The Challenge

This past year has been a difficult one for business owners seeking an exit. Is this the recession, or a reflection of a longer term reality? The answer, it seems, is that exiting business owners will need to engage a new reality for the foreseeable future.

According to an article published by Robert Avery of Cornell University in February 2006, “the majority of boomer wealth is held in 12 million privately owned businesses, of which more than 70% are expected to change hands in the next 10 to 15 years.” Only a portion of these businesses will successfully cash out, because of a fundamental oversupply of sellers.

Key Mistakes Sellers Make

Business owners make a mistake when they allow too little time to complete a properly executed exit strategy. Another mistake owners make is focusing on the price while disregarding the terms and structure of an exit transaction.

Other key mistakes business owners make in exiting their companies are:

- selling to the (only) competitor who approaches them
- not using experienced advisors (hoping to save transaction costs)

Characteristics which Appeal to Buyers

If the fundamental laws of risk and reward prevail, only the least risky and most profitable businesses will change hands successfully. With buyers focusing on businesses which represent good investments capable of operating with little or no dependence on their owners, the following characteristics will be seen as desirable:

- Businesses which have scaled beyond a total dependence on the owner
- proprietary products, services or processes
- strong, remaining management
- defensible, differentiated market position
- stable, diverse customer base
- recurring revenue business model
- business growth (opportunities)
- strong operating margins
- manageable business risk

Buyers of middle market companies don’t buy jobs for themselves in the way that small business buyers do, they “invest” with the expectation of a return commensurate with the risk. Nothing enhances a buyer’s perception of value more than:

- evidence of sustainable growth
- a capable management team as the key to managing the risk

The Business owner who engages professional advisors, plans thoroughly, and negotiates to ensure that the wealth transfer mechanism chosen most closely delivers on his goals, is the business owner who will have executed the optimal exit strategy.
quality business and accounting systems
audited annual and timely internal monthly financial statements

1. Defining the Exit

Exiting is more than selling
Exit Planning is a process involving the development and execution of a series of systematic steps taken to allow both the owner and the “accumulated wealth” to be extracted from the business, via one or more of the numerous available strategies, including:

- Selling the business to partners, strategic buyers, investors, competitors, international buyers, or the public
- Recapitalizing the business for partial liquidity
- Merging the business to achieve enhance valuation and/or marketability
- Transferring the business to family, management or employees
- Gifting the business to meet personal and/or tax planning goals
- Liquidating or partially liquidating the business

Exiting is a process, not an event.

The Optimal Exit will be achieved through the implementation of a managed process which includes:

- Establishing a business valuation reference point
- Clarifying “Life-after-Business” goals
- Working with a team of specialist advisors
- Preparing a written plan
- Identifying and evaluating the applicable alternative strategies (options)
- Executing any necessary positioning or preliminary strategies
- Executing the selected exit strategy

Exiting is a complex subject with many moving parts. No single advisor is an expert in all aspects, so the process should involve inputs from a team of experienced advisors, and should address the possible need to re-position the business before going to market.

2. Setting Goals

Clarifying the Endgame
The Exit Strategy begins with the M&A Advisor providing a likely range of the pricing, terms and structure expected from a sale in the current market. The Financial Planner or Wealth Manager then develops a plan to invest the after-tax wealth extracted from the business to meet lifestyle and life-after-business goals.

For the majority of business owners, this newly liquidated business wealth will constitute a meaningful portion of the total wealth driving the financial, tax and estate plans. The key, then, to beginning the exit planning process, is to clarify the endgame, taking into account the likely value of extracted business wealth.

- Legacy Goals – what will have been your contribution?
- Lifestyle and Life-after-Business Goals – what do you want from the next phase of your life?
- Estate Planning Goals – how will you ensure that your estate passes to your heirs in the most tax efficient way?
- Exit Strategy Goals – based on all of the above, what are the priorities to be met by your selected exit strategy as to risk, time, wealth and income?

3. Selecting a Team

Play the “A” Team
The M&A Advisor should assemble and coordinate a team, including existing advisors where applicable, that will ensure:

- access to all appropriate options and opportunities
- being fully informed as to the merits and demerits of proposed strategies
having expert counsel and representation
The team must include the necessary
knowledge, skills and experience in
Mergers & Acquisitions, Corporate Law,
Taxation and Financial Planning/Wealth
Management. It may also include
specialists in ESOPs, insurance, personnel
and business consulting disciplines.

