Exit Strategy – Selling a Business

Developing an Exit Strategy can be an overwhelming task. This white paper will review the importance of this strategy and provide additional guidelines as to when and how it should be used. Starting with the end in mind and working backwards will ensure that you will get to where you want to go so it's critical for business owners to address. Some of the details of selling or transitioning a business can get very technical, so it's important to include experts such as consultants, brokers, attorneys and accountants will help in this journey. CBR will try to provide you with insights and a better understanding of the transition process and what must be done before a business changes hand. For additional information on selling a business you should read, *The Business Sale System: Insider Secrets To Selling Any Small Business* by James Laab. You can also visit his website at www.businesssalecenter.com

The Selling Process

While many owners think of the start of the Selling Process as putting your business up for sale, usually with a business broker, in actuality the process begins long before this. Typically, most homeowners will put on fresh coat of paint, clean the yard and complete those repair projects that have been on the to-do list for years prior to listing their house. They do this to make the house as attractive as possible to maximize the price they will receive. Business owners must do the same.

When running the business one of the goals most owners have is to maximize their income which can lead to tax minimization strategies. To minimize taxes, they will often try to minimize income and maximize expenses using legal, or maybe not so legal, practices. This approach can make the business appear less attractive to prospective buyers then it actually is.

The other common practice we see is the blending of personal and business expenses. These will need to be separated and the financials will need to be modified. Assume, on paper, that an owner's salary and net profits are $100,000. Add to that additional owner benefits that are buried in the books….health insurance, cell phone, automobile and associated expenses, meals, entertainment, trips. These perks can be significant though will need to be separated to be understood by a buyer before they will pay for them.

Also, the high percentage of a company's market capitalization could be attributed to the knowledge that resides in people's heads. (Microsoft attributes 350 out of a $450 million capitalization to human knowledge). To some extent this applies to small businesses also. If the success of a business, and its associated value, is due to the business owner's knowledge the more you can take that knowledge and integrate it into the business the easier it will be to get a buyer to pay for it. This requires documenting systems and process and possibly creating a knowledge base within the business that will live on after the owner is gone. Utilizing the Operations and Training Manual, Apprenticeship Plan, Efficiency Renovation System are just a few of the areas an owner needs to address to help prepare a business for sale. Thinking this through 2-3 years prior to an actual sale will help an owner get the business in the best possible shape to sell.

Planning for the Sale

In the last section we discussed some of the items that should be addressed prior to selling a business. Bottomline, you must get our arms around operational, financial, customer specific, legal issues and more. Once you do that, you must work on getting them in order. The first step is to understand the extent of which policies and procedures are documented, the financials of the business, any outstanding legal risks etc. Usually a buyer will want to see the last couple years of financial statements, so this is a good place to start. Financial statements are the best indicator of the future performance of the business. Buyers will typically want to see statements for a minimum of 3 years; 5 years is better. Well documented financials, preferably audited, are a critical element of the transaction. Expect prospective buyers to also review recent tax returns.

Another consideration is the role that the existing owners will play in the new business. Will they step aside or be involved for a transition period once the transaction is complete? How critical is their role to the success of the business? If their role is critical to the success of the business the transition challenge will be greater. Developing a skilled, key associate that will stay on with the business can help alleviate any fears that a buyer may have. You can do this by having an Apprenticeship Program in place.

On the operational side of the business the following should all be reviewed and documented. Documented processes will provide a level of confidence to new buyers that they will be able to step in and run the business in a structured fashion:

The client experience – Do we understand the Unique Selling Proposition for our business? Why do our customers buy from us? This is important information that will add credibility to the business and be valued by the potential buyer.

The selling process – Is there a Sales Management System in place? Do we have a structured selling process in place?

Specific customer requests/practices – Are these documented especially for key customers. Can we make the transition seamless for customers?

Product/Service Delivery – Is the operational aspect of delivering the product or service to the customer well documented? Are there Operations and Training Manuals in place?

Collection practices – What are our terms? Do we have exceptions for some clients? What is our process for delinquent collections? What does the Cash Gap look like?

Taken as a whole, the better documented past performance of the business, and the corresponding business functions that delivered that performance, the easier it will be to sell your business at a higher price. This can often times take 2-3 years to get everything in place. In other words, the Exit Strategy should be discussed and developed well prior to the business being listed for sale.

Creating a Team of Advisors

As you get closer to putting the business up for sale you will want to involve an attorney, CPA, financial advisor and possibly even a business broker or business coach. Attorneys will handle and advise on the legal aspects of the sale and develop the purchase agreement. CPA's can support and back-up the financial statements and help structure the deal to minimize taxes. Financial advisors will help you in regard to how to best use or invest the proceeds for future needs. Business brokers will list the business and market to prospective buyers, possibly help with the valuation and listing price, and prepare a buyers packet. They also help with the negotiation process. It is important to understand and define the role of your advisors in this process. The book referenced at the beginning of this white paper will give you more in-depth information in regard to the team of advisors.

