is often the majority of their net worth. Planning for the transition takes significant time and forethought.

Financial advisors can help the seller with tax and investment planning by working alongside appropriate tax and legal consultants to review a variety of scenarios with varying valuation and transaction terms. This planning helps open up the widest number of options for sellers to consider before entering into negotiations.

Parsec has nearly 20 financial advisors located in six offices across North Carolina who are ready to help small-business owners. As part of the overall financial planning process, advisors will look at cashflow and determine how to invest proceeds accordingly.



■ Here are seven steps to utilize as a guide when working on a succession plan:

There are a range of both professional and personal reasons to sell a business, such as retirement, a job offer from another company or possibly a desire to go in a new direction, among many others. But it is important to weigh the rationale against external factors like market timing to determine if a potential sale is in the best interest of the owner.

1

**Determine if the  
business should be sold.**

Making the decision to sell a business doesn't necessarily mean that the business is saleable. Business owners should consult experts to perform due diligence to assess things like whether the business is in an attractive industry and a convenient location for potential buyers, whether the owner has a solid customer base and a healthy balance sheet, etc.

2

**Determine if the  
business is saleable.**

Business valuation varies widely by industry and company. Sale price is determined by assets on hand (cash, receivables, inventory, equipment, real estate) and revenue stream. Assets are priced using market valuation; revenue stream is valued by looking at a multiple of earnings, industry comps, historical growth and future growth potential.

It is not uncommon for businesses to transact as a multiple of cash flow or earnings, given that cash value is a key factor in determining value. A seller should be familiar with discounted cash flow analysis because a well-informed buyer likely will be. In professional service companies, the owner's compensation is also a key driver of business valuation.

Parsec advisors encourage business owners to get an appraisal from an industry specialist, such as an accountant or business broker. Sometimes it is wise to get multiple appraisals, especially if it is a niche or complex industry where assigning value to assets can be difficult.



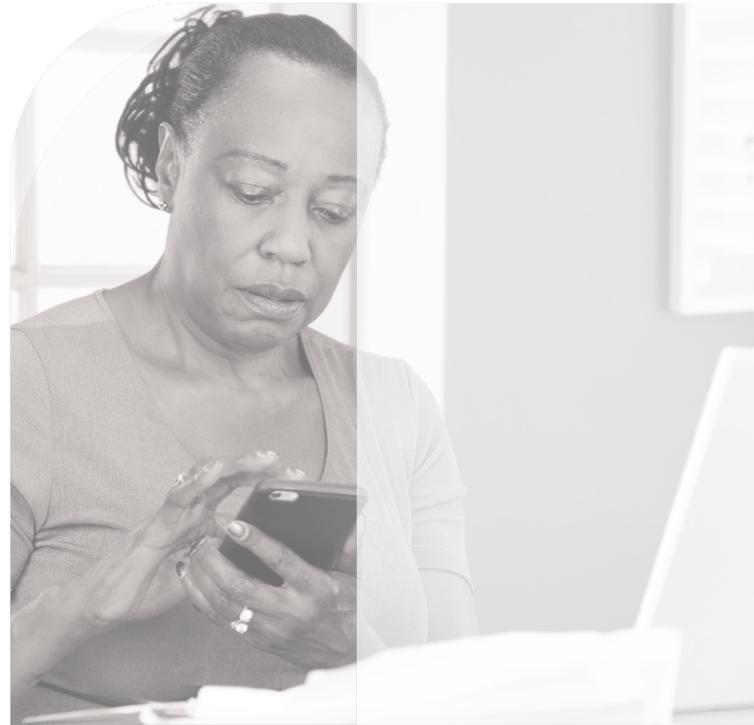
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## Prepare for sale.

Owners should organize and archive all historical financial statements and business-critical documentation. Buyers will complete due diligence on the business, including gaining access to all business contracts. Organization of all key materials will help avoid surprises and provide confidence that the books and records of the business are in good order. These basic considerations should be central to all business transactions, but the list becomes much more comprehensive as the business size and complexity grow.

Many small-business transactions are actually succession planning agreements. Professional service companies — e.g., firms in the legal, real estate, tax, financial and medical/dental fields — can have significant business value, but transactions do not include much book value and tangible property. Instead, the professional service company's value is dependent on service, reputation and goodwill. Because of the risk of death or disability, succession planning and continuity agreements are critical to most practitioners if there is to be any value to the enterprise.

Owners should also resolve outstanding issues such as unpaid accounts receivable and debt (if applicable) and prepare projected financial statements and a business plan.

