VALUATION

This Way to the Egress: What Business Valuators Need to Tell Their Clients as They Create Their Exit Strategy

By Paul Visokey, CBI, CVB

There is no denying the Baby Boomer Generation (people born from 1946 to 1964) have made a significant impact on society. From infancy on, Baby Boomers have changed perceptions on everything from childrearing to retirement. In general, these changes have helped boost the economy of every decade since the end of WWII. And now, the Boomers are about to have another impact, although this one may not be so positive. It has been likened to an Age Wave Tsunami and it is heading our way.

According to the U.S. census, since 2011,[1] 10,000 people in the U.S. turn sixty-five each day. Couple that with research that tells us the majority of businesses are owned by people age fifty-three and over. In a 2014 survey conducted by Pepperdine[2] University, sixty-five percent of businesses sold in Q1 2014 were owned by Baby Boomers, and sixty-seven percent of business owners want to retire in the next ten years. In other words, Baby Boomers selling their businesses is a trend that is already underway and only expected to intensify moving forward.

According to Christopher Snider, president and CEO of the Exit Planning Institute (EPI), Boomers probably will not be able to sell their businesses when they are ready because they are not taking critical steps toward a transition or toward getting the full value of the enterprise. EPI estimates that some 4.5 million firms representing more than ten trillion dollars in business value will transition over the next decade or so, but Snider believes only about twenty to thirty percent of businesses that go to market end up selling. This estimate is consistent with BizBuySell's most recent national report, which indicated about one of every five listings on the online marketplace for small business sales and purchases had closed a sales transaction in 2016.[3]

For business owners—Baby Boomers or not—this looming economic wealth market transfer crisis presents both a threat and an opportunity. The crisis, of course, is will they see a profit when they are ready to transfer their business to another owner? The opportunity occurs when a business owner starts the planning process. With proper planning and the appropriate advice, business owners in transition can capture and retain the wealth they have generated within their business. It can help them find the capital needed to close the transaction. But, surprisingly, many business owners do not take this critical step. By the time a business owner feels ready to make the transition, he or she has missed the opportunity to critically evaluate their business and take steps to maintain and keep the value of their business relevant. This article will discuss some of the steps you can take with your clients to help them understand the need for careful planning and ultimately, creating a team of experts to enable them to enact a successful exit strategy.

WHY IS THIS HAPPENING?

Before we delve into how you can help your clients ride this wave, we first need to discuss why this perfect storm is amassing. There are three major forces at work impacting business owners:

The Market Cycle

The economy goes in cycles. Currently, we are experiencing a robust bull market, which favors sellers. But, like all market

1 U.S. Census, The Baby Boom Cohort in the United States: 2012 to 2060, Issued May 2014, P25-1141, by Sandra L. Colby and Jennifer M. Ortman, Current Population Reports, Population Estimates, and Projections.

2 Pepperdine University, Large Percentage of Baby Boomers Bought and Sold Businesses in Q1 2014, October 23, 2014, bschool.pepperdine.edu/news/2014/05/large-percentage-baby-boomers-bought-and-sold-businesses-q1-2014/

3 Mary Ellen Biery, Study Shows Why Many Business Owners Can't Sell When They Want To, February 2017, Forbes.com.

cycles, this momentum will not last forever. At some point, the market will make a downward turn, and buyers will be in a strong position. Markets in decline often mirror the demands in the ascendancy, meaning, the higher they go, the lower they fall. This market has been unprecedented over the past eight years. Eventually, after a crash, the market starts to rise, but there is no predictable time frame for a turnaround.

The Number of Businesses for Sale

Baby Boomer business owners are not the only potential sellers. Companies owned by private equity firms—roughly 7,000 + companies—are also available for sale at any one time. Additionally, business owners who are ten years younger than the youngest Baby Boomers are also in the market and will be seeking capital for growth initiatives. These facts add up to a host of competition for retiring business owners. It will serve to drive the prices of businesses down.

