Bank of Ireland

Growth Finance Expertise

Transfer of Family Business

Business Banking

Family businesses are the keystone of the Irish economy, notable family firms include the Musgrave Group, in family ownership since 1876 and Flahavan's, in family control since 1785.

Introduction

75% of Irish SMEs are family-owned businesses, as compared with 60% of all firms in most nations, employing seven out of every ten people in the private sector in Ireland.

2016 PWC research of 100 Irish family businesses shows:

- 42% will use bank finance to scale versus 63% globally, while 13% will use external equity versus 35% globally.
- 41% plan to hand the family business onto the next generation.

These findings point to opportunities for Irish family businesses to look beyond their own resources to fund growth and transfer to the next generation.

At Bank of Ireland we have over 230 years of experience helping Irish family businesses grow. We recognise there are particular financial and personal considerations when transferring a family business. Having an appropriate funding structure is an important part of ensuring the business and family (including those who may not want an active role in the business) can reach their potential. In this overview, we discuss what the key considerations are for a bank funded family business transfer / buyout, with reference to recent Bank of Ireland funded transactions.

A common scenario is where parents wish to exit the business or farm to release value to fund a pension in a tax efficient fashion and a child chooses to buy out the shareholding of siblings.

The purchase / transfer of shares in a family company typically takes the following form:

- **Cross-Purchase Agreement:** Remaining shareholders purchase the shares from the selling shareholder or the selling shareholder's estate directly.
- **Redemption Agreement:** The company rather than shareholders buys the shares.

Borrowing to fund the transfer can be done through the existing company or through related entities, depending on the level of current borrowings of the business and / or tax planning strategies of the involved parties. It's strongly recommended that a business seeks professional tax advice and consult the latest Revenue advice on the available reliefs.

Why Bank of Ireland?

Relationship

- 85 skilled Business Banking Relationship Managers in our retail network
- Supported by the Sectors and Transaction Support teams

Delivery

- Record of delivering funding for family buyouts across all sectors
- Confidence in credit terms offered

Sector

- Team of sector experts recruited from industry with real 'hands on' experience
- Relevant sector insights and benchmarks to inform value added customer dialogue
- Support the application through the credit process

Transactions

- Team skilled in structuring credit proposals
- Mix of credit and lending experiences

Bank of Ireland for Family Transfer

Bank of Ireland delivers funding for the next generation to become owners across all key sectors. We know that a successful bank funded family transfer relies on building a relationship, understanding your family, business and sector while structuring the transaction to help ensure the success of the business and harmony of the family.

