

4th EDITION

TAX & FINANCIAL GROUP

REPORT OF CLOSELY HELD BUSINESS OWNERS: THE EXIT PLANNING PROCESS



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BACKGROUND, OBJECTIVES AND METHODOLOGY

BACKGROUND

Closely held companies (or small businesses) constitute one of the most important, dynamic and growing segments of the U.S. economy. According to the Small Business Administration, in 2010 these businesses accounted for 43% of private sector payroll and produced almost 45% of non-farm gross domestic product (GDP). Net job gains of small businesses matched large businesses (500+ employees) in 2010 and gross job gains outpaced large businesses by 3 to 1. Additionally, small businesses make-up more than 99% of all employers and employ half of all workers in the U.S.

Despite this, little empirical data exists on how owners think about, prepare for and eventually accomplish their exit. Also, few studies have tracked important trends in owner exits and exit planning against the Baby Boomer population. This void is remarkable, yet understandable: closely held companies generally share little data, most exit strategies do not require public disclosure, and the tendency to discuss succession planning (transfer of management) synonymously with exit planning (conversion of ownership to personal wealth) obscures many important exit planning issues.

For most business owners, their focus is on the following issues:

- Cost Control
- Profitability
- Growing revenues
- Healthcare expenses
- Building personal wealth through the business

OBJECTIVES

- Understand owner attitudes towards the exit planning process, including their challenges and behaviors

- Compare what owners think are important steps in the exit process versus what they are actually doing
- Determine key objectives for the exit (e.g., business continuity, passing the business onto family, shareholders or employees, minimizing taxes, maximizing the value of the business, achieving personal financial security, etc.)
- Evaluate owner expectations for the exit process
- Understand correlations between all of the above and summarize key data such as: owner age, business size, type of business (product vs. service) and what options owners might have to exit their businesses

METHODOLOGY

- The research was conducted with a selection of business owners located throughout Southern California.
- This is the 4th edition of our annual report. A total of 207 business owners have been surveyed for this in-depth report.
- At the time of the survey, 35% of participants were current Tax & Financial Group (TFG) clients; 65% of participants were not clients and were either referred to TFG by clients or contacted by TFG because they are known to be a business owner.
- The 4th edition survey was conducted between March 2013 and February 2014 and compiled with data from previous editions.
- Survey interviews were conducted in person or over the phone.

*Source: "Small but Mighty: Growing Opportunities for Financial Advisors and Small Business Owners, Securian Financial Group

EXECUTIVE SUMMARY

This section summarizes the survey's most important findings. The survey results provide strong evidence that business owners are not actively planning for their eventual exit from their respective companies.

Business owners are heavily reliant on a successful exit from their business to meet their retirement needs. However, owners are also investing in asset categories independent of their business, providing diversification in their financial position and not exclusively depending on their business value to meet their future income needs.

Although owners can identify strategies they should be employing, they are not consistently taking action on them to ensure a successful exit from their companies. Many have begun grooming successors to take over the business someday, but they are not confident about financing available to transfer ownership to these individuals.

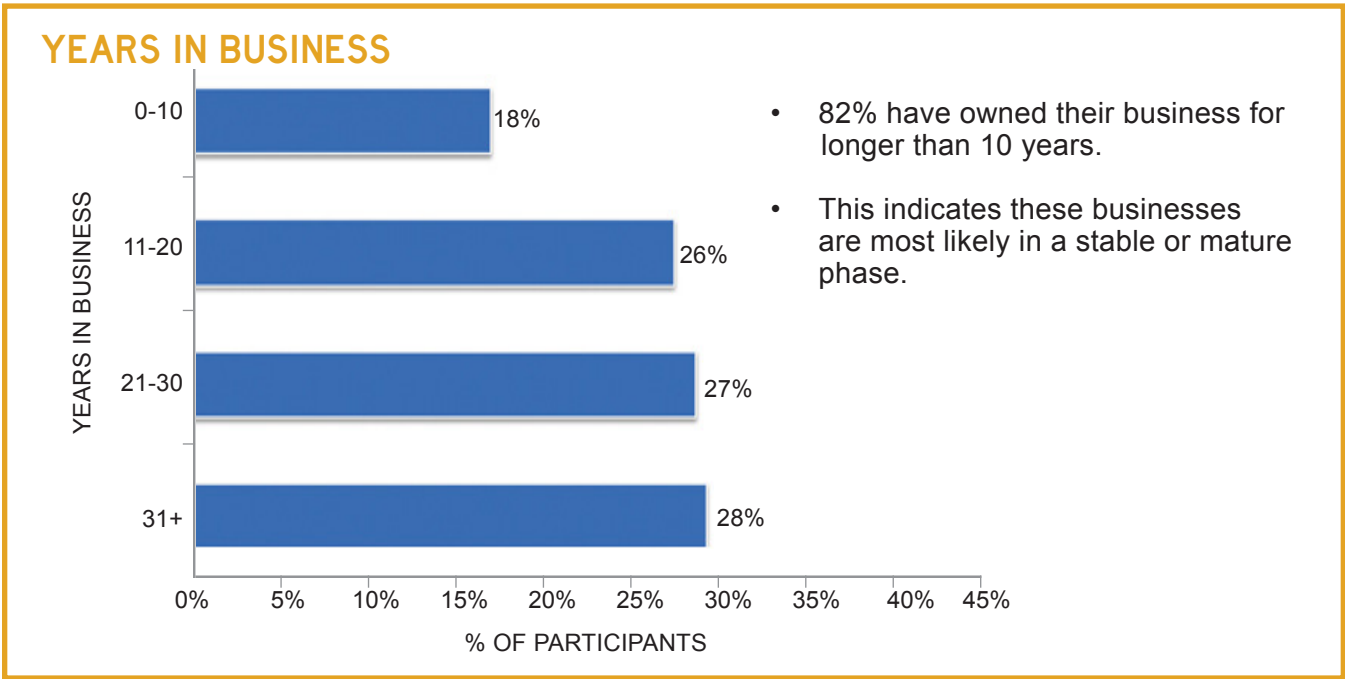
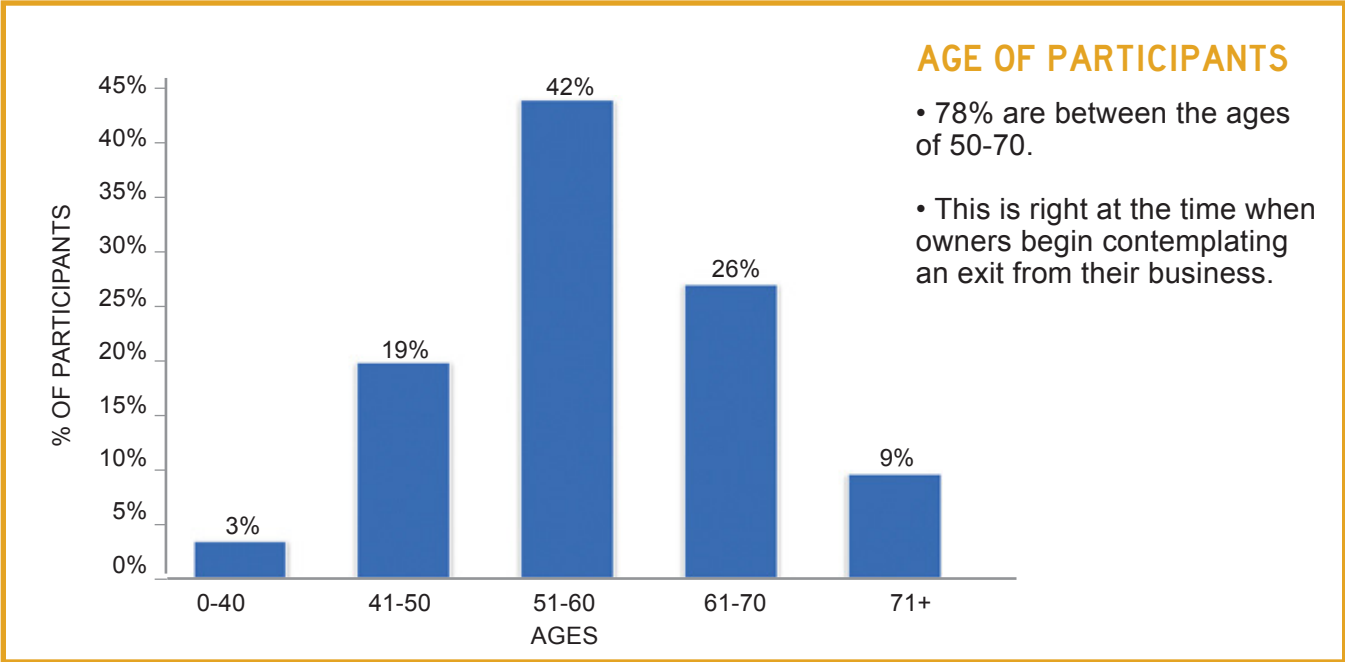
Below are some of the relevant statistics found in our 2014 report:

- **92% of owners say they don't have an exit strategy in place, a slightly higher percentage than in previous years.**
- **70% want to exit their business in less than 10 years.**
- **Selling to outsiders or selling to family members is still the most likely exit strategy in owner's minds.**
- **Grooming a successor is cited more prevalently as a key to exit. However, potential financing for purchase by a successor is seen as a larger obstacle than in the past.**

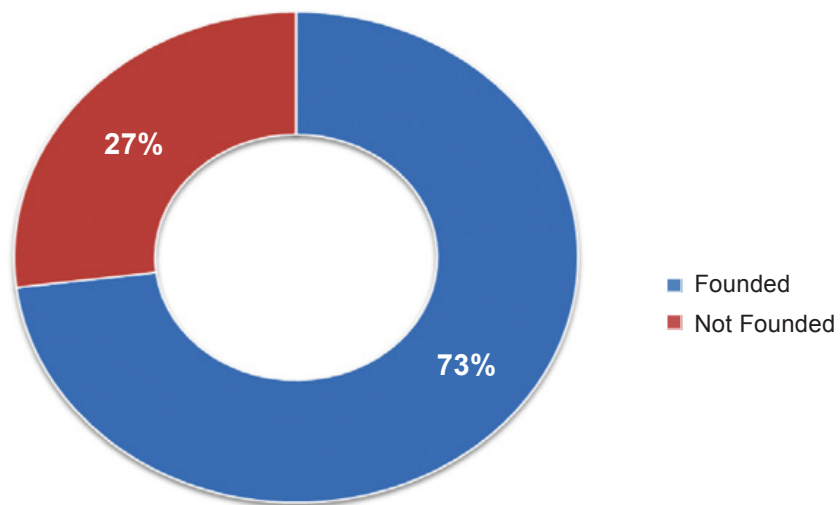
- **Developing a written exit plan is also seen as important to owners, while obtaining a business valuation is seen as a less important piece of a plan than in previous years.**
- **Personal retirement preparation is still a critical issue for most owners, yet only 50% have an idea of what they will need to retire.**
- **In this edition we asked if owners were investing outside of their business. Here we found that owners are doing a fairly good job in diversification of their assets, with many investing in 2-4 asset categories besides their business.**

PROFILE OF PARTICIPANTS

We began the survey by asking the participants to answer some key questions about themselves and their businesses. We asked the participants for their age, the industry of their business, the length of time they have owned their business, the number of employees they currently have, the number of shareholders in their business, and if they founded their company. Being able to categorize those surveyed by these attributes enabled us to identify how certain groups of individuals responded to specific questions later in the report.

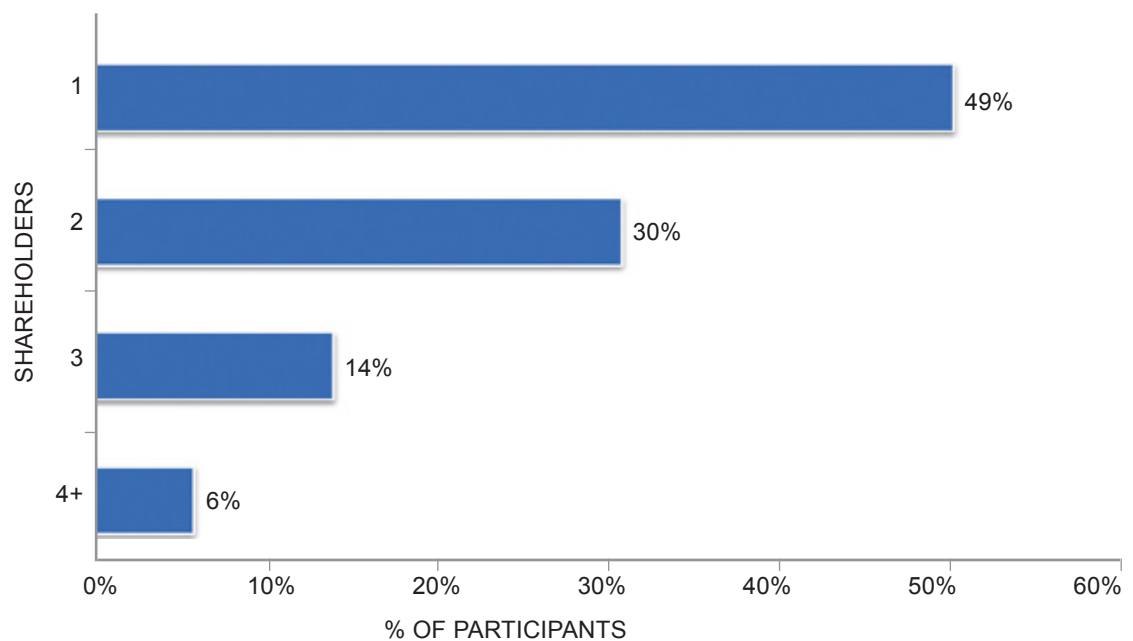


FOUNDED COMPANY



- 73% of those surveyed founded their company
- 27% bought or inherited their company

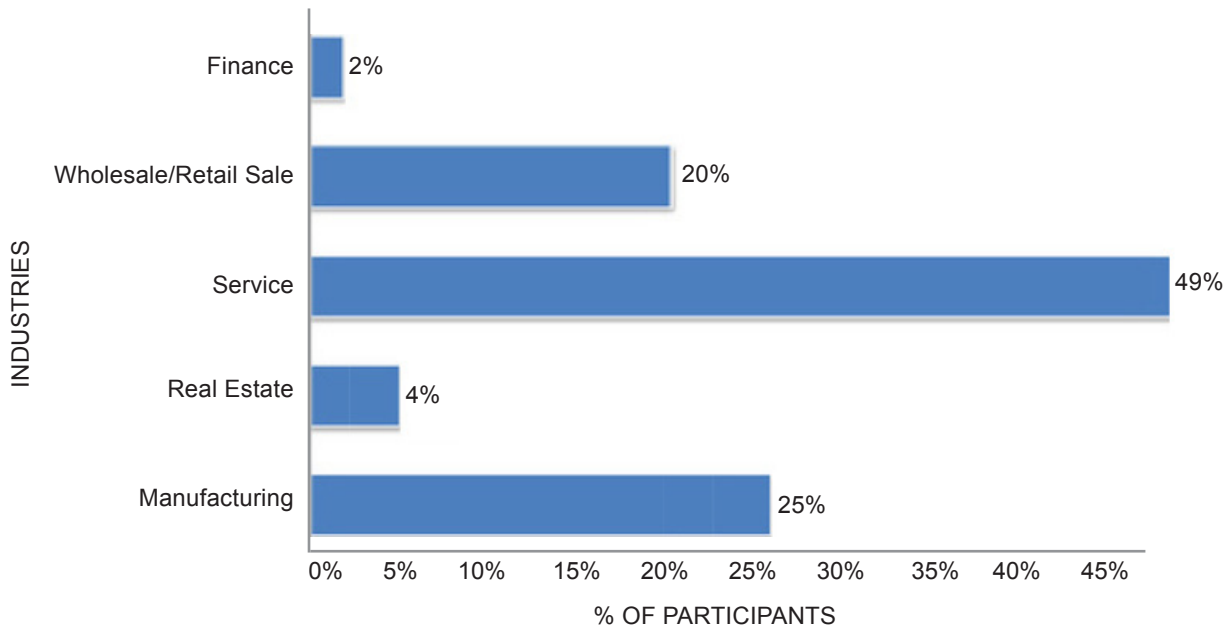
NUMBER OF SHAREHOLDERS



- Nearly 80% of businesses surveyed have one or two owners.
- This indicates that many of the businesses are closely-held.