Lack of Capital

There is not enough funding to satisfy all the sellers looking to transition. If every business owner in the Baby Boomer demographic were to sell their business, the amount of capital required to close all those transactions is over ten trillion dollars. Currently, the private equity available to complete these transactions is roughly $535 billion.[4] This amount will be able to handle about ten percent of the deals offered for sale in the next decade. Private equity fundraising cannot keep up with the demand. The lack of funding will make buyers very selective, and only the A++ deals will get done—and even those will have reduced purchase price multiples.

PLANNING TO SUCCEED: WHY A ROADMAP TO THE EXIT RAMP IS IMPORTANT

Most business owners fail to realize they have to plan for the sale of their business. According to recent statistics,[5] only twenty to thirty-three percent of businesses complete the sales process. A study conducted by ROCG, a company that specializes in business transitions, showed eighty-four percent of the respondents to their survey indicated that the proceeds from their transactions were essential to their future life style security.

According to the same study, fifty-eight percent of all business owners do not have a formal plan. Among the reasons given for this lack of planning were:

- Too early to plan
- Too time-consuming
- Too complex
- No adequate advice
- Do not want to deal with family/employee issues
- Too intimidating

THE STEPS TO CONSIDER WHEN EVALUATING OWNERSHIP TRANSITION

Successful ownership transition is a process. It requires skills and behaviors that may feel counterintuitive. It forces business owners to ask themselves a series of hard questions that go to the emotional, personal, and business aspects of their world.

Step One: Determining Personal Goals

It is not enough for a business owner to want to sell their business at a certain point. A business owner needs to clarify what that means to them. In speaking to your client, you want them to reflect upon the following:

- Do I want a clean break, or do I want to be part of the organization I built?
- Is there a family member ready and willing to succeed me or should I look for an entirely different buyer?
- How much money will I need to pursue my goals and take care of my family once the business is sold?
- Am I retiring or moving on to something else?
- What is my potential "sell by" date?

These are essential questions and require some thought.

As your client begins to evaluate and weigh their options for their business, you should make them aware that their situation can change. The earlier they start this process, the more options will be available to them.

Step Two: Establishing Business Goals

When you can help your client think through how they envision their future, a client in transition can achieve clarity in viewing their business as a means to an end. Once this has been accomplished, you, as the advisor, can help your client weigh the various options.

The first thing a business owner should consider is how their business can be sold. There is rarely only one option open to a motivated seller. While it is far from simple, most business owners have more options than they realize. Here are the most common types of sales options:

4 Exit Planning Institute, http://exit-planning-institute.org
5 ROCG NORTH AMERICAS, Exit Planning Survey, 2011, http://exit-planning-institute.org

Outright Sale

This approach is the simplest way to exit a business and makes the most sense when the owner's family members are not interested in taking over the business, or the owner just wants to move on. There are two ways to cash out:

Stock Sale

An owner can sell the company's assets outright, or he can sell his stock in the company (or units if it is a limited-liability company). Stock sales tend to benefit the seller.

Asset Sale

An asset buyer purchases the company's physical equipment, facilities, and customers. The buyer also purchases intangibles such as trademarks and goodwill. In an asset sale, a buyer is protected against prior claims against the business. Usually, the sale of small, closely-held businesses is an asset sale.

The next option concerns to whom do you intend to sell the business. Potential buyers can come from surprising sources. They can be your employees, customers, suppliers, or competitors. While people buy businesses for a variety of reasons, they fall into two groups: strategic buyers and financial buyers.

Strategic Buyers

Strategic buyers are interested in how your business compliments their existing business. These buyers could be one of your competitors or the owner of a more substantial business who wants to enter a new market or offer a new product. These buyers are willing to pay a little more for a good fit with their long-range plans.

Financial Buyers

These buyers are interested in your company's profitability and stability. They could be companies or individuals with money to invest. Some will want a stable, well-managed company that requires little oversight; while others may look to buy a business they can tweak to turn a profit.

KEEPING THE BUSINESS IN THE FAMILY

If this is a goal, you need to consider who the qualified family members are and their willingness to continue the business. The challenge is to keep the needs of the business first, not just your personal goals or the wishes of family members. You do not want to create a permanent job for a family member; you want to determine if this serves the long-term needs of your business. Learning if your family members can own and lead the business into the future is the most challenging aspect of this option.

