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A **Structured Financial Partners** White Paper

Exit Planning after the Great Recession
*Advance actions business owners must take to drive value and
exit their companies successfully*

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Executive Summary

Business owners will all, one day, leave their companies. When and how they do and to whom they sell is an open question.

It is impossible to say what segment of society was hardest hit by the collapse of the credit markets and the recession that followed. Business owners, approaching their desired retirement age, however, may have caught the negative trifecta. These owners not only found their real estate and stock portfolio values decimated, but in most cases, their business values dropped sharply as well. This meant plans for retirement have had to be reformulated.

Those owners, who had hoped to sell companies in 2009, 2010 or 2011, are likely to put off selling until profits improve and prices bounce back to what the seller deems to be a reasonable level.

As baby boomers continue to reach traditional retirement age, we anticipate there will be a glut of businesses on the market in the next ten years. This abundance of supply will likely keep downward pressure on prices and will assure that only the best run, best prepared companies will command top dollar.

In this paper, we will discuss actions business owners should take now to increase the value and marketability of their companies whether selling to their co-owners, management team, family members or third parties.

The Eternal Problem

Business owners don't like to plan. And with the economic meltdown, many owners have been focused on short-term survival tactics rather than long-term exit strategies.

Baby boom business owners do not have the luxury to delay planning.

With the oversupply of companies we anticipate on the market over the next ten years, a business owner **must** plan, or risk reducing the number of options available.

Business owners and buyers look at a company from completely different perspectives. When an owner is running his or her company and it is running smoothly, he sees it as successful in terms of income, benefits and lifestyle. Income is easy to measure. Benefits are all those little items that don't show up on the W-2. It is common for business owners to pay for cars, travel, entertainment and other lifestyle expenses that can be shown to have some business purpose.

The buyer analyzes the business differently. He wants to see a reliable and growing stream of income. Buyers see the operation. Is there value in the people...in the systems and procedures? Will the business run without you and continue to yield a steady stream of profit?

The Ongoing Problem

According to Business Brokerage Press, roughly 25% of all US businesses are for sale at any time and 50% or less actually sell.

There are a number of differences between those that sell and those that don't. In the recession and early recovery market, the biggest roadblock is unrealistic seller expectations. In the smaller business arena, where a business broker is handling the sale, there are qualified buyers looking to buy, but they feel the businesses they see are overpriced. With larger businesses, where M & A firms handle the transaction, if the owner has unrealistic expectations or if the company is simply not positioned to fetch top dollar in this difficult market, the M&A firm is likely to turn down the engagement, instead suggesting the owner focus on growing the value of the company before selling.

The Solution—enhancing the business with Value Drivers

For most businesses a buyer is going to look at EBITDA (Earnings before Interest, Tax, Depreciation and Amortization) as the primary measure of profit. Everything else about the business must support a consistent and growing stream of profit.

We call items that support profit growth *value drivers*. Some are specific to individual industries, but some are universal, such as:

- Operating systems and controls
- Financial systems and controls

- Growth Plan
- Diversified customer base
- Depth of management team

These are critical areas which need to be addressed well before any planned transition. Doing so prior to the owner's transition will make the company more efficient, more profitable and more enjoyable before the sale. Let's look at each Value Driver in more detail.

Operating Systems and Controls

All buyers want a business which will continue to grow under new ownership. Too many owners retain valuable business information in their heads. It is critical the owners get this knowledge out of their heads and into written, transferable systems.

This systemization includes both computerized and manual processes designed to track customers, sales, expenses, employees, marketing and new client acquisition, as well as those metrics specific to your industry. These procedures and controls create a platform which will ensure that a business will run more smoothly and that employees can be cross-trained. A buyer will have a greater level of comfort knowing that the business will continue to operate seamlessly under new ownership and that the systems provide the tools necessary to generate a growing stream of revenue and income.

Financial Systems and Controls

In order to sell your business as a going concern, buyers will want to see proof of prior financial results. Operating systems and controls are the backbone of sales and profitability. But, financial systems and controls allow you and a buyer to see documented consistency in financial results.