4. Writing a Plan

Planning Precedes Execution
Business owners should not expect to exit
successfully in the next 10 years without
figuring out how best to exit and what
preparatory steps should be taken. … and
should not assume they can wait until they
are “ready”.

While the critical execution phase will not
be a problem for most take-charge
entrepreneur business owners, the planning
for an exit will be foreign to them as
exiting has never been their purpose. Their purpose
has been to create and build, and to
consider the exit (if at all) a retreat.

The M&A Advisor should coordinate a
collaborative team effort to prepare a
written Exit Plan incorporating a valuation
of the business, a statement of goals and
objectives, a review of alternative strategies
(options), an analysis of the gap between
the goals and the options, and strategies for
closing the gap.

5. Reconciling Goals and
   Options
Once one has established an indication of
the Expected Wealth Transfer (the after-
tax proceeds from the business exit) on the
one hand, and an estimate of the Targeted
Wealth Transfer (the wealth transfer
required to provide the personal life-after-
business goals) on the other, the business
owner and the exit team must now
reconcile the two before selecting and
implementing an exit strategy.

Whether or not the expected and targeted
wealth transfer values are the same, the
owner should review all exit options, and
should also evaluate a number of
Positioning Strategies for execution prior
to implementing an Exit Strategy.

Reconciliation or Closing the Gap is an
iterative process of evaluating comb-
inations of positioning and exit strategies
that will yield a release of wealth (the
Expected Wealth Transfer) compatible, as
to quality, time, value and certainty, with
achieving the specified goals and the
associated Targeted Wealth Transfer.
Closing the gap may also involve
modification of the Targeted Wealth
Transfer.

Again, notice that there are two key points
of inflection for matching the exit with the personal goals:

1. The ability to vary the value, timing
   and certainty associated with
   extracting the business wealth
2. The ability to vary the timing, risk
tolerance, estate wealth, living
   standards and other variables
   inherent in the personal goals

A key issue business owners face in
considering Positioning Strategies is the
very central question of the risk – reward
paradigm. Positioning strategies cannot be
executed entirely without risk, but
manageable risk strategies may deserve
consideration if they serve to better ensure
that the business wealth will be delivered in
the context, amount, time and certainty
needed to meet the identified personal
goals.
6. Positioning Strategies

Corporate Value Enhancement
The team should look at the corporate structure and governance mechanisms to consider whether the business is optimally positioned for the intended exit. For instance, an asset sale from a C Corp could result in tax obligations at both the corporate and the individual levels. Conversion to an S Corp may be advantageous, but the tax benefits vest over an extended period of time.

The make-up of the Board and any Advisory Board may also have an impact on the value perceived by a buyer. Management strength is considered below.

From the standpoints of scale, product or market diversity, management strength or any number of others, the business may benefit from a combination with or consolidation into another business prior to its sale. Alternatively, it may be desirable to spin-off one or more non-synergistic or non-performing divisions to increase profitability or allow greater management focus.

Business Value Enhancement
Business value enhancement strategies generally influence valuation because of their perceived impact on risk, growth or profit margins. At the top of many buyers’ lists is the need to see a strong, experienced and motivated management in place. For financial buyers, this often includes the need to be assured that management has skin in the game, typically an equity interest.

Improvements in profit margins are strongest when they are reflected in trailing (historical) earnings. More recently effected changes, or even planned changes, can also influence valuation, however, if the benefit of the changes can be quantified and demonstrated. Because of the multiplier effect built into earnings-based valuations, a $1mm earnings improvement may increase the valuation by, say, $5mm.

It doesn’t seem entirely logical that an exiting business owner would have unexplored opportunities available for making improvements to the business. It’s a little like living with an outdated kitchen and upgrading just before selling the house. As in the real estate analogy, the stakes are higher at the time of exit, and the focus on marketability and valuation greater, so these opportunities often do exist.