Bank of Ireland Funded Family Transfers

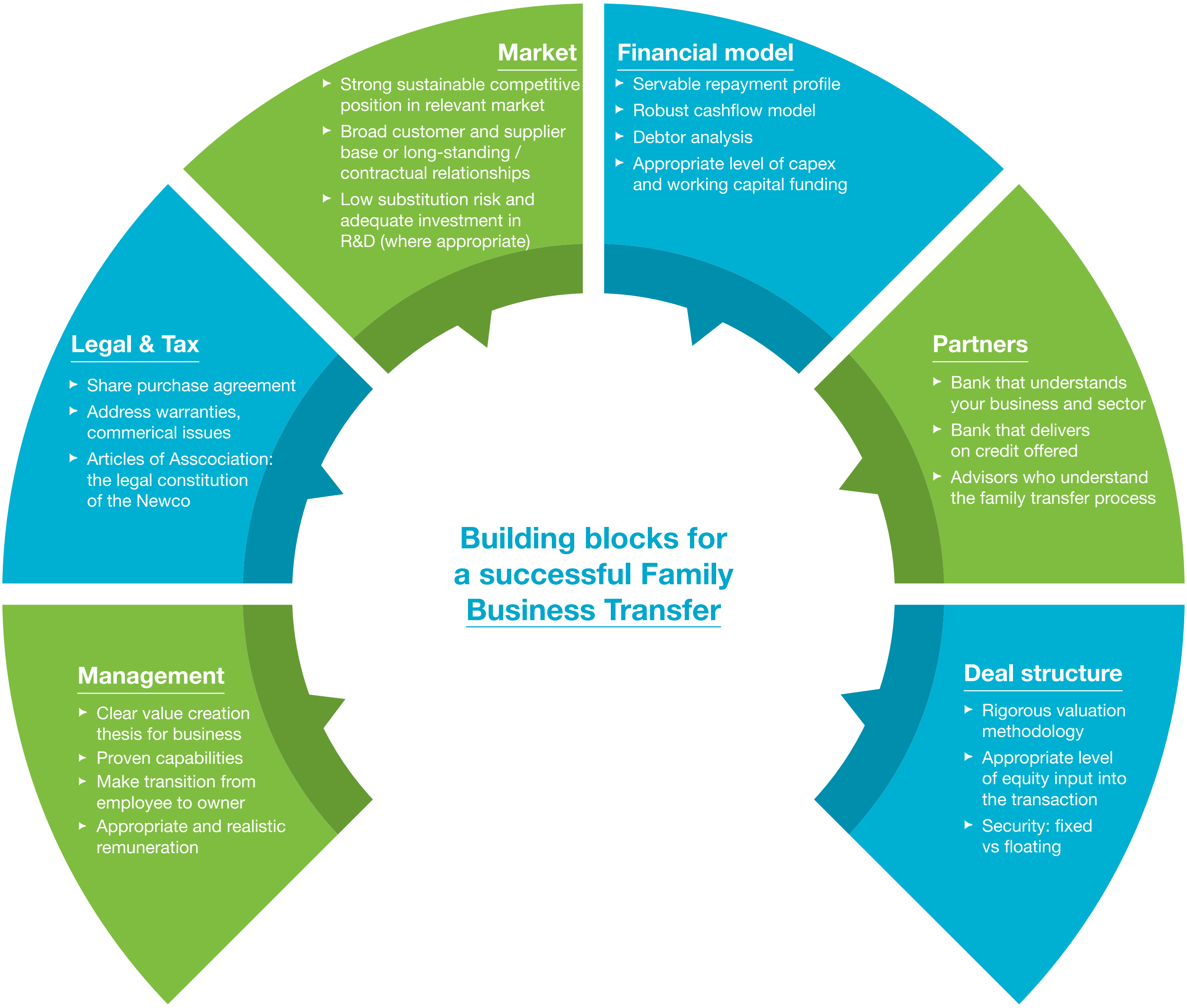
The following are recent Bank of Ireland funded family transfers and the metrics applied.

Background	Facility	Purpose	Metrics	Security
Farming business	▸ €417k x 15 years ▸ €40k overdraft ▸ €20k stocking loan x 7 months ▸ €78k loan x 9 months re farming grant	▸ Acquisition of 2 farms (from father & uncle) along with normal working capital / stocking facilities	▸ 1.24x Debt Service Cover ▸ 60% LTV ▸ 5.7x Debt / EBITDA ▸ 5% equity input	▸ Legal Charge over two farms acquired ▸ Life cover
Retail convenience store	▸ €4.5m term loan ▸ €100k overdraft	▸ Refinance of existing debts and transfer of business into ownership of the next generation	▸ 1.26x Debt Service Cover ▸ 5x Debt / EBITDA	▸ Fixed and Floating Debenture with charge over trading premises ▸ Element of Wholesaler Guarantee ▸ Keyman cover ▸ Partial Personal Guarantee
Manufacturing business	▸ €4.25m term loan ▸ €150k overdraft	▸ Acquire 100% of business from father through a new holding company structure	▸ 1.9x Debt Service cover ▸ 2.7x Debt / EBITDA ▸ 30% equity input	▸ Fixed and Floating Debenture incorporating charge over company premises ▸ Keyman cover ▸ Partial Personal Guarantee
Retail convenience store	▸ €2.1m term loan ▸ €2.9m term loan	▸ Two children acquired 90% of a store each from their parents who retained 10% shareholding in both businesses	▸ 1.39x Debt Service Cover ▸ 4.96 Debt / EBITDA ▸ 1.65x Debt Service Cover ▸ 4.45x Debt EBITDA	▸ Fixed and Floating Debenture incorporating charge over trading premises ▸ Life cover ▸ Partial Personal Guarantee

A review of these transactions shows that there is no ‘one size fits all’ for funding a family business transfer. Our relationship managers take the time to understand your business and work with you to deliver the optimal funding model.

Building Blocks For Succesful Family Business Transfer

From our experience of funding family transfers, discussions with professional advisors and a review of international research, the 'building blocks' of a successful family transfer are discussed below.



Family

Planning: A lack of planning can be a barrier to a successful family business transfer. Half (49%) of Irish family businesses have no succession plan at all and only 14% have a plan that is robust, documented and communicated (PWC). For the business, family and key stakeholders, including funders, it's important to map out the future of the business.