We occasionally meet an owner who proudly tells us that he does a substantial amount of business “off the books.” While this may reduce tax liability in the short term, it makes the business very difficult to sell at a price the owner thinks is reasonable. Buyers have one question about revenue and profit—“*can you prove it?*” The simple answer is, “If you cannot document it, you won’t get paid for it.” Most businesses sell for a multiple of EBITDA. So is the short term tax savings worth sacrificing your long term goal of selling for top dollar?

There are five basic levels of financial documents you might show to a buyer. They are, in order of usefulness:

- Internal Financial Statements Prepared by your in-house accounting staff for your own internal purposes and won’t be looked upon by the buyer with any confidence.
- Tax returns These, of course, are filed with the government, but everyone knows they are prepared to minimize tax liability. Tax documents are of very little value to the buyer in

assessing the true value of a company.

- Compiled In compiled financial statements, the financial data has been assembled by a CPA but not reviewed for accuracy. The preparer must issue a disclaimer which states that he or she is not rendering an opinion on it. Compiled statements are subject to less rigorous standards than reviewed or audited financials do not provide a buyer with a great deal of reliable information.
- Reviewed A review is less extensive than an audit. Review procedures provide a basis for expressing limited assurance that the accountant did not become aware of any material changes that should be made to the financial statements. In a review, the accountant must be familiar with the company’s business and the accounting practices of its industry, allowing the accountant to have a reasonable basis for expressing some assurance that there are no material modifications that should be made.
- Audited An audit is the “gold standard” of financial statements. It is a methodical and objective examination of accounts and items that support the financial statements of the company. It requires the CPA to study the accounting systems

and evaluate the risk of misstatement from error or fraud. An audit also requires the CPA to test the books and financial records to see if they are producing reliable financial data. Unlike a review, an audit requires the CPA to check numbers against source documents, confirm balances or other information and trace transactions through the records. An audit is more work and provides a greater degree of assurance that the financial statements are fairly stated in accordance with generally accepted accounting principles.

In the three years prior to leaving their businesses, we normally counsel our clients with \$10 million + in annual revenue to have at least reviewed financials. If their companies are over \$20 million, we recommend audited financials. While audits are expensive, buyers won't pay top dollar for a company whose financial statements they don't believe. The business can get sold without the audited financials, but often at a lower price.

Diversified Customer Base

In assessing opportunities for sales growth, there are two basic areas to focus on--increase sales with existing customers and increase the number of customers. Too often owners choose the easier path—focusing on established customers, because customer acquisition is time consuming and expensive. But lack of diversification is risky. What would

happen if your single largest customer one day dropped you? How would you withstand the loss?

It just makes good business sense over the life cycle of your company to continually examine all ways to expand your customer base. But with a transition looming, this becomes even more critical. It has been a theme throughout this paper that buyers are looking for sustainable earnings with growth potential. If just a few clients generate 40% or more of your revenue and profit, this lack of diversification represents a risk for which they will discount their offering price—or not buy at all. A buyer looks at the risk/reward scenarios when considering a purchase. If there is a similar business for sale where the revenue is less dependent on any single client, that buyer will likely pay a premium for that business over yours.

To address this issue, a buyer may make an offer in which the purchase price is contingent on several factors including customer retention. If you sell your business to a third party, how much of your financial future is tied to a business you no longer control? By mitigating this issue **before** you sell, you can be in a better position to negotiate better terms at the time of sale.

Growth Plan

Every business has a story. How you started, how you have grown, how you plan for any and all contingencies and how you plan to exit. When you go to the bank to get a line of credit or raise money through debt financing, you need to tell your story with both numbers (financial statements) and words (growth strategy). And when you are ready to sell your business, whether to insiders or third parties, there is a story to be told. The better the story, the better the price and terms...

Having a written growth plan in the years immediately prior to your exit--one that you can share with prospective buyers--will add value to the business... The plan doesn't have to be long, just a few pages, but it must clearly define and address questions such as: *What additional markets will we pursue? What segments of the current market offer the most growth potential? What additional products can we deliver to the same customers? Where are our best margins and how can we deliver more in that product area?* It must also contain the steps to be taken in order to implement the plan. And most important of all, the plan must be attainable. Setting unrealistic goals can only lead to failure and a breakdown in your company's growth.