Other business value enhancement strategies include:
- Reviewing and revising the revenue and/or business models
- Implementing product / market enhancement plans
- Expanding and diversifying the customer base
- Securing title to patents and intellectual property
- Commissioning of financial and operational audits
- Strengthening or upgrading of systems and procedures
- Documenting or codifying contractual relationships (employees, vendors, customers, debt)

Business Marketability Enhancement
If growth opportunity, managed risk and strong margins are the foundation for building value enhancement strategies, then clarity, transparency and certainty are the engines which drive marketability. Business performance is clearly reported and accounted for, activities and status are transparent to the buyer, and all information portrays a level of certainty about the future.
Experienced buyers know that completing acquisitions is a time-consuming and expensive exercise. Buyers will perceive greater clarity, transparency and certainty, and therefore be more motivated to engage, when the seller has:

- Audited financial statements
- A business plan with a clearly defined growth path
- An in-place sector-experienced management
- Current market metrics and analysis

**Multi-Step Liquidation Strategies**
Reference is made above to the risk-reward paradigm. This fundamental reality plays out in ways too numerous to mention, including strategies elected by business owners to both take cash off the table to reduce risk/exposure as in a re-cap, and assume reasonable risks for an enhanced valuation as in an earn-out structure.

Consider:

- The lowest price is an all cash price (not often available in today’s market)
- Waiting before selling is risky
- Participating in an industry consolidation or roll-up increases the risks and uncertainty of an exit, but potentially enhances marketability and yields a greater valuation

A classic two-stage exit is accomplished by means of a re-capitalization in which an investor / partner / buyer acquires part of the business with an expectation to either buy the rest of the business or to market the business in cooperation with the remaining owner at a later time and at a greater valuation. The owner takes some chips off the table, but retains a stake, and usually continues to participate in management.

Merging the business into one or more other businesses before exiting can lead to increased marketability and even an improved valuation sometimes referred to as **multiple bump**. Consider a $20mm revenue business with earnings of $3mm which commands a valuation of $15mm (or a 5 multiple). Combining that business into a $100mm business with earnings of $15mm and which commands a valuation of $90mm (a multiple of 6), now values the original company’s participation at $18mm, and the consolidation strategy has yielded a $3mm valuation gain.

**Transaction Structuring Strategies**
Every step along the complex path of executing an exit strategy demands access to advice from professionals who have been there and who know the opportunities and the pitfalls.

Even though the structuring of the exit transaction comes toward the end of the process, structuring is included here as a positioning strategy because it impacts the value of the Expected Wealth Transfer.

Key structuring considerations include:

- Considerations of risk and reward
- Tax considerations
- What incomes and expenses are included (i.e. belong to the transacted business)?
- What assets and liabilities are ex/included
- What pre-transaction liquidation, settlement/exclusion opportunities exist?
- What relationships between buyer and seller arise? (employment, advisory, landlord, supplier, partners, etc.)
- Documenting or codifying contractual relationships (employees, vendors, customers, debt)

The majority of middle-market businesses bought and sold derive their valuation, at least in part, from cash flow or earnings. The very key question then arises: “What assets and liabilities are essential to and an integral part of the ongoing enterprise, thereby supporting the established earnings flow?”
7. Exit Strategies

The business owner should have his M&A Advisor prepare an analysis of the fit and applicability of each of the exit strategy options to the stated goal and objectives. Not all options will fit every business or every set of goals.

Key qualifications for individual strategies might include:

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<th>Buyer</th>
<th>Qualifications</th>
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<td>Merge</td>
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<td></td>
<td>To Employees *</td>
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<td>Liquidate</td>
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<td>Modest or negative return on assets</td>
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* Specific qualifications must be met as preconditions to accessing the designated tax benefits.

Benefits of a Planned Exit

The primary purpose of approaching a business exit in a systematic, goal-focused and planned way is to dramatically increase the likelihood that the outcome will be optimal to the stated goals.

The employment of a team of professional and experienced advisors will add a cost of, say, 3% - 6% of the wealth transferred, but will potentially add considerably more value by:

- mitigating against a failure of the mission
- dramatically expediting the mission
- Intermediating the process to eliminate the risks associated with direct negotiations between principals
- increasing the negotiated value of the mission
- reducing the income tax burden
- helping to reconcile the Expected Wealth Transfer to the Targeted Wealth Transfer

… not to mention providing the knowledge and human resources to navigate a complex and time-consuming labyrinth of decision making and task execution.