Key considerations are:

- Are a number of family members involved in the business?
- Are they suitable to run the business going forward?
- Control could be given to one family member, but the value split equally between all family members?
- Will ownership be restricted to family, can it be gifted or freely sold to non-family members?
- What shareholding / corporate structure supports the succession plan?
- What are the views of key stakeholders i.e. employees, customers, suppliers and funders?
- Where more than one family member is involved, should some dispute framework, such as a shareholder's agreement, be in place?
- What is the founder's role post transfer?
- What will be the board composition?
- Does the family have a banking partner that understands the business and its sector with demonstrated ability to fund successful family transfers?

Business

Strategy

The new management need to articulate in detail a strategy how they will generate value from the business. Strategy will need to take account of:

- How to maintain and grow core competencies that determine success in their chosen market?
- How will the business grow (organically and / or acquisition)?
- How will expansion be funded?
- What are the key products and geographic markets?
- What is the competitive landscape over the short to medium term?
- What are the key trends / technological forces?
- What is the businesses approach to stakeholders (employees / customers / community)?

Metrics

Often what drives the performance of successful family businesses is attributed to the founder's intangible 'know-how'. This intangible know-how needs to be mapped to a set of processes, metrics and financial reporting that ongoing performance can be measured against.

Structure and Advisors

Businesses with agreed formal governance structure with a board and set of external advisors are better positioned to scale and attract the best talent than those that don't. While there are costs involved, a family buyout is a transformative personal and professional experience, so it is important to pick advisors that understand the family dynamic,
the business itself and the legal and taxation process.

Successor

As with any funding proposal, the quality of the management team is paramount. The incoming family management team must demonstrate to the key stakeholders in the business (customers, employees, suppliers and funders) that they have the ability to drive on the business. The successor and business should consider the following in the years before the handover:

- Does the successor have a personal development plan?
- Find and use a suitable mentor or coach for the successor.
- Identify opportunities for skills development, e.g. turn-around situations, start-up situations, handling employee performance problems.
- The successor should gain experience outside of the business.
- The successor should develop their profile independent of the owner's e.g. by joining local groups and industry associations and attending relevant seminars.

Founder & Tax Considerations

Tax plays a very significant role in a family business transfer. It is important to be familiar with the latest provisions of the key schemes outlined below and to consult with professional advisors.

Capital Gains Tax (CGT)

Applies to the tax on the increase in value of assets while these assets were in the hands of the person now considering transferring them. The tax applies only for the person who owns the asset and is about to transfer it.

Capital Acquisitions Tax (CAT)

Is a tax that targets the person receiving the assets via a gift (lifetime transfer) or via an inheritance (on death). So unlike CGT, CAT could apply where assets pass by lifetime transfer or on a death. The tax is levied on the received benefit and the tax liability is calculated based on the total value of the benefit on the date that it is received.

Tax reliefs apply (subject to conditions) from Capital Gains Tax where interest in the business is transferred.

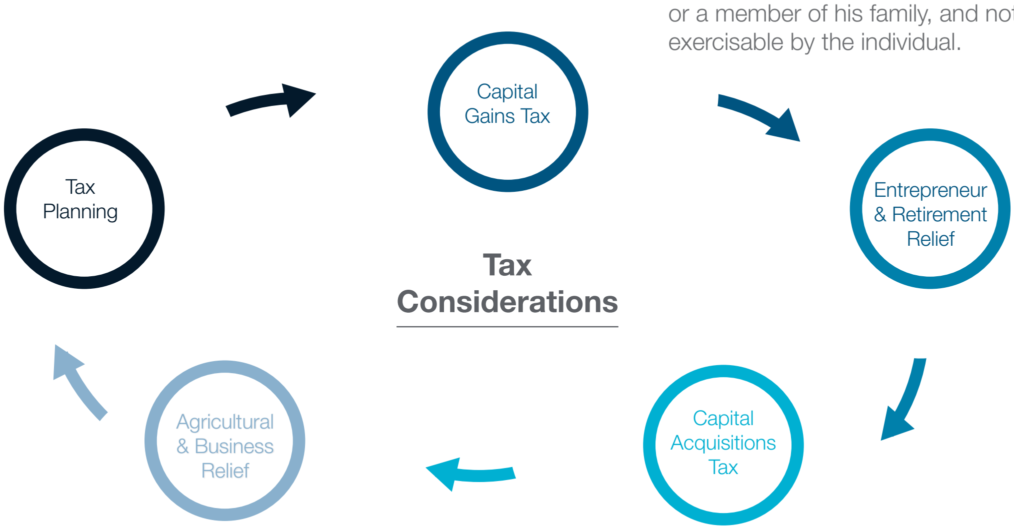
As of 2017, the following tax reliefs are available on the transfer of a business.

