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Beginning with the End in Mind

**Advising
Businesses on
Maximizing
Transition Value**

Plus: 2023 Delaware Trust Conference!



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Contents

View from the Chair 4
President's Report 6
What's New at the DBA 8
Beginning with the End in Mind 10
Charitable Giving That Yields Tax Advantages 16
2023 Delaware Trust Conference Special Section 21
Accounting for Success 34
For Your Benefit 36
Lending Law Update 38

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Beginning with the End in Mind

Effectively advising business owners on maximizing transition value



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Benjamin Franklin famously wrote “[I]n this world, nothing is certain except death and taxes.” These certainties lead to a third universal truth for every business owner - they WILL transition their business, and death and taxes will play a significant role in the value of the business during the transition. Whether due to economic stresses that require an exit to meet financial needs, successes that facilitate an early retirement, or incapacity and death which force a business owner from the business, helping a business owner plan with the end in mind can help maximize and maintain value during the process. Knowing when or how it will end is not critical to the planning. Simply acknowledging that the owner’s participation in the business will end helps bring important business management and transition issues into focus and will motivate the business owner to maximize value during a transition.

Successful transitions depend upon 3 key components – i) wealth and estate planning, ii) prioritizing reinvestment over distributions, and iii) managing expectations regarding likely outcomes and avoiding unrealistic comparisons.

Failure to invest in people and processes may make the owner indispensable—if the owner leaves, business value may suffer. That outcome could be avoided by building and engaging a multi-disciplined team, delegating authority, implementing good systems, and developing repeatable processes. These investments may slowly reduce the current owner's importance to the operation and make the business more easily transferable to a future owner. This sort of “turn-key” operation is generally far better positioned to maximize business value than an owner-dependent one.

- **The predictability lesson:** Predictable cash flow is often a cornerstone of value maximization. Think of software companies. They typically trade for higher price/earnings ratios than most other sectors because their license-based revenue models and high switching costs “lock in” highly predictable future cash streams from a broad base of customers. We've also seen the flip side in a highly profitable contract manufacturing business. Significant distributions supported a great lifestyle for the shareholders, but purchase offers were disappointing when they sought to retire. The problem: over 60% of sales were to one customer who could easily switch to other providers. Consequently, the owners enjoyed current cash flow, but buyers couldn't depend on future cash flows. Opting for lower distributions and directing cash toward new customer development could have diversified the company's revenue stream, boosted cash flow predictability, and spurred investors to more appealing valuation levels.

- **The sustainability lesson:** Many years ago, we advised a transportation company on a potential sale. A clearly articulated niche strategy and peer group-leading profitability attracted many potential buyers, but passions cooled when they figured out that the company's fleet was meaningfully older than the industry average. The reason: The seller valued cash distributions over fleet reinvestment. The result: The business didn't fetch the top-of-the-market valuation the seller coveted. Buyers estimated the cash outlays to update the fleet and reduced their valuations accordingly. If she had lowered distributions to fund more regular fleet investment, the owner could have enhanced the sustainability of the company and perhaps achieved a higher valuation.

So, where do these lessons leave us? A valuable mantra to entrepreneurs is, “you don't get it twice.” This simple yet profound advice is rooted in a bedrock truth—growing business value is often an investing activity. When owners pick their spots on the spectrum between distributing cash or reinvesting in their business, the truly wise ones take care that they are not diminishing future business value as they reward themselves today.

Managing expectation where perception is reality - keeping up with the Joneses

Next, managing the business owner's expectations regarding what may be achieved through a sale of their business helps provide a positive outcome. The power of comparison visits virtually every aspect of life. From education to fashion to careers to choosing our favorite sports teams – we all look to see what others are doing and it can color our choices. People ascribe value to being better educated, better dressed, better paid, a better athlete.

The same holds true in mergers and acquisitions. The desire for “better” has been on regular display. Highly successful and insightful entrepreneurs often approached their exits with expectations that were less about the actual merits of their businesses and more about how a desired outcome would position them against a standard they viewed as important – whether it was realistic or not. The consistent longing for “better” manifests itself regularly in four key ways:

- **ONE: The Living Standard** – For many entrepreneurs, their business touches every corner of their lives – the home they live in, the car they drive, the vacations they take, the schools their children attend. Consequently, maintaining or improving their current lifestyle is – and should be – a fundamental, threshold concern when considering a business sale. But additional challenges can mount if an owner expects a sale to radically change their standard of living. Very often, owners target a desired lifestyle and back solve for their hard sale price without regard for their company's comparative attributes in the competitive marketplace.