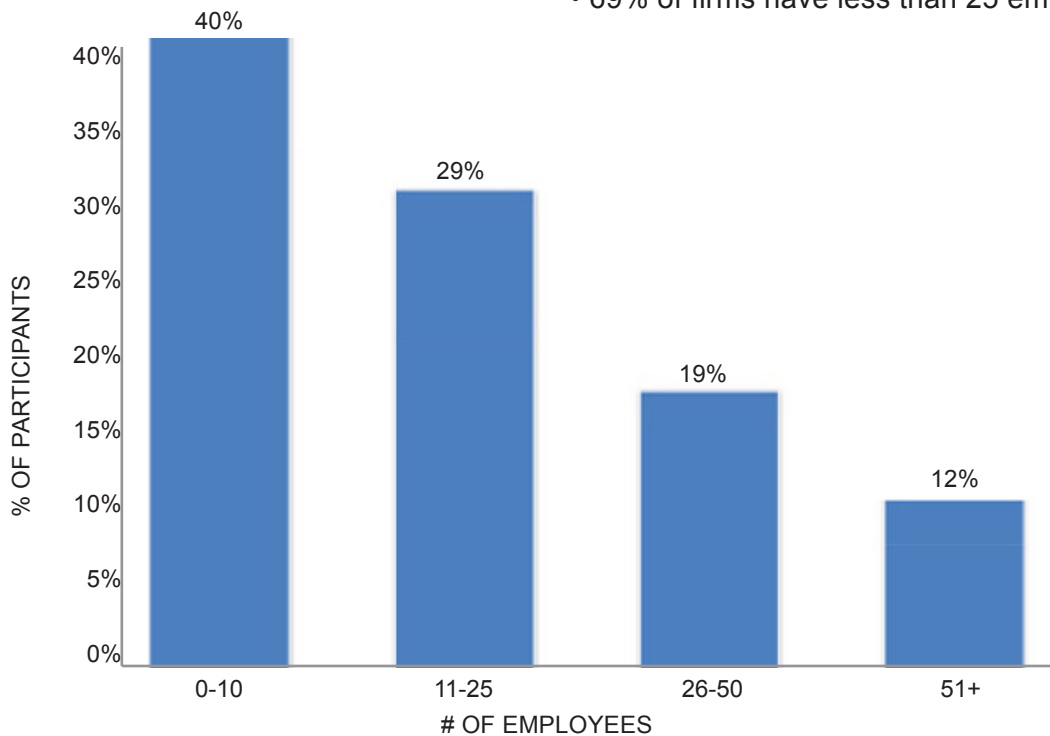
INDUSTRIES

- Manufacturing and the service industry made up the majority (76%) of those surveyed.



NUMBER OF EMPLOYEES

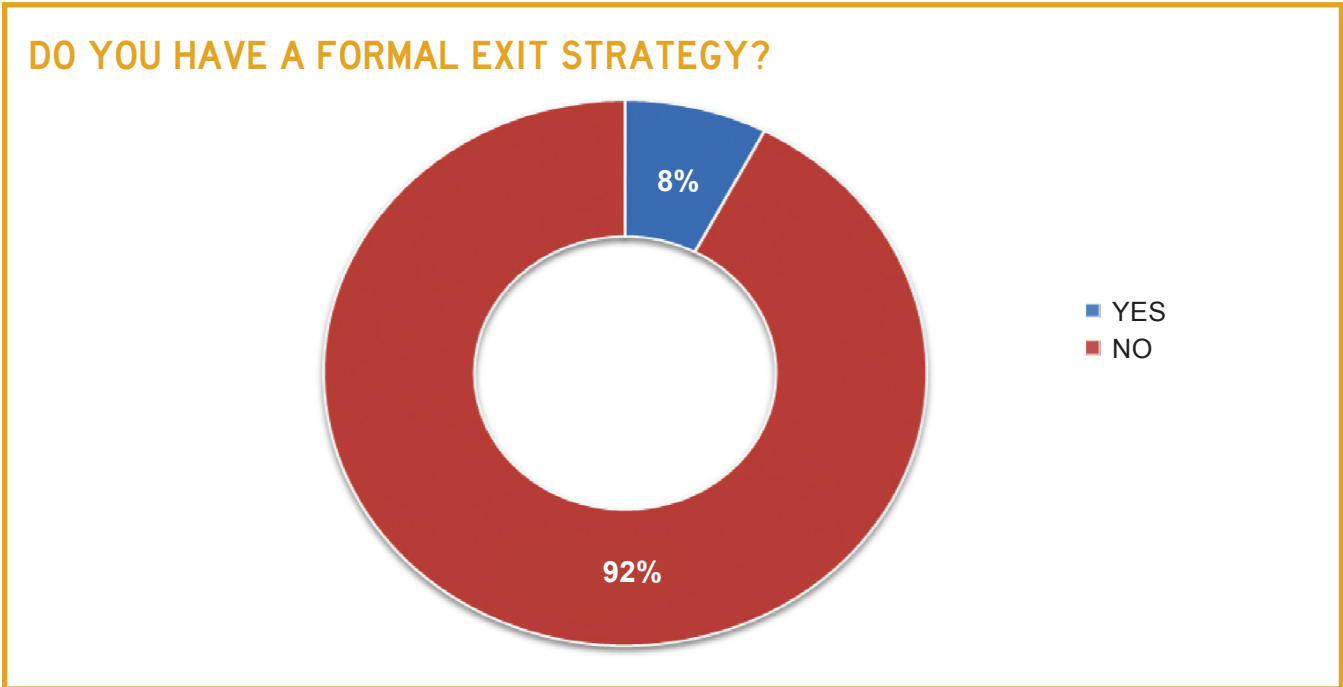
- 69% of firms have less than 25 employees.



TOP INSIGHTS AND ISSUES

“DO YOU HAVE A FORMAL EXIT STRATEGY FOR YOUR BUSINESS IN PLACE?”

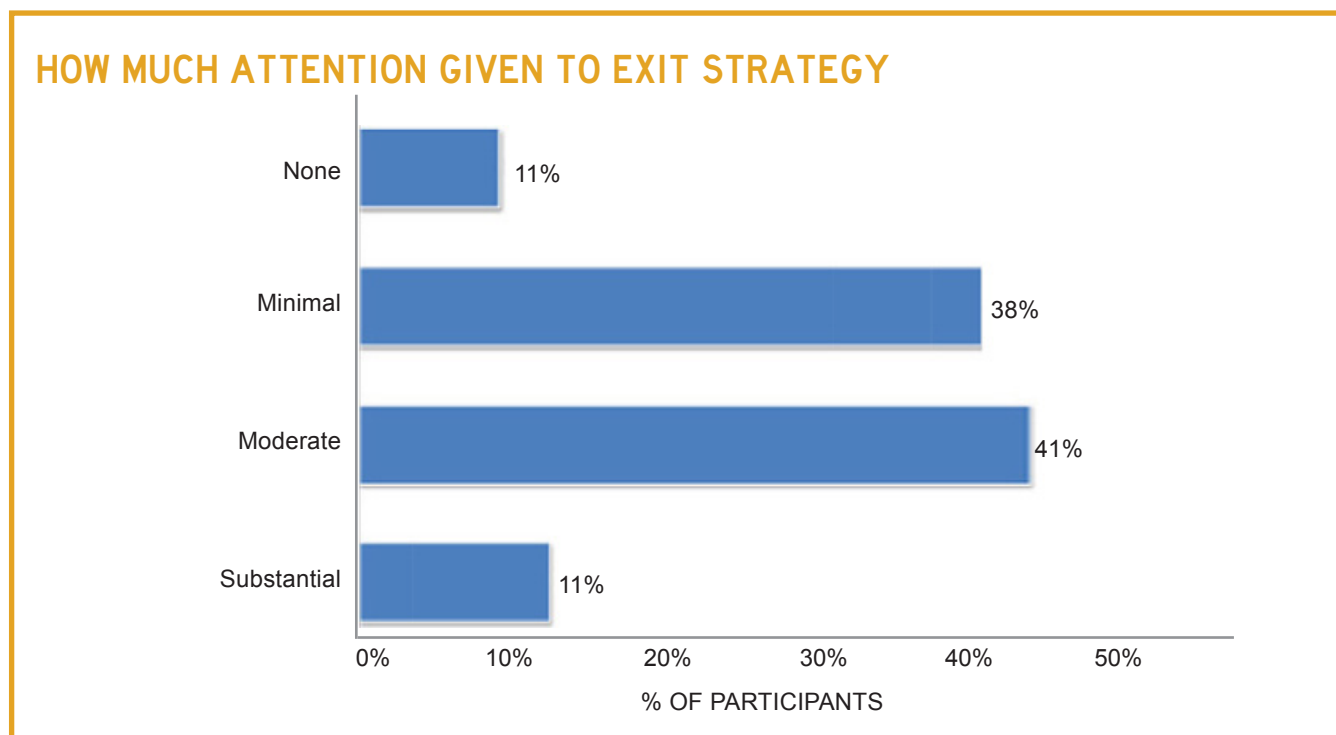
We set out to identify those who felt that they were well prepared to exit their business and those that felt they were not.



