

EXIT STRATEGIES

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Outline of Presentation

- Transfer Stages
- Dividing Business Income
- Management Transfer
- Transferring Assets

Introduction

■ **Key Questions: Transferring the Family Business**

- Is the business large enough to productively employ another person?
- Is the business profitable enough to support another operator?
- Can management responsibilities be shared?
- What management skills does each person contribute?
- **Who should be allowed to join?**

Transfer Stages

- **Testing Stage**

- Wage Agreement
- Wage Incentive Plan

- **Commitment Stage**

- Younger generation begins to contribute property and management in addition to labor to the business.

- **Established Stage**

- All parties are fully engaged in management of the business.

- **Withdrawal Stage**

Dividing Business Income

- If everyone in the farm business owned a similar amount of assets, worked the same number of hours, and provided management expertise, business income could be split equally.
- Because this is often not the case, it is important to come up with a conceptual framework to divide farm business income.

Dividing Business Income

- If there is enough income to pay both resource owners and family employees, a contributions model can be used to divide farm business income.
- With this model, an annual contribution is computed and allocated to each party before splitting net income.
- Annual contributions are computed using the relative value of each party's contribution of resources to the farm business.

Dividing Business Income

▪ **Resources Owned by Each Party:**

- Labor and management
- Working capital
- Breeding livestock
- Machinery and equipment
- Buildings
- Land

Dividing Business Income

▪ **Labor and Management:**

- Value using typical wages for performing comparable work or the opportunity cost associated with other employment opportunities.

▪ **Working Capital:**

- Includes cash, accounts receivable, purchased inputs, grain inventories, and market livestock inventories.
- Value using a rate of return that would have been received from alternative investments.

Dividing Business Income

- **Breeding Livestock:**

- Value at its current market value.

- **Machinery and Equipment:**

- Estimate using a rental rate or cost of ownership.
- If the owner of the machinery pays insurance and repairs, economic depreciation and opportunity interest charge could be used to the value the annual contributions for each party.
- Example: multiply value of machinery and equipment by 15%

Dividing Business Income

▪ **Buildings:**

- Estimate using a rental charge or cost of ownership.
 - Grain bins: use survey information.
 - General purpose buildings: multiply value by 10%.

▪ **Land:**

- Use current rental values.

Dividing Business Income

Table 1. Annual Value of Contributions for Case Farm, Year 1.

Item	Younger Generation	Older Generation
Land	\$0	\$125,000
Buildings	\$0	\$50,000
Machinery and Equipment	\$15,000	\$135,000
Breeding Livestock	\$0	\$0
Working Capital	\$5,000	\$25,000
Labor and Management	\$60,000	\$45,000
Sub-Total	\$80,000	\$380,000

Dividing Business Income

▪ **Important Notes:**

- Annual contributions are made before net income is split between parties
- Need to update the annual value of contributions every year to account for changes in working capital, and machinery and equipment, buildings, and land ownership.
- When dealing with a younger generation and an older generation, what typically happens is the annual contribution of the younger generation increases over time.

Dividing Business Income

- **What happens if there is not sufficient income to pay all of the resources?**
 - This is not an easy question to answer, which means that it is important to plan for this event!
 - In years with low income, it would make sense to have a hierarchy with regard to which resources are going to be covered first, second, third, etc. This hierarchy would likely vary among farms. However, it would make sense for labor and management to be the first resource covered. Any resources that are not fully compensated could receive extra compensation in subsequent years.

Transferring Business Management

- Transferring business management between generations is one of the most critical steps in transitioning the business from an older generation to a younger generation.
- Having said that, in numerous instances, this step is given little thought.

Transferring Business Management

- In the discussion below, I assume that the two parties can work together and that the business is large enough to support two generations.
- This means that the older generation is ready to bring in a new generation and begin turning over management, control, ownership, and income; and that the younger generation is committed.

Transferring Business Management

- For a multiple generation business to be successful, the parties need to agree on the future direction of the business.
- In other words, the parties involved need to share a common vision of their future together in farming.
- One of the ways to come up with this common vision is to explore the goals and objectives of the relevant parties.

Transferring Business Management

- Goals are broad and general statements of what an individual or business wants to achieve.
- Objectives are precise and quantifiable measures related to how you will achieve your goals.
- In addition to having an impact on management transfer, goals and objectives impact how business income should be divided between parties and how property will be divided between the younger generation coming back to the farm and off-farm heirs.

Transferring Business Management

- **Why is it so important to discuss goals and objectives?**
 - **We are dealing with family and business!**
 - **Contrast between the two systems:**
 - Family is inward looking; business is outward looking
 - Family avoids risk; business embraces risk
 - Family focuses on emotions; business focuses on work
 - Family seeks stability; business seeks change
 - Family does not count cost; business tracks cost

Transferring Business Management

- Even before the younger generation returns to the farm, it is imperative that both the younger and the older generation think about what skills the younger generation is bringing to the operation.
- We often want to hire individuals that are like us.
- In a small business, hiring someone that is like you or bringing in a family member that has a similar skill set is problematic.

Transferring Business Management

■ **Management Skill Questions**

- What experiences does the new person need?
- How are you going to teach them what they need to know?
- How will this change my job and other jobs in the business?
- What do we expect from the new person?
- What will they be responsible for?
- What authority will they have?

Transferring Business Management

▪ **Decision-Making Authority**

- The key is to find a decision-making structure that develops the younger party's managerial ability while protecting the parent's financial interest or desire for control.
- Two general structures:
 - General manager
 - Equal voice

Transferring Business Management

▪ **Division of Management Responsibility**

- Business arrangements are often more effective if the daily management responsibilities are divided between the two parties.
- Management specialization often results in better decision making. Division is often based on individual interests and skills.
- Dividing management responsibilities reduces disagreements between the parties and promotes the development of the young person's management skills.

Transferring Business Management

▪ **Division of Management Responsibility (continued)**

- **Enterprise Division**

- Crop decisions for a single tract or landlord
- Livestock decisions for a single barn or pen

- **Functional Division**

- Marketing
- Financial records and analysis
- New technology

Transferring Business Management

- **Transfer of Management Checklist**
 - Finance
 - Marketing
 - Personnel
 - Production

Transferring Assets

▪ **Asset Categories**

- **Current Assets**
- **Machinery and Equipment**
- **Buildings and Grain Bins**
- **Land**

Concluding Comments

- The slides above discussed important concepts related to transfer stages, dividing business income, transferring management, and transferring assets.
- The concepts are not difficult to understand!
- **That being the case, why is the process so difficult?**

Critical Success Factors

- **Are the parents ready for a partner?**
- **Is the younger party committed?**
- **Is the business large enough?**
- **Can you live and work together?**
- **Are there non-business children and how will they be treated?**

Financial Management Series

Web Site:

<https://ag.purdue.edu/commercialag/home/resource/2020/10/financial-management/>