Determining the Value of the Business

Sellers may often have an over-estimated opinion regarding the value of their business and feel it has value beyond any amount determined through a formula. They are right, to a point. There may be emotional value to them and to a potential buyer. So, the actual transaction value of a business will always be whatever the buyer and seller agree upon.

That said, understanding a few mathematical approaches to calculating business value is useful in the negotiation in order to develop a buy/sell agreement. Remember that no calculated number is perfect. Different methods may make more sense for some types of businesses than others. The various methods may also be used together to create a general sense of the range of value rather than a single number. It's important to realize that the four basic valuation methods described below are only typical methods and that it may be helpful to utilize a blend of them or to adjust them based on the business circumstances and based on negotiation.

Valuation Methods:

1. **<u>Value of Sales</u>** – In some industries (for example, restaurants) it's common to value the business at its level of annual sales. It is easy to calculate and readily understandable. This method may be appropriate when the "asset" that is sold primarily consists of the customer list, the brand, or the reputation. Value of Sales method makes sense when the ongoing revenue performance of the business after sale seems likely to be as good as past performance. However, the shortcoming in use of this method alone is when sales trends don't accurately reflect profit trends for the business. So, for a buyer seeking to calculate a return or a cash flow from the business purchase, more analysis is needed.
2. **<u>Value of Assets</u>** – This method is also somewhat easy to calculate as a starting point. Value of Assets may refer to receivables, inventory, equipment or fixed property and more. Current assets like receivables and inventory generally have a book value that accurately reflects actual value. Often value of these assets is modified to reflect agreed realized value, such as, if not all receivables are collectible, perhaps 80% (or other percentage) of book value is used. Or if some inventory is old or obsolete, another percentage of book value is agreed to or an audit is performed. But typically, Value of Assets is used in heavy equipment industries or where significant and income producing property makes up the business. With fixed assets their book value may not reflect the true present and ongoing value. That's when some type of market assessment can be used.

3. **Discounted Cash Flow** – This method usually relies on past performance and trends, or on an agreed projection to calculate the present value of future cash flow of the business. From the standpoint of a financially oriented buyer, this method is the best indicator of what type of return on investment can be achieved. However, there are two key elements that need agreement between buyer and seller that can be difficult to nail down. First is the accuracy and likelihood of achieving the projected performance. And second is the length of time to include in the present value calculation (how many years of future projection to include).
4. **Multiple of EBITDA** – EBITDA is by far the most common valuation method used. EBITDA stands for "Earnings Before Interest, Taxes, Depreciation & Amortization". As such it reflects the past or current performance of the business in terms of cash flow from operations, and is relatively easy to calculate. Business value is ultimately agreed to based on a multiple of EBITDA. For example, you may hear the phrase "three times EBITDA" or "four times EBITDA". The multiple suggests the period of time (in years) that the buyer expects their investment to be recovered. Multiples typically range from 2 to 7 years, with 3 or 4 being most common. The challenges with use of EBITDA are mainly in agreeing to the appropriate multiple and in understanding that it does not necessarily indicate future performance.

Note – This is where your team of advisors comes in, specifically your CPA. It is always recommended that an accountant or other professional experienced in valuation be consulted in a buy/sell situation.

Ways to Maximize Value

Here is a typical list of possible value enhancement ideas:

- ✓ Get receivables and payables to current values typical for the industry or better.
- ✓ Sell or discard obsolete inventory.
- ✓ Have a strategic plan that can be shared with a buyer and is actively being worked on.
- ✓ Create a strong leader or team that can carry on the work of the business.
- ✓ Clean and organize any physical property.
- ✓ Make sure accounting reports and records are accurate and current.
- ✓ Assemble, review and update all contracts.
- ✓ Separate any personal owner charges from the business.
- ✓ Document organization policies and procedures.
- ✓ Create Key Performance Indicators.
- ✓ Delegate most of the work performed by the owner if possible.
- ✓ Meet with the CPA, attorney, financial planner, business coach, business broker as appropriate.

The Negotiation

It is always recommended that an experienced attorney lead the negotiations in a buy/sell transaction. However, the team of advisors can certainly play a valuable role supporting the business owner. They can point out aspects of the business that justify the value. The very fact that a buyer sees involvement of a trusted advisor in the business will enhance their perception of the value.

The key to a successful outcome is the team of advisors working together:

- ✓ The attorney to lead negotiations, examine payment options, protect legal future of the client, prepare sales documents.
- ✓ The accountant to confirm financial records, assist with valuation, create a post-sale entity if necessary, take responsibility for tax documentation.
- ✓ The financial planner to advise on use of proceeds, help the business owner understand retirement needs (if necessary), create investment vehicles for proceeds, examine payout alternatives.
- ✓ The business broker to help prepare business for sale, seek motivated buyers, market the opportunity, advise buyer financing options.
- ✓ The business coach to help develop systems, policies and procedures that support an efficient, profitable business.