SELLING THE BUSINESS TO KEY EMPLOYEES

The owner may also want to reward loyal employees who have made significant contributions to the business' successes. This option requires a long-term plan. It also requires understanding the qualifications of the employee or employees hoping to succeed you. There are other risks involved as well. You need to consider the employee(s) ability to obtain financing, and the ability of the deal to go through. You want to minimize the risk of losing key employees in the event a deal does not go through. (see sidebar)

KEEPING LIQUIDITY AND BECOMING A CAPITAL PARTNER

If this is your client's business goal, an equity firm can be the appropriate partner to help take the business to the next level. The economics of the business may allow the current owner to gain some liquidity and still provide him or her an opportunity to share in the growth of the value of the business. A private equity firm typically wants to own a business for a five-to-seven-year period. In choosing this option, the business owner is committed to the business for that time, after which the final sale of the business will be completed.

Which option a business owner chooses depends upon the nature and health of the business and the owner's intentions as to staying with the company or moving on. Understanding all the options, and getting good advice from experienced business professionals, can make it easier to pursue the plan that best meshes with the exiting owner's plans and goals, and the needs of the potential buyer.

Once a business owner has established his or her goals, it is time to create an active, viable plan. This plan can be revised should their objectives change, but the critical component is that the plan needs to be in writing and cover a variety of topics.

DEVELOPING THE STRATEGY: POSITIONING A BUSINESS TO SELL

Most—approximately eighty-seven percent[6]—business owners do not have a documented transition plan. The reasons for this lack of formal planning are, in most cases, understandable. In the case of a new business owner, establishing a new company is far more important than looking at the endgame. Ownership transition requires careful planning and thinking. It also needs the help of a team of experts. Transition planning is not a DIY project. While some business owners can act as their own facilitator or quarterback, most cannot. In most cases, the expertise of

6 *Ibid.*

CONSIDERING AN ESOP

If the owner is willing to receive fair market value rather than a strategic value, an employee stock ownership plan, commonly known as an "ESOP," may provide a practical exit strategy. An ESOP strategy has several advantages that are unavailable with alternative transition strategies.

In the March 2015 issue of *Business Law Today* www.americanbar.org/publications/blt/2015/03/02_hearn.html), Sharon B. Hearn, a partner at Krieg DeVault LLP in Carmel, Indiana, writes:

An ESOP is a type of qualified retirement plan similar to a profit-sharing plan, except that an ESOP is required by statute to invest primarily in shares of stock of the ESOP sponsor. Unlike other qualified retirement plans, ESOPs are specifically permitted to finance the purchase of employer stock by borrowing from the corporation or selling shareholders. ESOPs are, therefore, not just tax-qualified retirement plans, but also tools of corporate finance.

The tax benefits of the ESOP exit strategy accrue to the selling shareholder, the corporation, and the employees who participate in the ESOP. The tax benefits to the selling shareholder and corporation vary depending on whether the corporation is taxed as an S corporation or as a C corporation.

Employees participating in an ESOP also receive favorable tax treatment. As in other tax-qualified retirement plans, tax on amounts allocated to participants' ESOP accounts is deferred until distribution of the participants' accounts.

One advantage of selling to an ESOP is the creation of a ready market for the business owner's stock, providing a buyer for the business when there is no other readily apparent buyer. Because the ESOP provides a market for the shares, the marketability discount applied when valuing shares in an ESOP is typically only five to ten percent. In addition, an ESOP permits a business owner to gradually transition ownership over an extended period of time, allowing the business owner to remain actively involved in the corporation. This is particularly helpful, for example, if the business owner desires some liquidity but is not yet ready to sell 100 percent of his or her ownership interest. The owner can sell a minority interest in an initial transaction and sell his or her remaining ownership interest in later transactions.

Many owners would prefer to sell their businesses to the next level of management, but rarely do these individuals have the funds to acquire the business. A partial or full sale to an ESOP allows the business owner to get the desired liquidity without selling to a competitor or other third party. Senior managers can be rewarded through equity-based performance plans. In addition, although ESOPs are broad-based plans that generally provide a retirement benefit to all of the corporation's employees, shares are typically allocated to participants' accounts in proportion to their relative compensation, which will generally result in the more highly-compensated management employees receiving larger ESOP allocations.