FINDINGS

- Most owners (92%) said they do not have a specific exit strategy in place. This is a slight increase from 89% in previous years.
- Of those that answered “no” (that they do not have a formal exit strategy), 48% are sole owners and 52% have 2 or more owners, indicating that the number of owners does not necessarily impact the importance of developing an exit strategy.

“HOW MUCH ATTENTION HAVE YOU GIVEN TO THE EXIT OF YOUR BUSINESS?”

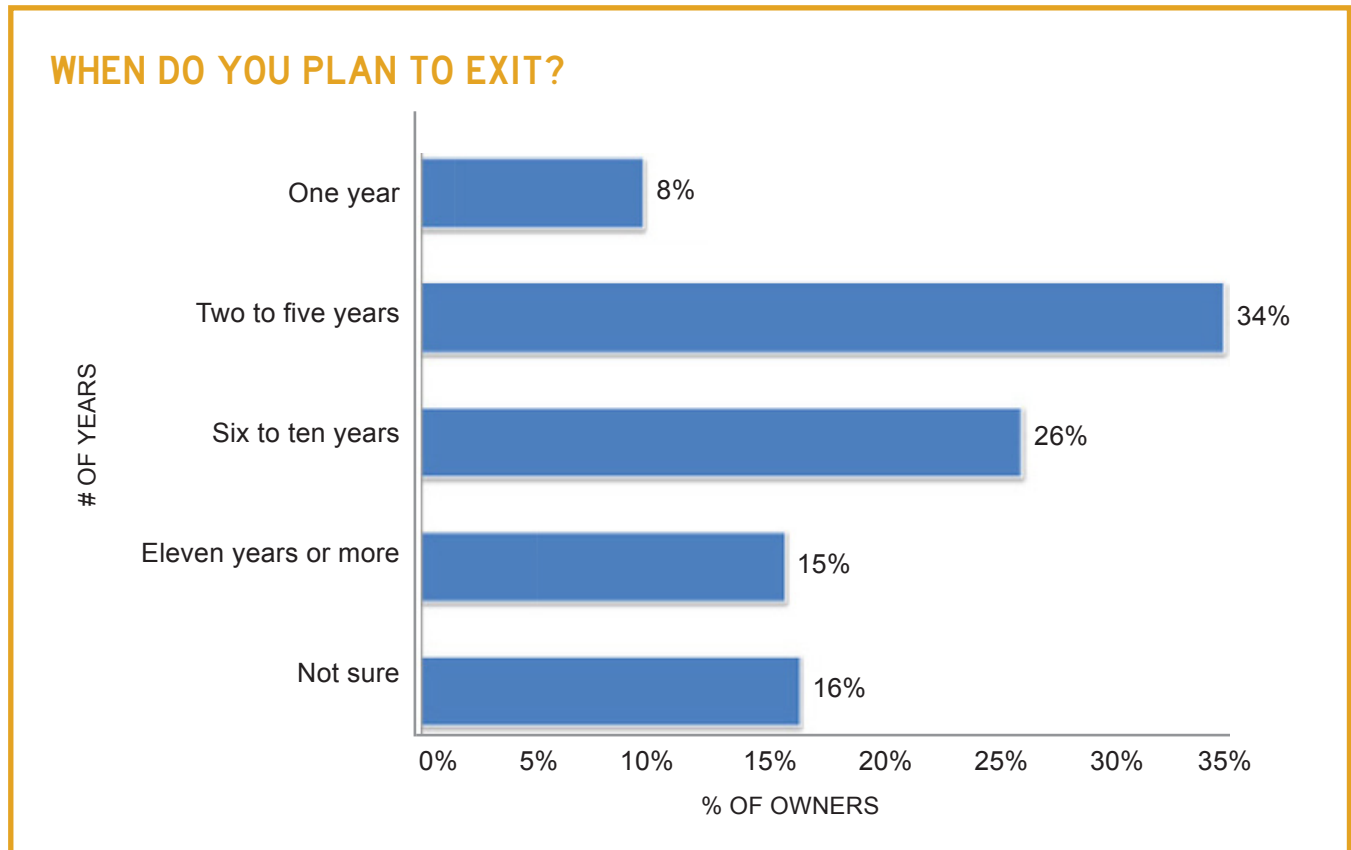


FINDINGS

- Those who answered “moderate” or “substantial” rose slightly from previous years (8% to 11%).
- The average age of those who answered either “moderate” or “substantial” was 60. This makes sense as those owners who are getting older are more likely to begin thinking about their exit.
- The average age of those who answered “minimal” was 54.
- The average age of those who answered “none” was 57.

“WHEN DO THEY PLAN ON EXITING THEIR BUSINESS?”

We next set out to identify the exit horizon in which business owners plan to exit their business. Our premise was that older owners should be more likely to want to exit their business sooner than younger owners.

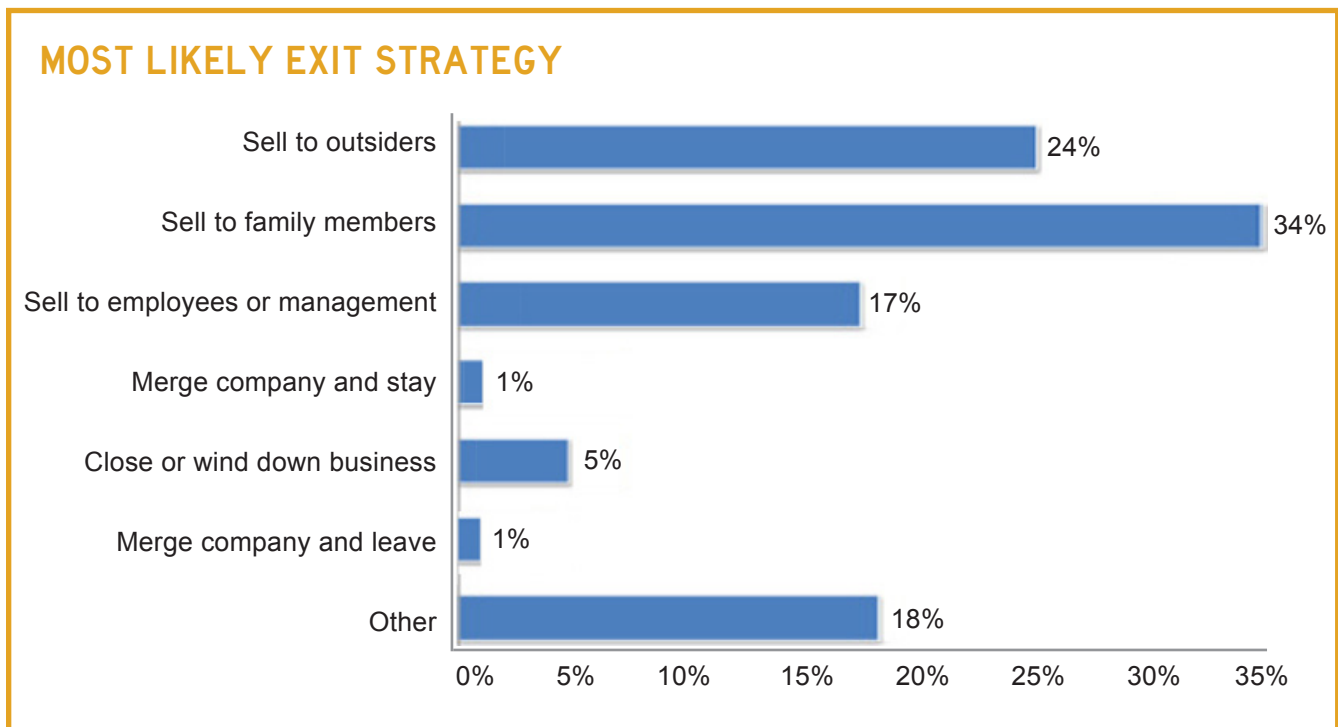


FINDINGS

- Those who want to exit in one year or less diminished slightly than in previous years (12% to 8%).
- Almost 70% want to exit their business in less than 10 years.