Capital Gains Relief for Family Transfer

- **Retirement Relief:** Business or farming assets are relieved from CGT where the person disposing of the assets is aged 55 or over and had owned and used the asset for the ten years prior to disposal. The operation of the relief differs as between persons aged 55 to 65 and persons aged 66 and over[1].
- For individuals aged 55–65, the relief applies to assets valued up to €750,000 on disposal where the assets are transferred outside the family. Where the disposal is made to a 'child' of the transferor, there is no monetary limit to the relief.
- For individuals aged 66 years and over disposing of a business or farm assets outside the family, the consideration limit is €500,000. For individuals aged 66 years and over disposing of a business or farm assets to a child, or to a nephew / niece who has worked full time in the business / on the farm for the previous five years, the relief can be claimed up to a consideration or value limit of €3 million. If the child disposes of the asset within six years, Revenue will withdraw the relief. The child must pay CGT on the original disposal, in addition to the CGT on their disposal.
- 'Family company' means a company where the voting rights are:

  (a) not less than 25 per cent, exercisable by the individual, or

  (b) not less than 75 per cent, exercisable by the individual or a member of his family, and not less than 10 per cent, exercisable by the individual.



[1] http://www.revenue.ie/en/gains-gifts-and-inheritance/transfering-an-asset/cgt-reliefs-disposal-of-a-business-or-farm.aspx

- **CGT Entrepreneur Relief:** Budget 2016 introduced a revised CGT entrepreneur relief. It provided that disposals of qualifying business assets (in most productive businesses but excluding those involving dealing in land or holding investments) by qualifying individuals are charged at 10% up to a lifetime limit of €1 million in chargeable gains. To qualify, among other conditions, an individual must own at least 5% of the business and have spent a certain proportion of their time working in the business as a director or employee for three out of the previous five years, prior to disposal.

Capital Acquisitions Tax Relief for Family Transfer

- **Agricultural Relief:** Available to the recipient of defined agricultural property, the relief reduces the taxable value of the property, including land, by 90%.
- **Business Relief :** Also available for up to 90% of CAT, business property is defined as a business, or interest in a business, land, buildings, machinery or plant used solely for the business purposes of the company.

Pension Planning:

Another important area to consider during succession planning is the adequacy of each director's pension fund. An ongoing tax-efficient manner of transferring company wealth into personal wealth for a director is via a director's pension scheme. The Revenue Commissioners allow companies to offset significant pension contributions for tax purposes against corporation tax. Bank of Ireland has a wide range of pension solutions so it's worth discussing as part of a broader funding strategy with your relationship manager[2].

Shareholders' Agreement:

It is a contract between some or all of the shareholders in a company. The purpose is to detail how the company is to be managed and proactively address issues that might cause conflict. Shareholder's agreements are distinct from company constitutions which are public documents registered with Companies Registration Office. Common features of a shareholder agreement are:

- **Voting rights:** There are certain requirements in the Companies Acts which provide that certain decisions require a majority vote (51%) e.g. a decision to increase the authorised share capital of the company, whereas other decisions require a 75% majority vote e.g. alterations to a company's Memorandum and Articles of Association or a change to a company's name.
  A shareholders' agreement can provide additional protection in relation to key decisions for the company, such as strategic acquisitions or borrowing facilities, and decisions to pay any dividend or make any distribution to the members of the company. This can be achieved by including a clause in the shareholders' agreement which provides that these and other decisions will not take effect unless they are agreed on by a certain percentage, such as 75% or even 90%.
- **Dividends**: It is common to include in a shareholders' agreement a provision whereby a certain amount of the profits of a company must be declared and paid out in each year by way of dividend.
- **Board Meetings:** It is common in shareholders' agreements to provide that a certain number of scheduled board meetings will be held at regular intervals and will be convened on a specified period of notice. It is to be accompanied by an agenda and board papers.
- **Information Rights:** A shareholder who is not a director has very limited rights to receive information which is not much more than a right to receive the accounts which are to be laid before the annual general meeting for approval. Accordingly it is important, particularly for minority shareholders, to include a right to receive information concerning the conduct of the business.
- **Transfer of shares:** A shareholders' agreement can include provisions governing the transferability of shares to either impose restrictions or to allow for the type of transfers that would be permitted. The rationale for these provisions involves the following:
  - **Control:** provisions can rule that certain transactions may not be undertaken without the consent of a specified shareholder. This allows the shareholder to maintain control and protect his / her investment.
  - **Preventing outsiders from becoming shareholders:** provisions can oblige shareholders not to sell their shares to third parties without first offering them for sale to the existing shareholders or to the company at a specified price.