Your growth strategy is critical to making the business what you need in order to exit on your financial terms, no matter the exit path you choose. And it is also an important part of the value calculation for any business. Having a well thought out **and** implemented

growth plan allows a buyer to see that the plan is set in motion and will be a template to follow under new ownership.

Depth of Management Team

One of the biggest transformations a company can make is changing from being **entrepreneur lead** to being **management lead**. Too often, we meet business owners who proudly tell us, "I am this business." We know this attitude depresses the value of the business **and** it does not bode well for a successful and profitable transition out of the business.

For your business to grow, it needs to outgrow you. It needs to operate without you, otherwise, what exactly is a buyer acquiring? It is critical to surround yourself with a team of people whose skill sets complement yours and help create the path to a smooth and successful exit.

To develop a management team we like to think of this process as the three R's—**Recruit, Reward, Retain**.

- **Recruit** Finding the right people to fill key management roles is not an easy task. Sometimes the people in these roles have risen to higher levels of responsibility than their capabilities warrant. It is difficult to think about repurposing these people, but if your business isn't running optimally you are doing both yourself and them a disservice. Identifying the positions of responsibility is the first step.

Defining the traits of the person to fill the positions is the second. Only then can you begin to search both in your organization and outside to find the appropriate talent.

- **Reward** Now that you have spent the time and energy identifying the members of your management team, it is critical to put in place an incentive compensation plan which rewards this group of people as the company grows. These plans take various forms but will include cash, stock or stock equivalents and may have both immediate and deferred awards. No matter what form the plan takes, it must be consistent, documented and provide a meaningful amount—often 25% to 100% of base compensation. Triggers used to determine payout must align Key Employee performance with the company's strategic objectives.
- **Retain** Many owners make the mistake of valuing their equipment more highly than their key people even though their people are delivering the profits. A strong and stable management team is a large part of the value calculation of your business. In the years leading up to your sale, this team will be critical in the growth of your company. You can put in place all the plans to strengthen other value drivers, but without a team in place to execute those plans, you risk failure. By including a "golden handcuff" feature to

your incentive compensation plan, you not only reward your team financially, but also tie them to the company. Well designed golden handcuffs make your key employee incentive awards contingent on long term employment. If they walk away from you, they walk away from a large amount of their accrued incentive comp.

Your management team is an important component of what is acquired when your company is sold. Their training, motivation and compensation should be seen as a strategic investment that will pay tremendous dividends.

Management Team as Potential Buyers

Not all owners want to sell their companies to third parties. Others may find that after testing the waters, they may not want to go into the M & A market. For these owners, having built a strong management team, they will have prepared for their own succession and exit. A management buyout can be rewarding for the owner if structured carefully, providing tax benefits for both seller and buyer.

Conclusion

More business owners than ever will be looking to transition out of their companies in the next ten years. There will be many opportunities for business owners to sell their companies to qualified buyers, but to get the attention of those buyers, an owner must engage in an exit planning process that will focus on value driving activities in the three to five year period prior to the sale.

About the Authors

Steven R. Craig began his career in financial services in 1983 and founded his first company, Craig and Associates, in 1991. After growing the firm to 19 employees with locations in Los Angeles and San Diego, Steve sold it in 1999. He then accepted an opportunity to be groomed as the next president of a major eastern life insurance company. When that company was acquired, Steve returned to Los Angeles and in 2004, he and Susan founded Structured Financial Partners.

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Susan Laine spent more than 20 years as an investment banker with once prestigious firms including Citicorp Investment Bank, AIG Trading and AIG Risk Finance, advising CFOs, Treasurers and other senior finance executives in the Fortune 500. Her deals included “one-of-a-kind” financial solutions to managing all manners of risk that affect the value of a business.

Armed with her MBA from UCLA and her investment banking experience Susan took over the reins of a family-owned business and prepared her first exit plan for her parents. She can be reached at susan@sfparkers.net