“WHAT IS THE MOST LIKELY EXIT STRATEGY YOU WILL USE TO EXIT YOUR BUSINESS?”

With this question, we hoped to identify the most popular means of transferring a business.



FINDINGS

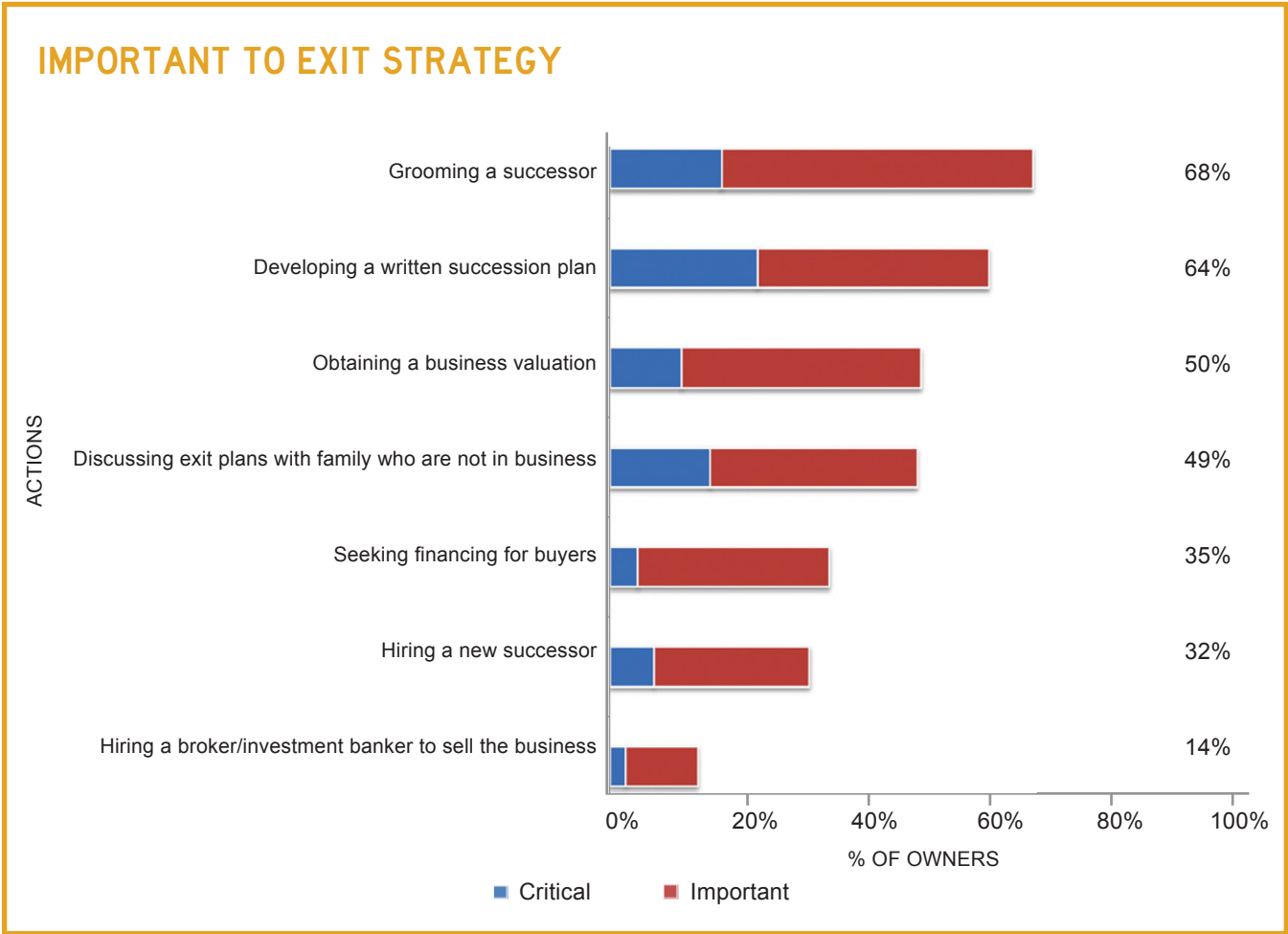
- “Sell to outsiders” and “sell to family members” were the two most likely exit strategies, making up 58% of the responses.
- Those who don’t know or indicated another strategy increased to 18%. Those who thought they might merge or wind down their companies, decreased to 7% collectively from 19% in previous years.

“WHAT DO YOU CONSIDER AS CRITICAL OR IMPORTANT STEPS TO A SUCCESSFUL EXIT STRATEGY?”

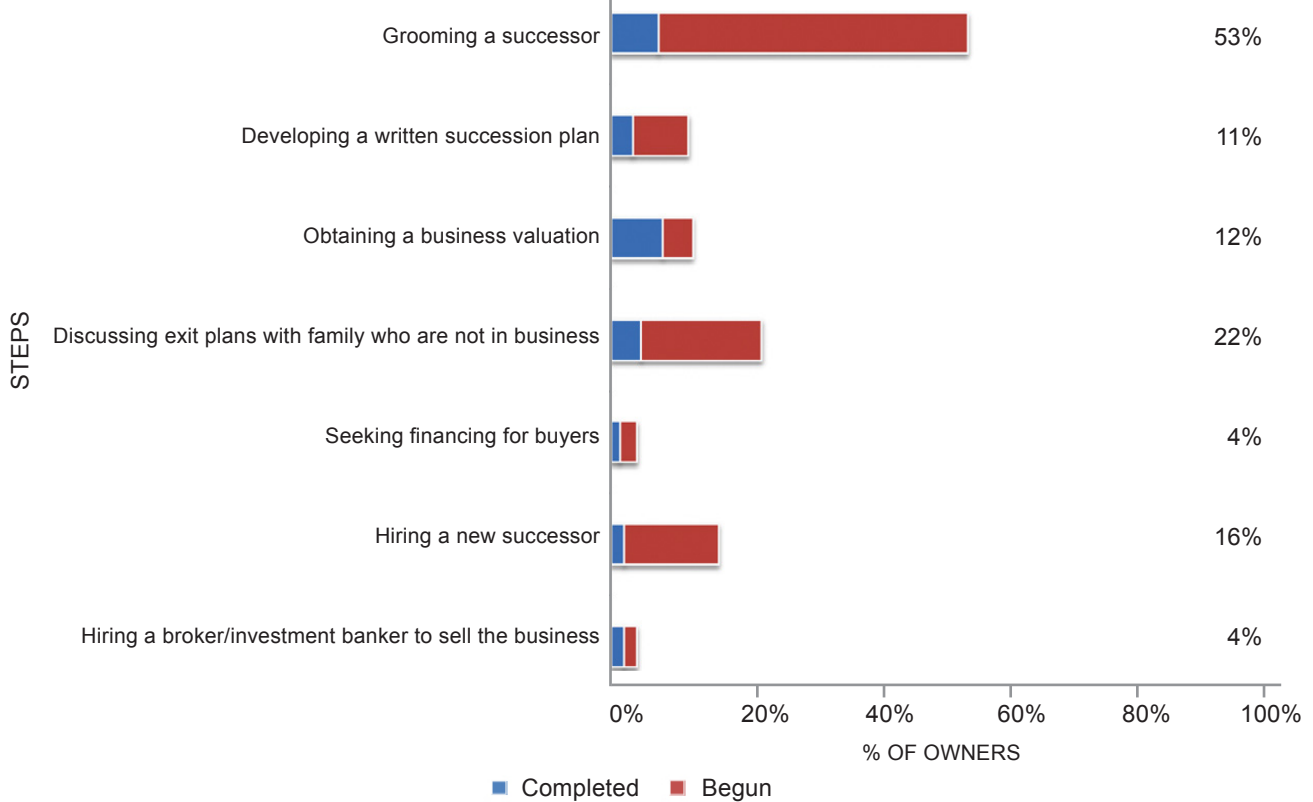
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“WHICH OF THESE EXIT STRATEGY STEPS HAVE YOU BEGUN OR COMPLETED?”

By asking these questions we hoped to identify what steps owners feel are important to a successful exit strategy and if they have started or completed any of these steps.



WHAT EXIT STRATEGY STEPS HAVE YOU BEGUN OR COMPLETED?