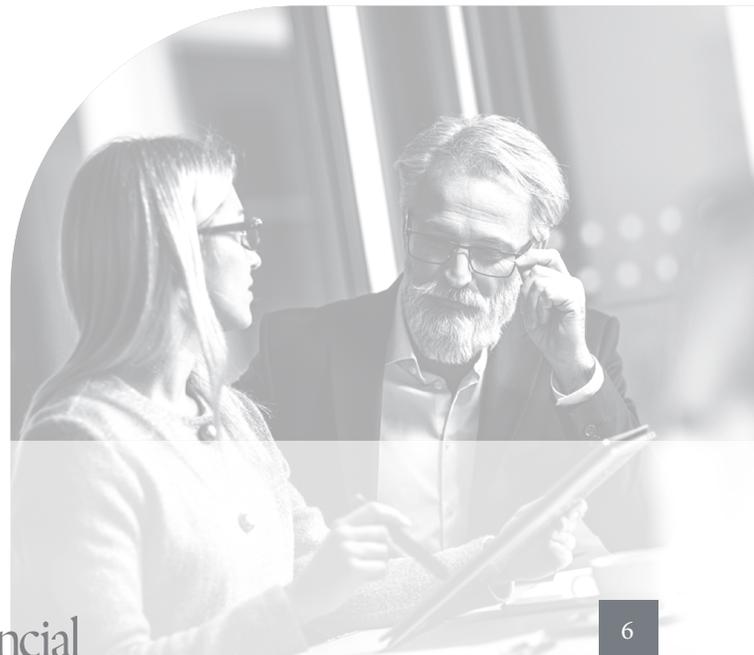


## 5

## Look for a prospective buyer/successor.

This step could be quick, as sometimes there is an obvious candidate in-house based on tenure and management experience. Other times there are several qualified candidates and selecting one over the others might be problematic. If there are no active employees who should serve as the successor, it makes sense to look externally for an outside buyer. This might be a local competitor who is interested in absorbing the business, a savvy entrepreneur in the same industry or a loyal customer.

If the best option is the owner's children, ensure that the children have substantial experience working with the owner and other leaders in the business. Also, it is important to have an attorney prepare legal documents for terms, answering questions like what future role, if any, the owner will have in the company, what that might look like, what the dispute resolution process is and how to handle a potential default, among others.



## 6

## Negotiate/close the deal.

Sellers should work with professionals to determine key aspects such as buyer qualification, payment terms, noncompete agreements and transition terms.

Exit strategy is extremely important. The seller should consider the likelihood of staying on with the new buyer and for what period of time. Transaction terms can include equity, notes receivable, cash, etc. These terms affect valuation and need to be considered in the presale planning.

It is very important for the small-business owner to have a plan for the assets they will receive in the sale. How will they be able to generate income from those assets, particularly if they are no longer going to be working for the company? Often small-business owners have all their net worth in the business that they control and will most likely have to invest in assets of companies they do not have direct control over. It can be a very emotional hurdle to overcome. Finding the right advisors to guide them through that process is crucial to their comfort level in selling the business.



## 7

## Ease tax exposure.

Last but certainly not least, work with a tax professional to discuss implications of succession planning as it relates to income tax, gift tax, generation-skipping tax and estate tax.

Transfers of business ownership interests can be structured in a multitude of ways, each having significantly different income and estate tax implications. Business owners should consult a tax professional to investigate areas such as whether to transfer stock or assets; how transactions are allocated to various kinds of assets; forms of business organization; and valuation issues. Moreover, although the estate and gift tax exclusion is at an all-time high, with careful planning there are ways to preserve it if needed in future years. An important part of preserving your legacy is keeping too much of it from going outside the family and a tax professional is invaluable in keeping that from happening.



## WE ARE HERE TO HELP

If you're a small-business owner considering a sale, Parsec will work with you to understand your unique set of circumstances. Scenario planning, which looks at various ways to structure the terms of the sale, is extremely useful in the early stages. Planning with your advisor will better prepare you for negotiating with your potential buyer and achieving the most desired outcome. Parsec also has accountants on staff to work alongside Parsec advisors to build out a robust tax strategy that is complementary to your overall financial plan.



### About Parsec Financial:

Parsec Financial is a fee-only registered investment advisor (RIA) with \$3.4 billion in assets under management as of Sept. 30, 2022. Parsec provides investment management, financial planning, tax planning, trust services and business retirement services to more than 2,050 households and businesses in six offices across North Carolina.

**Learn more:** [parsecfinancial.com/small-business-owners](https://parsecfinancial.com/small-business-owners)

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