Share Purchase Agreement:

The share purchase agreement (also known as an SPA or sale and purchase agreement) is the principal contractual document in a share acquisition. The share purchase agreement will set out all the terms of the transaction, including details of the company being acquired and the respective parties' obligations in connection with the transaction.

Valuation and Price:

In the scenario where family members are buying out siblings, determining a fair price can be a complex and challenging process. While valuing any company is not an exact science, there are three methods employed:

- **Market based valuations:** Method of determining the appraisal value of an asset based on the selling price of similar items or companies and adjusting accordingly for the asset in question.
- **Net Asset valuations:** Value of an entity's assets minus the value of its liabilities.
- **Discounted cash flows:** Future free cash flow projections discounted to present value estimate.

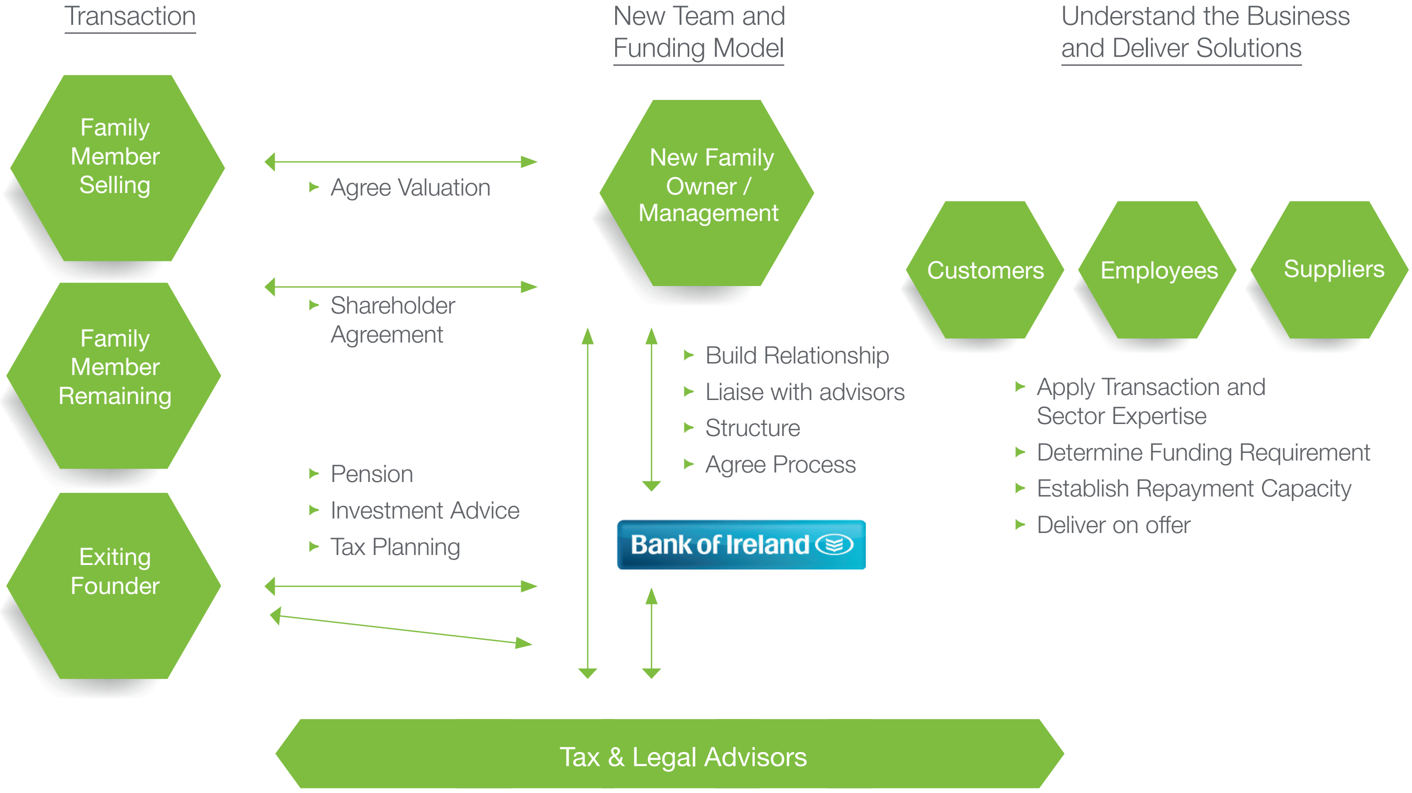
Obtaining an independent valuation of the business and its assets can help reduce conflict and give a bank a degree of comfort when appraising a funding proposal.