FINDINGS

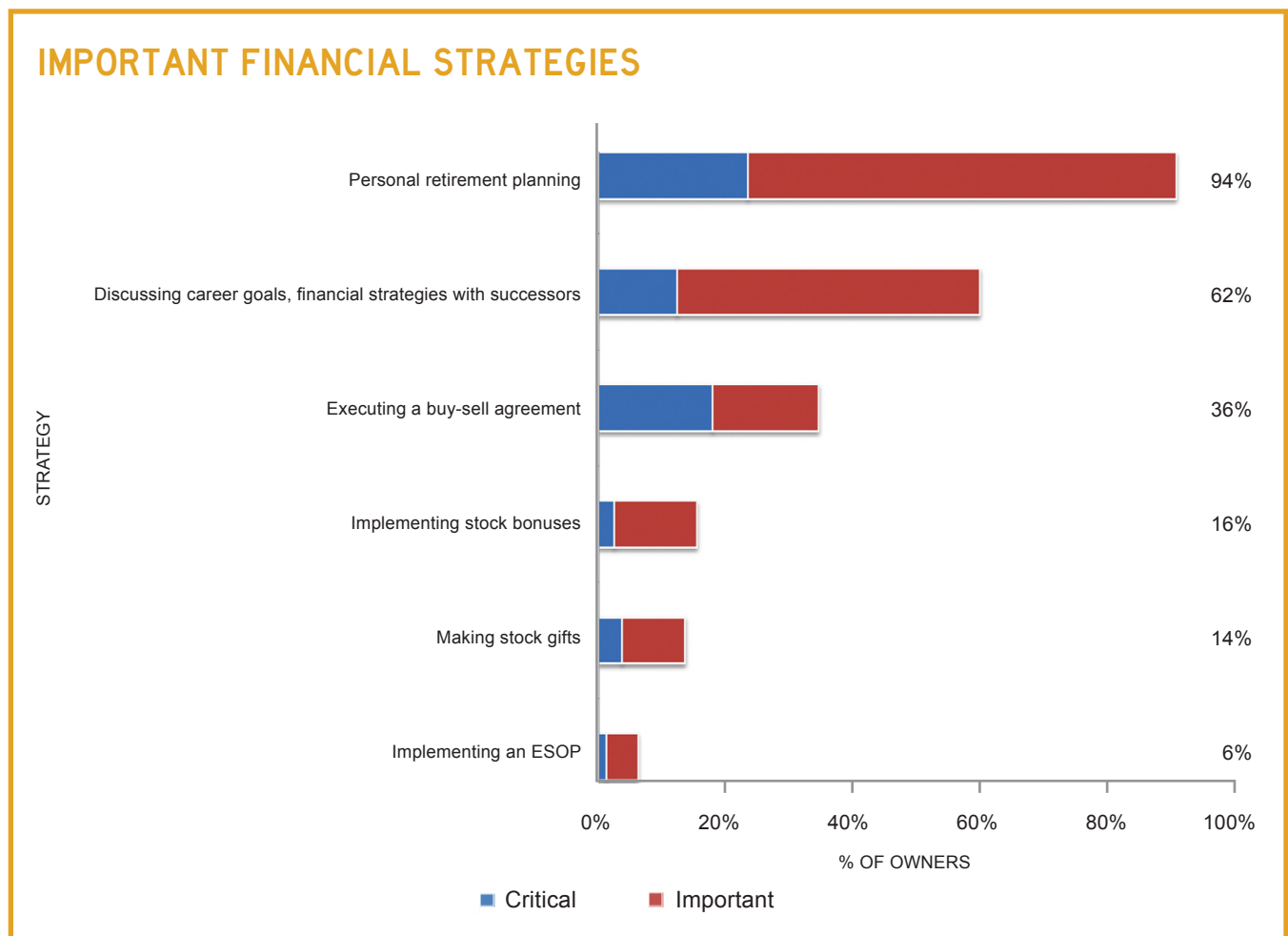
- **Grooming a successor is still the top priority for an exit strategy.**
- **Developing a written plan is also identified as a significant step in the exit process.**
- **The only step that more than half of those surveyed have begun or completed is “grooming a successor (53%).” This percentage is higher than in previous years.**
- **Developing a written plan was slightly lower than in previous years (11%).**

“WHICH FINANCIAL STRATEGIES ARE CRITICAL OR IMPORTANT TO THE EXITING OF YOUR BUSINESS?”

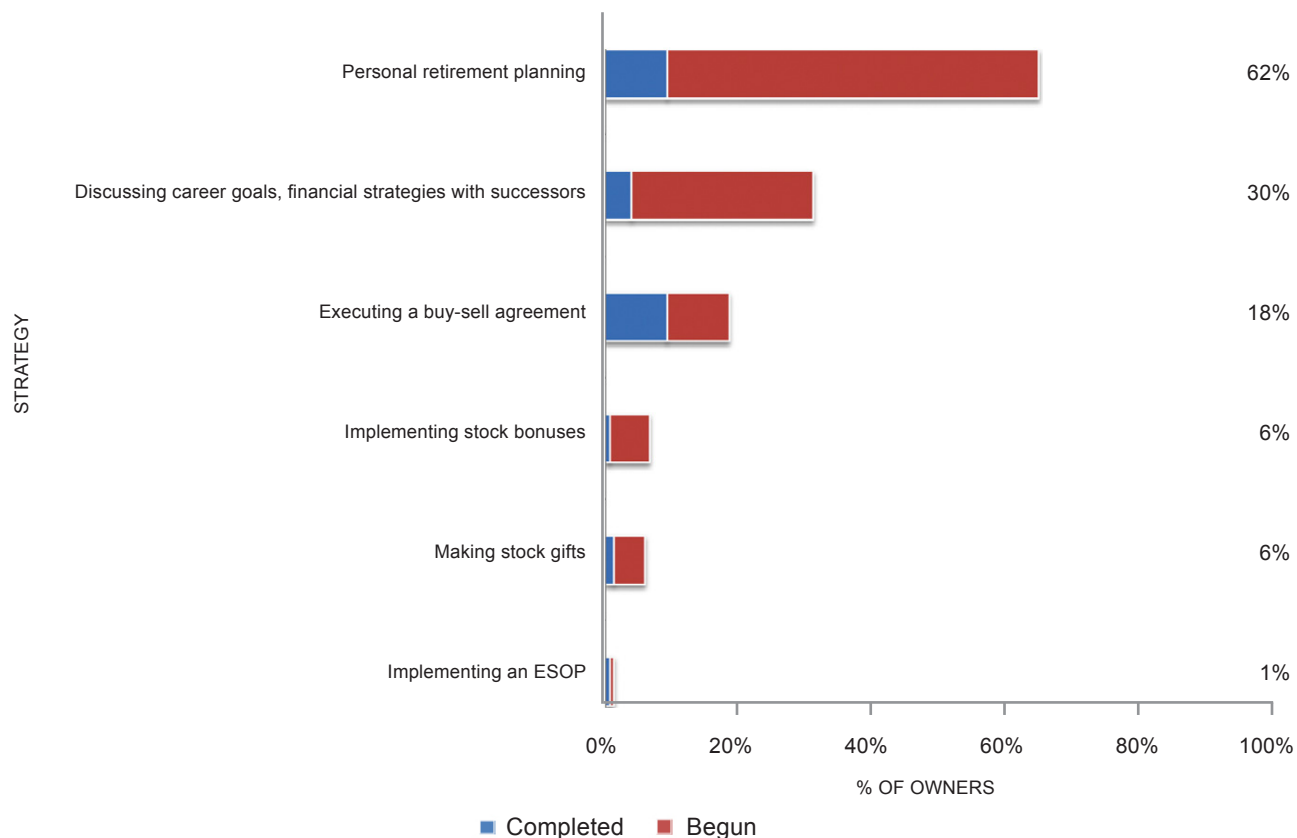
AND

“WHICH OF THESE FINANCIAL STRATEGY STEPS HAVE YOU COMPLETED OR BEGUN?”

We hoped to identify what core financial strategies owners felt were vital to the exit of their companies and if they were implementing any of these important strategies within their exit plan.



WHICH FINANCIAL STRATEGY STEPS HAVE YOU COMPLETED?