- **TWO: The Market Standard** – In virtually any market, similar assets can command very different values due to their unique characteristics and a buyer's particular needs. The marketplace for business acquisitions is no different. In most industries, businesses are valued by multiplying earnings before interest, taxes, depreciation, and amortization (commonly shortened to “EBITDA”) by a sector-specific EBITDA multiple within an established historical range. Readily transferable companies with highly predictable cash flows are best-positioned to fetch top-of-range multiples because they have built sustainable value. Framing deal expectations on word-of-mouth, “industry averages” or achieving “the highest multiple in my sector” is likely to disappoint an owner who hasn't truly set the business apart through the hard work of corporate value-building.

- **THREE: The Headline Standard** – An old investment banking joke recounts the tale of a business owner who rebuffed interested buyers for years until one finally showed up with a truly remarkable price. The owner quickly agreed and, as they walked around the plant, informed the buyer that his price was substantially higher than past bids. The buyer merely smiled and said, “Well, we haven't discussed the structure yet.” This highlights an important truth for business owners – the “headline” value may stoke the ego, but the true measurement of a deal is what is collected and

when. Smart owners understand that an all-cash deal now may be worth far more than an incentive-laden deal with a larger price tag. So, it's critical to go beyond the headline to understand the real story.

• **FOUR: The Datapoint Standard** – People naturally seek evidence to support their arguments and beliefs. But, not all evidence is created equally, and some is flimsy at best. For business owners pursuing a sale, it's vitally important to substantiate negotiating positions with ample data. We've seen owners seek to highlight one great year as proof of consistent business strength. Others have tried to justify their valuation by emphasizing the multiple paid for a substantially larger, more diversified peer company. Still more have insisted on favorable deal terms "that a friend got" despite the irrelevance to their specific transaction. In each case, the owners relied on single data points to keep up with a perceived standard. None of them won those arguments and some lost credibility with their buyers in the process.

On May 6, 1954, Roger Bannister became the first person to run a mile in under four minutes. In the past seven decades, only about 1,400 runners have matched the feat. Put another way — millions have lacked the winning recipe of opportunity, work ethic, and talent to join Bannister within that elite company of athletes.

Any runner striving for that standard must make a clear-eyed judgment about the likelihood of reaching their goal with the assets at their disposal. Business owners considering a sale are in the same spot. Unfortunately, many impose standards for their deal without really understanding if they are even attainable. The savviest owners know their strengths and work to improve their limitations. They are comfortable with not getting a record-setting multiple or an unbelievable structure, as long as they're getting a fair deal that reflects business reality. They don't worry about outrunning the Joneses ... and in so doing, they may even surpass them.

Due to the certainty that a business owner must exit their business, it is important for them to begin with end in mind. Planning early for this exit with contingency wealth and estate planning, maintaining the business through reinvestment in lieu of distributions, and managing expectations in order to take advantage of realistic opportunities, all support a positive outcome when the inevitable transfer occurs.



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Transition Planning

(continued from p. 13)



As part of the Wilmington Trust Emerald Family Office & Advisory® team, Jeff is responsible for developing trust planning strategies for wealthy individuals and families throughout the United States and abroad. He works closely with his clients' legal, tax, and investment advisors to construct and implement appropriate trust structures that take advantage of the state of Delaware's unique trust and tax laws. Jeff is a recipient of the Wilmington Trust Chairman's Club award. He is a member of the Estates and Trusts Section of the Delaware State Bar Association and the Real Property, Trust & Estate Section of the American Bar Association.



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Prior to joining Wilmington Trust in 2019, Stuart was a managing director in the M&T Investment Banking Group, where he co-founded the bank's M&A/Corporate Finance business in 2001 and was co-head of the team since 2014. Stuart has more than 25 years of diversified financial services experience including senior and subordinated debt raises, private equity raises, mergers and acquisitions, and leveraged buyouts across a wide range of industries. Stuart is a recipient of the Wilmington Trust Chairman's Club award.

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