[2] http://www.revenue.ie/en/gains-gifts-and-inheritance/cat-exemptions-and-reliefs/business-relief/what-is-relevant-business-property.aspx

Funding Model

There is no 'one size fits all' funding model for a family business transfer. In the diagram below, we outline a scenario where children are purchasing the shares of the exiting founder and other family shareholders.

Bank Supported Family Transfer



Role of Advisors:

Family transfer with a management buyout or 'Fambo' involves correct application of accounting and legal considerations. Professional advisors can help to identify issues proactively and structure the business for success. In the scenario outlined below, one child is buying out the exiting parent and one sibling's shareholding, while another sibling is retaining a shareholding in the business.

Phase 1

- Family has agreed the new ownership / management structure
- Debt requirement to enable equity release
- Meet with Bank and advisors
- Outline of transaction

Phase 2

- Analysis of business and market
- Develop cash flow model
- Determine legal structure to enable borrowing

Phase 3

- Due Diligence
- Negotiation
- Credit approved Offer Letter
- Legals
- Drawdown

Financial Plan

- Aside from deciding on the overall amount of debt it is also important that the debt is structured appropriately.
- Detailed planning and sensitivity analysis are essential in ensuring there are no surprises going forward.
- Bank of Ireland provides a range of business finance products that can be combined to deliver the right mix for your business. One such product is Invoice Finance, a flexible and increasingly prevalent funding tool that releases the value inherent in your trade debtors, often your biggest asset. Funds may be released from the debtor book at an early stage, to assist in the purchase of the business and also to provide an ongoing source of working capital.

When putting together an appropriate structure, it is important to consider the following:

- Cash flow is the most important factor and it is of crucial importance that the next generation has a detailed understanding of projected cash flows. Profit generation is important, but capital expenditure, depreciation, interest, dividends and other factors such as restructuring costs come into the equation, making cash generation the key driver of valuation.
- The 'quality' of the cash flows is another consideration, which includes the predictability of future orders (backlog), the prospects for the marketplace, and the types of customers. The higher the quality of the cash flows, the more debt a company should be able to raise.
- Depending on the nature of the company's trade there may be certain periods when expenditure exceeds income. Likewise, the timing of tax payments and outflows may dictate when the company will be short of cash in certain periods. When determining an appropriate structure it is important to plan for these fluctuations.
- In general, at least some of the bank debt will need to be secured by assets held by the company. In addition to the projected cash flows, the bank will also consider the realisable value of the assets it will take security over.

Appendix

Glossary

Articles of Association:
The legal constitution of Newco.

Enterprise value:
The debt-free value of a business equivalent to the business valuation plus the level of debt to be absorbed by the purchaser.

Fixed or floating charge:
A legal mechanism whereby security over the assets of the business is granted.

Goodwill:
The difference between the price which is paid for a business and the fair value of its assets.

Newco:
A new company formed to effect the buy-out by acquiring the operating subsidiaries.

Senior debt:
Debt provided by a Bank, usually secured and ranking ahead of other loans and borrowings in the event of a winding up.

Subordinated loan:
Loans which rank after other debt. These loans will normally be repayable after other debt has been serviced and are thus more risky from the lender's point of view.

Retirement Relief:
Capital gains tax retirement relief is a relief from capital gains tax (CGT) available to individuals who dispose of all or part of the 'qualifying assets' of their business. The qualifying assets could, for example, include business assets used in a trade (such as premises, goodwill or farming land) or family company shares.

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