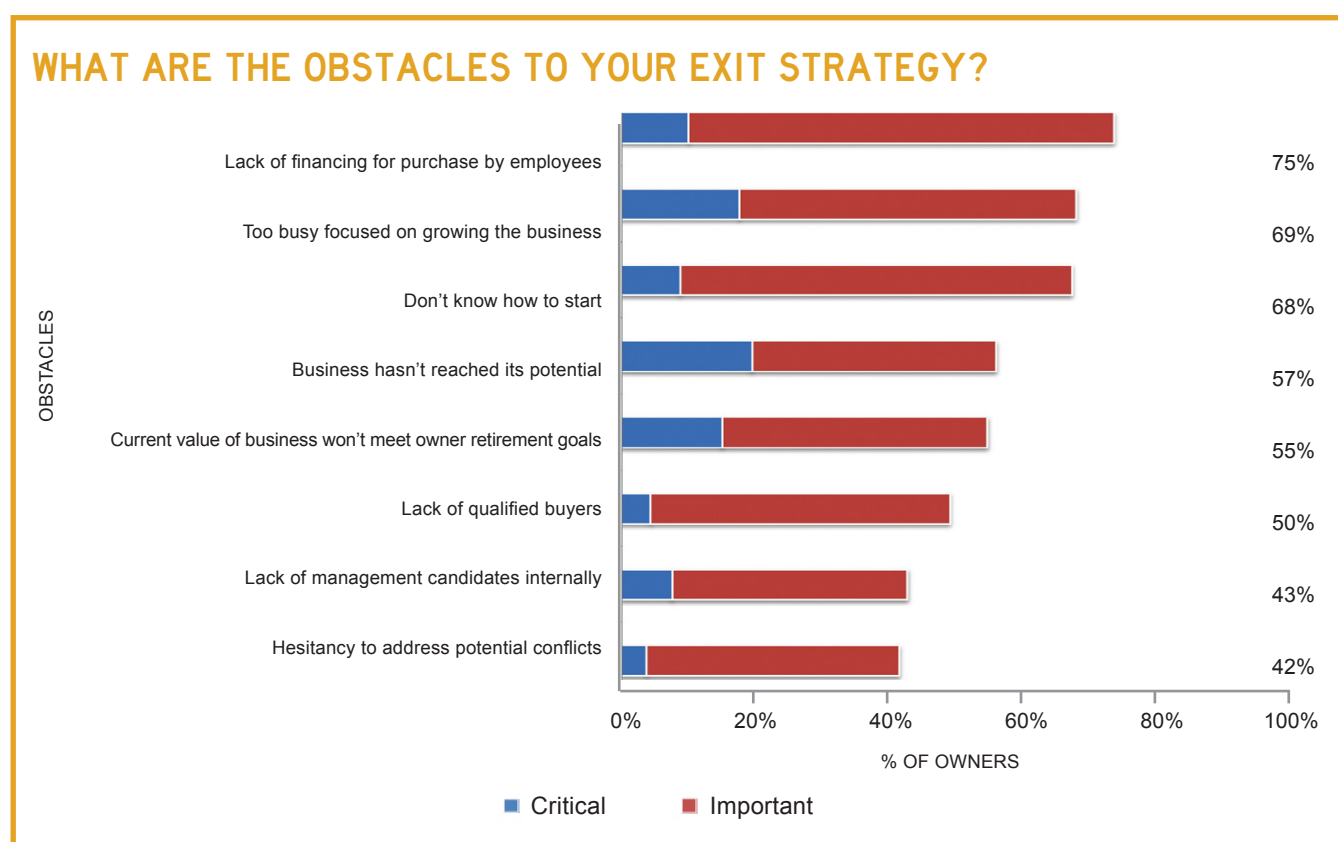


FINDINGS

- A majority of those surveyed said that “personal retirement planning” and “discussing career goals and financial strategies with successors” are vital to a successful exit.
- Slightly more owners this year said personal retirement planning is an important step in the exit process (94% vs. 92% in previous years).
- 62% of those surveyed say they have begun or completed retirement planning. This is slightly higher than in previous years (58%).
- However, this implies that 38% still have not addressed their retirement needs.

“WHAT ARE THE OBSTACLES PROHIBITING YOU FROM COMPLETING A SUCCESSFUL EXIT FROM YOUR BUSINESS?”

We set out to identify what issues are obstructing business owners from exiting their business.

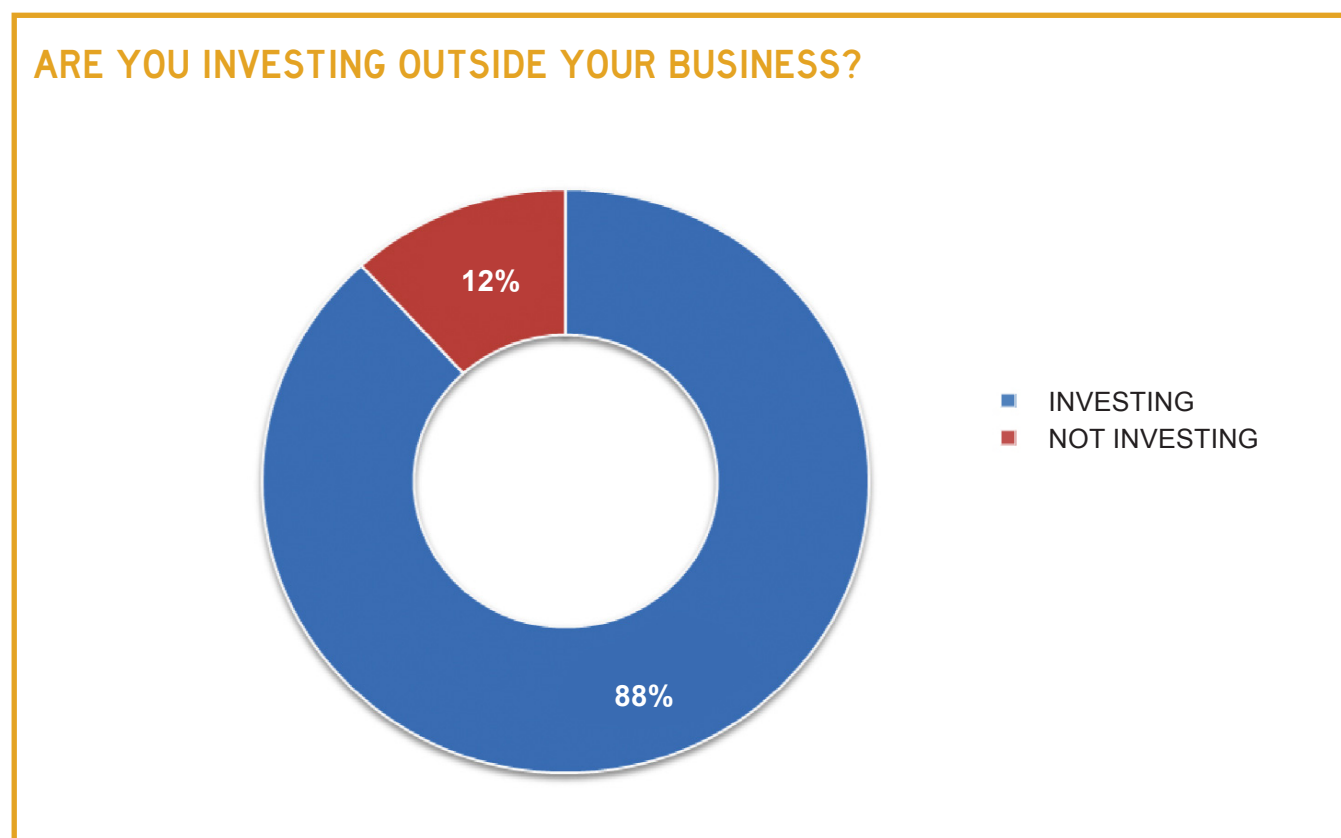


FINDINGS

- Owners identified multiple obstacles that impede the exit process.
- “Lack of financing for purchase by employees” was the obstacle identified the most this year, an increase of 12% over previous years.

“ARE YOU INVESTING OUTSIDE YOUR BUSINESS OR OUTSIDE YOUR COMPANY?”