As an advisor, you can help your client determine if the economics work for both sides before entering into the legal aspects of an actual transaction. If successful, this can be a satisfying option for owners who have prepared their personal financial situations to allow them to take the inherent risk.

an outside party, who has or can gain an understanding of the business owner, the business, and all the stakeholders, is needed. This is a key point to make to business owners who are considering a transition—you need a team and someone who can help you coordinate the activities of that team.

The Pre-planning Stage

Preparing to sell a business takes many years of preparation. It is a good idea to advise your client to create an exit strategy team. Your job is to explain to your client or prospect that there is nothing simple about exiting from a business. It is usually complicated; a business owner needs an internal and external team charged with tasks from knowing the value of the business, to getting all the business accounts in order, to arranging legal documentation, and evaluating tax implications.

Another pre-planning step is the creation of a succession plan. A succession plan lays out what will happen in the event of a change of ownership. It includes:

- A consideration of who will replace the owner and other key employees—if and when—the owner or they leave
- Determining how key employees will be replaced
- Establishing what the involvement of the current business owner with the company will look like if he or she choose to stay on and how they envision it working

Business Challenges to Consider

There are some exit planning challenges all business owners need to consider before establishing their strategy.

What is the Value of the Business

The primary goal of anyone ready to transfer business ownership is making sure there is value in the business. Building value in the context of exit planning means knowing:

- The current value of the business. Guesses and estimates about a company's value can only hurt a business owner's exit strategy. As an advisor, your job is to help your client understand the company's current worth. Be prepared, however. Most business owners assume their life's work is valued higher than the current market will support. The business owner needs a realistic picture of where they are today, so they can better prepare for tomorrow.
- The amount the business must achieve to allow the business owner to reach his/her lifetime income and other exit objectives. An owner needs to ask and answer hard questions about how lavishly or simple their post-exit lifestyle will be. Without an accurate and realistic assessment of their goals, business owners will find it difficult, if not impossible, to implement a plan.
- The tactics the owner needs to employ to close any gap between the current value and the value necessary upon exit. First, a business owner needs to determine how significant the difference is between current and desired business value (the value gap). Next, the owner needs to decide how far he/she must go within a specific time frame. For example, the business owner needs to look into the future and determine a point at which his or her daily involvement is not crucial. To accomplish this, the owner must determine how to enable the business to operate successfully without his/her involvement by creating a stable and highly-skilled management team. The owner must also understand and use the current financial information to track and alter company performance. And, finally, an owner planning an exit strategy needs to be able to collect, interpret, and use the data necessary to monitor progress toward his or her goal.
- The most efficient (tax and otherwise) way to transfer the business. Exit plans filter value-building through the lens of the IRS. Business owners routinely use every legal strategy and tactic to manage taxes while they are growing their business. The same concepts apply when exiting a business. The best course is to use knowledgeable advisors who can help mitigate the tax burden on both the current business owner and the eventual buyer.

HOW TO BUILD VALUE

Building value is among the key things any business owner must do to keep a business viable for the long haul. Owners need to build value for a variety of reasons: to be more profitable, improve growth, and to develop or maintain organization within the business. Business owners also look to build value when they are ready to exit a business. The last strategy requires some careful, strategic planning, as well as an understanding of the challenges facing the business and its owner.

KNOWING THE VALUE GAPS

Business owners who are ready to sell their business are frequently surprised that a value gap exists. Worse, they are reluctant to invest any resources into bridging these gaps. These gaps exist regarding:

- The timing of "buyer's vs. seller's markets"
- What a seller needs and what a buyer is willing to pay
- The schedule of a seller's desire to sell vs. the differing perceptions of both parties of the risk in the future growth and earnings flow of the business, among others

Business owners can be extremely optimistic when they are ready to sell. Often, a business owner will assume the buyer will correlate the owner's efforts with the businesses value. Meaning the business owner equates his or her "sweat equity" with actual equity. A buyer does not put the same value on the hard work of the seller. This perception can hurt the seller. By not appreciating these gaps exist and how long it will take to bridge them, the business owner who is hoping for a quick, lucrative sale is in for an unhappy surprise.

