STRATEGY

How To Know When It's Time To Sell The Family Business

In many cases, it makes more sense to sell a family business instead of passing it to the next generation to operate.

By Gene Rebeck
July 09, 2020

Brad Johnston wasn't necessarily looking to sell his business. But when he received an offer in late 2018, he was ready to accept it. But how would his family react?

Johnston had launched the Johnston Group, a Minneapolis-based boutique investment advisory firm, in 1994. The firm's fee-only approach has become commonplace these days, but it was considered pioneering back then, Johnston says. His clients were primarily top executives in public and private companies. By 2018, the firm's head count was 11, which included his wife, Maggie, two of their children, and a son-in-law.

Every family business arrives at the kind of crossroads the Johnston Group had reached. So how does the family decide which road to take? There are numerous family and financial factors that owners must consider before a sale can work to everyone's benefit.

Brad Johnston launched a Minneapolis-based boutique investment advisory firm in 1994.

A couple of years ago, Johnston recalls, "I recognized the evolving economy and the requirements for fulfilling our value proposition." His clients were requesting services beyond investment advice, including tax return preparation, insurance coverage, and trust services. Some of these services required a law degree, which Johnston didn't have.

Maggie Johnston and her husband, Brad, chose to sell their firm. A Kansas-based professional services business called Creative Planning acquired it in 2019.

He examined other companies that might serve as a model for transforming the Johnston Group. That's how he discovered Creative Planning, based in the Kansas City suburb of Overland Park, Kansas. "I found them to be the only firm in the country that, under one roof, had the ability to practice law, do tax returns, provide insurance expertise, provide investment management, and offer trust services," Johnston says. He met Peter Mallouk, Creative Planning's president and chief investment officer, and the two men hit it off. Soon the offer was on the table.

"We immediately had a family meeting to propose the opportunity to our children," Johnston recalls; the gathering also included offspring not working for the business. "It was a pretty unanimous vote that this was the right thing to do," he says. On April 1, 2019, the acquisition became official.

Why sell, and to whom?

During nearly five decades of practicing law, Bob Abdo has advised numerous family businesses. One thing he's learned: "No two families are the same." Abdo, executive vice president of Minneapolis-based law firm Lommen Abdo, says family dynamics can be mind-bendingly complex, and not every business owner wants to pass their company on to the next generation—nor does that generation necessarily want to take it.

Most people build up their businesses for their family, Abdo notes, and they'd also like the family to maintain the business after their death or retirement. Typically, they seek to pass it on to a family member or members whom they've mentored to assume leadership.

Bob Abdo is an attorney who says "no two families are the same" and family dynamics can be "mind-bendingly complex."

"But not everyone in the family has the same talents; not everyone is suited to be a leader or a business owner," Abdo says. Even in situations where different talents from different children contribute to the business, "they're not always in the position to be the head of the business," he adds. These owners may choose to have someone from outside the family run the business, while family members continue to be employed there.

All told, family owners need to determine their key objective, says Jon Flack, U.S. family enterprise services leader for tax, audit, and business consultancy PwC. The company advises family-run enterprises in Minnesota and nationally.

In some cases, the family might simply be open to a good offer. Other times, there might be a strong impetus to sell due to factors such as the lack of an heir. Or the business may be at a point where it needs "a lot more capital to transition to a new phase or to the new generation," Flack says. "And that capital may not be available to the family." In some cases, the family doesn't want to put more money into the enterprise.

Jon Flack is a PwC leader who works with family businesses. Some of them sell their companies because they lack the capital to move their businesses to the next phase.

If the family does decide to sell, the next step Flack advises is to assess what he calls "the buyer universe." Broadly speaking, there are two types of buyers. Strategic buyers are companies that operate in the same or a similar industry sector. Financial buyers are looking to acquire companies primarily as investments. "Generally, a strategic buyer will pay more [for a business] than a financial buyer [will]," Abdo says.

Flack notes that the type of buyer influences how the seller prepares the business for sale. "If you have a product or service that has very few competitors, the buyer universe may be much narrower than a business that has a broad competitive landscape," he says. And if the family business makes a product that's part of a vertical supply chain, that's likely to appeal more to a strategic buyer because it can maximize efficiencies through further vertical integration, Flack adds.

Getting ready to sell

Perhaps the most familiar species of financial buyer is the private equity firm. Those businesses often are led by savvy investors who can provide the companies they buy a great deal of support. They also are looking for a substantial return on their investment. They typically plan to sell their portfolio companies at some point to other buyers that will pay a premium.

But some financial buyers don't fit this general profile. Case in point is Encore One LLC, a Minnetonka-based investment holding company that is itself a family business. About 20 years ago, that family, whose core business is real estate development and construction, set up Encore One to diversify its assets.

“We represent a unique buyer in the sense that we’re owned in a family trust that can last for generations,” says Paul Moffatt, Encore One’s director of business development. “The companies we own, we can own long term.” (Moffatt, who has had an extensive banking career in Chicago and Minnesota, isn’t a family member.)