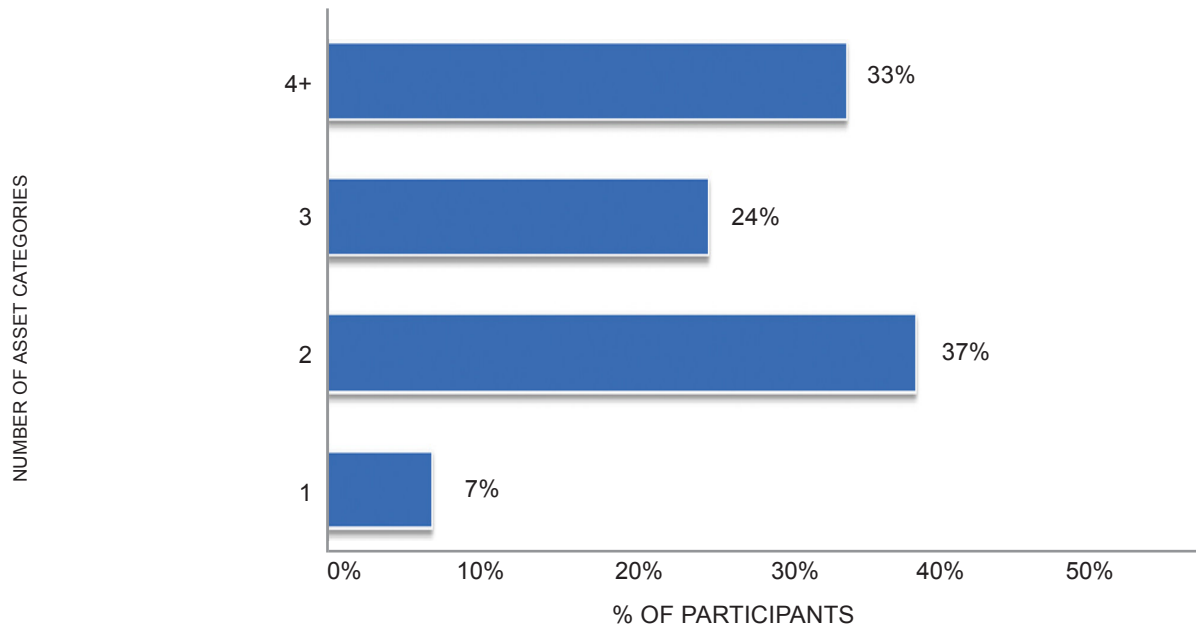
We set out to identify what percentage of business owners are investing in assets outside of their company.



FINDINGS

- This is a new question in this year's edition. The reasoning is that many business owners typically invest a large percentage of their profits/assets back into the business, thereby putting more pressure on their business to do well in order to help accomplish their financial goals.
- Categories of outside investments were identified as 401(k), IRA/Roth IRA, Pension Plan, Commercial/Investment Real Estate, Savings/Investment Accounts, Cash Value Life Insurance, Outside Business Interests, and Other.
- A majority of owners are investing in assets outside their company.

ARE YOU INVESTING OUTSIDE YOUR COMPANY



FINDINGS

- Here we asked how many of the asset categories owners' were investing in.
- The majority (92%) are investing in two or more categories.

CONCLUSIONS

In conclusion, we step beyond the results of the survey and offer our own interpretation of the data. Although this sample is a diverse group with participants having individual goals, in different stages of their life and in their business lifecycle, there are broad implications that can be drawn from those surveyed, especially looking at the data over the four years of the report. There were many interesting findings in the report but the three most important conclusions from the survey are:

OWNERS STILL NOT PLANNING FOR EXIT

The majority of those surveyed are not preparing for the exit from their companies. This does not make the issue of exiting one's business go away; rather, it merely postpones the process. 48% of respondents said they have given their exit strategy little or no attention. Depending on the type of exit an owner seeks, this process could potentially take up to 10 years. Thus, without enough time or a viable exit strategy, many business owners will likely have to work longer than they would otherwise prefer. Delaying the exit process may have unintended consequences such as settling for a lower price for the company or having to close the doors permanently.

IMPORTANCE OF GROOMING A SUCCESSOR/DEVELOPING A BUY-OUT PLAN

Fortunately, many owners surveyed (60%) recognize that grooming a successor is critical to their ability to exit someday. This is important not only if the owner wishes to sell the business to the successor, but also if the owner wants to sell to an outsider. Outside buyers are looking for businesses that can be operated independently of the owner, and want to know that there will be someone competent to run the business when the owner leaves. A successor can create this credibility for new ownership. Not only do the

owners we survey recognize the importance of grooming a successor, but nearly half have begun the process, for which they are to be commended. Although there are many more steps to take in the process, they have started a step that greatly enhances the possibility of a successful exit someday.

Additionally, many owners (75%) in this year's survey stated that the lack of financing for purchase of the business by employees is an obstacle. This is an issue that should be addressed early on in the exit process. Securing or financing a buy-out plan could take up to 10 years or more depending on the financial situation of the employee(s) or successor(s).

SELLING THE BUSINESS IS ESSENTIAL TO RETIREMENT GOALS

Nearly all of those surveyed said that exiting their company is important or critical to their retirement planning. A majority of business owners (56%) also said that the current value of the business does not meet their retirement goals and therefore they have to work longer than they expected.

There are typically two scenarios in which owners will be able to meet their retirement needs. Either the current value of the company increases to a price sufficient to meet his/her retirement needs through a sale or buy-out, or the owner works until that time in which the value of the company grows to a point that will be able to meet his/her retirement needs.

RECOMMENDATIONS

Business owners need to ask themselves: “After all of the effort I’ve put into building my business, what will I ultimately be looking to get out of it?” Once this question is answered, factors like retirement age, family considerations and specific financial goals begin to take shape.

There are many tools to help individuals get into business, but few to help them get out. The exit planning process is a customized, comprehensive approach to designing a business owner’s successful exit from the business and incorporating unique personal objectives into realizing his/her desired outcome.

As we learned from our research, without an exit plan or strategy in place, the likelihood of maximizing financial return, minimizing tax liability, preparing for contingencies and realizing a successful transition from the business are greatly diminished. To mitigate the risk of a negative outcome, owners should also be saving and investing in assets outside their business to supplement their retirement and future cash flow needs. It appears owners are doing a good job in this area and we encourage them to continue this practice.

Further, owners realize the importance of grooming a successor to takeover the business someday. But they also need to begin developing financing arrangements for these employees so in order to realize an income stream that can supplement the owners’ retirement. With limited financing options, a buy-out and exit becomes increasingly difficult and usually mandates that the owner remain in the business until a buy-out becomes viable.

Since a successful exit usually takes time to complete (sometimes many years), owners should begin the process well before they expect to exit. To begin the exit process, owners should address key issues including:

For sale to family, partners or employees:

- Business valuation

- Implement or update buy/sell agreement
- Groom successor(s)
- Identify retirement income needs/goals
- Golden handcuffs for key employees
- Initiate stock programs to key executives
- Delegate owner responsibilities to management and employees
- Get pre-qualified for financing arrangement
- Structure buyout terms from successor or partners
- Communicate transition to key customers and vendors

For sale to outside parties:

- Business valuation
- Groom successor(s)
- Identify retirement income needs/goals
- Golden handcuffs for key employees
- Implement business growth strategies and cut expenses
- Delegate owner responsibilities to management and employees
- Prepare audited financials for the business for prior years
- Write a comprehensive summary of the business
- Consult advisors on how to structure the deal and potential tax exposure
- Identify the potential universe of buyers
- Be prepared for extended sale process (expect minimum of 6 months to 2 years to complete deal)

Business owners are busy running day-to-day operations and for many, their identity is so closely tied to their business, that it’s difficult to imagine leaving. For those reasons, many haven’t prepared for, or even contemplated, their exit. But delaying the process will typically increase the risk of not reaching a positive outcome. To preserve their options and equity, owners must remember that time is of the essence. They should not wait until they’re ready to leave to start exit planning.

RECOMMENDATIONS

No matter how long they've been running the business, the evidence is clear that owners should start the process earlier to map out their exit.

Engaging in the exit planning process early on, potentially 5 to 10 years before they are ready to exit, can help owners see their options, identify and resolve problems, get their business in order and ultimately maximize its value.

ABOUT TAX & FINANCIAL GROUP

Tax & Financial Group (TFG) is a leading financial services, planning and advisory firm headquartered in Newport Beach, California. Founded in 1970, TFG has offices throughout Southern California, as well as Hawaii, Colorado, and Texas.

TFG is comprised of over 120 individuals dedicated to assisting a successful clientele with the creation, management and preservation of wealth. Professional expertise includes:

- Financial Planning
- Business Succession Strategies
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- Investment Advisory Services
- Group Employee Benefits
- 401(k)/Pension Plans
- Retirement Income
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