THE DRIVERS AND INFLUENCES OF BUSINESS VALUATIONS

Business owners need to be continuously measuring and improving critical value drivers of the business. The better case they can make for good future earnings potential, the stronger the valuation. The key to this is regular internal due diligence regarding these drivers.

Buyers and sellers obviously see a business differently. The buyer is looking at the value he or she can get out of it; the seller recognizes the value he or she put into it. Knowing

what parameters drive value, what buyers are looking for, and taking the steps that increase the business valuation are key. Business owners should take this diagnostic action on a regular basis, but it is especially critical for someone who is interested in selling their business within two to five years.

Business owners need to know:

- The current value and likely growth rate of the business. It is never too soon to begin managing a business with a valuation in mind. To help with this, owners should have an accurate understanding of cash flow.
- Knowing the current cash flow and what the business can generate in the future, serves an integral part of the overall enterprise value. It tells buyers if the business will be a good investment. It includes metrics, such as: return on assets, returns on equity, return on investment, and a score of other parameters that track the performance of the money invested in the business.
- If a company has a positive cash flow, a multiple of earnings before interest, taxes, depreciation, and amortization (EBITDA) is a standard measure of value. If the business has a negative cash flow, valuation may be calculated as a percent of the market value of the assets, net of liabilities, or the liquidation value of the business. These financial parameters set the baseline for the initial determination of value.
- The metrics used to value businesses. Potential buyers place different parameters on how they determine the valuation of a business. Understanding these metrics will help an owner manage their business for maximum valuation when they are ready to sell. An essential valuation will consider a number of factors, including: revenue, historical and projected EBITDA, revenue stability, margin percentages, return on assets, growth potential, location/target markets, and customer concentration. Secondary drivers of valuation include: financial controls, asset quality, revenue concentration, owner dependency, competitive landscape, asset turns, staffing deficiencies, material and equipment demand, quality control, facilities, regulatory issues. Other potential drivers of valuations include: personnel turnover, training, local talent pool, operations systems, payroll, percentage of sales, legal issues, certifications, and licenses.
- The selling time frame. If an owner is looking to sell a business within a two-to five-year time-frame, the most important emphasis should be on achieving overall financial improvement.

CREATING AN EXIT STRATEGY ROADMAP FOR YOUR CLIENT

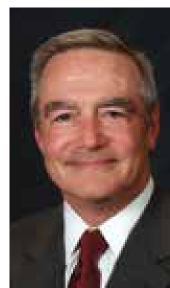
In most cases, a written business plan should outline an individual's personal exit strategy as well as his/her business exit strategy. Although creating an exit strategy is a business decision, it also has private implications. Leaving a business opens a new chapter in the owner's life, whether they are planning to travel, retire, start another business, or begin a new adventure. Their finances need to be in order. In terms of business accounts, owners in transition should review the following:

- Simplification and documentation of processes
- Selling off non-core businesses
- Collecting accounts receivable
- Paying off debts
- Removing any entanglement between your finances and those of the business

Sketching out how they plan to leave the business, reap its value, and ensure its ongoing vitality under new ownership is an important first step in guiding the final chapter of your client's involvement to a positive conclusion.

CONCLUSION

The bottom line in building value is to remember that buyers will always look for deficiencies in the business. These deficiencies result in perceived risk. Being able to address these issues confidently will justify a stronger valuation. The role of the advisor is to help the business owner understand the steps he or she needs to take for a successful transition, guide him or her in keeping track of the steps needed for a successful business transfer, and, ultimately, to help the business owner create a plan. VE



Paul Visokey, CBI, CVB, is an expert in building and leading sales and marketing organizations in startup environments. He used this experience to start the Stony Hill Business M&A firm in 2010. Mr. Visokey is the president of the firm and is a senior business broker intermediary focusing on Bucks County PA and New Jersey Counties—Mercer, Hunterdon, Monmouth, and all counties north. He has the detailed knowledge required to assist business owners with their exit planning strategies. E-mail: paul@stonyhilladvisors.com