Paul Moffatt directs business development for Encore One, which acquires businesses to serve as long-term investments. Encore One leaves existing managers in place.

Encore One offers the option for family businesses that need or want to sell outside the family to a buyer that would keep the leadership and other employees in place, Moffatt says. “Unlike traditional private equity firms, we don’t have to fundraise,” he says. “We don’t run the companies. We really rely on management to do that. And we don’t intend to sell them.” Not surprisingly, Encore One takes a particularly careful look at the strength of a company’s management team before deciding to make an acquisition.

A strong management team “is going to enhance the transferability of the business” to outside ownership, says Dyanne Ross-Hanson, president and CEO of Woodbury-based Exit Planning Strategies, a consultancy that helps family businesses prepare for an ownership transition. The management team is one of the major “value drivers” Ross-Hanson identifies that can attract multiple buyers,

Dyanne Ross-Hanson is CEO of Exit Planning Strategies. She notes a company’s ability to attract multiple buyers hinges on the management’s quality, profitability, and a diverse customer base.

thus garnering a higher sale
price. Most of these drivers are generally just good business practices, she says, including factors such as historical profitability, audited financial statements, and a diverse customer base.

"The owners should consider a one- to three-year ramp-up, or more, to focus on and work on those value drivers," Ross-Hanson advises. "Discovering that one of these value drivers is weak during a negotiation with your buyer is absolutely the worst time to discover its importance." She believes that not addressing these weak points early on is one of the big reasons why fewer than 30 percent of businesses of all types that go to market end in a successful closing. Key managers, she adds, are the people responsible for monitoring and enhancing all the other value drivers.

Indeed, the family may wish to transfer the business to the managers themselves. But "there are a couple of primary challenges associated with that," Ross-Hanson notes. The first is gauging the talent capability of the management team. The best way to identify that is by conducting an assessment of their abilities and doing it as far in advance of a sale as possible. "If the team lacks any of the necessary skills to continue to grow the company, owners have the opportunity of filling in the weak spots, so to speak, before making the transition," she says.

An even bigger challenge: The managers may not have the money to fund the acquisition. "Nor do they often have the bankability to be able to garner outside capital," Ross-Hanson notes. The family also can address this problem, she says, with a well-designed key-employee incentive plan established long before the anticipated sale. An approach she advises is deferring at least 50 percent of the annual award bonuses given to managers to prefund a partial or total stock buy-in. Ross-Hanson advises establishing this plan at least five years before the planned transition.

Life after the business

Like many family business advisors, PwC's Flack helps his clients prepare for life after the deal. He advises clients intent on selling their business to undertake both estate and tax planning strategies. That might involve establishing a family foundation or investment office to manage the proceeds in ways that minimize the tax bite. "Planning for that needs to happen before the deal is completed in order to maximize all of the available options," Flack says. Most tax-advantaged strategies can't be created after the sale closes.

In sum, selling a business requires thoughtful planning. The sale of the Johnston Group has succeeded because the family did the deliberative work. Everyone at the firm was offered a job for one year after the sale and could then make the move to the Kansas City area if the job required it.

The Johnstons' daughter, Abby, chose to stay in Minnesota and left Creative Planning in February to work for a Twin Cities-based company. Their son, Ty, a wealth manager, and son-in-law, Kevin, chief marketing officer, continue to work for Creative Planning and have remained in the Twin Cities. Maggie Johnston retired Dec. 31. Brad Johnston has stayed with Creative Planning as a managing director.

"By being intentional, when an opportunity presented itself, we were able to make a clear decision because we saw the alignment between all of the interests of family, business, and ownership," Johnston says.

Covid-19 Delays Family Business Transactions

The Covid-19 pandemic has stressed just about every business. The novel coronavirus outbreak also is slowing family business transitions, according to Jon Flack, U.S. family enterprise services leader for tax, audit, and business consultancy PwC.

"Even if I run a family business that's really strong right now, and I'm open to acquisition, I'm going to proceed with caution," Flack says. Family-owned companies, he notes, tend to be more conservative than other businesses. Their leaders think long-term, they're very loyal to their employees, and they want to do everything they can to maintain their businesses and payrolls. This means that many of PwC's family-business clients are focused on keeping the lights on.

Flack says that many PwC clients have elected to reduce or eliminate dividends or other distributions to owners. Their goals are to preserve cash and keep as many employees as possible on the payroll. As always in a downturn, businesses are looking for ways to cut spending, such as on capital expenditures.

During the economic downturn, there's another option for family businesses to consider. "Debt right now is really cheap," Flack says. "The economy had been strong for most businesses. And if they haven't used debt to make acquisitions, what I'm seeing is that a lot of family businesses have good liquidity and unused debt or lines of credit, which they can use to help weather this."

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This story appears in the June/July 2020 issue with the title "Primed for Sale."