Preparing For a Successful Business Exit

Key Mistakes Sellers Make

Business owners often allow too little time to complete an exit strategy and they focus on the price while disregarding the terms and structure of the 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)
- Setting expectations based on personal needs and without reference to the market
- Failing to explore legitimate positioning strategies

The owner who prepares with professional advisors, plans thoroughly, and negotiates to ensure that the wealth transfer mechanism chosen most closely delivers on his goals is the owner who will have executed the optimal exit strategy.

Characteristics Which Appeal to Buyers

When purchasing a business, buyers focus on businesses capable of operating with little or no dependence on their owners. Other quality characteristics include businesses with:

- Scale 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
- Quality business and accounting systems
- Audited annual and timely internal monthly financial statements

Defining the Exit

There are several methods for exiting a business:

- 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

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Exiting a business 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
- Collaborating 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

An optimal exit requires a team of professional advisors covering multiple disciplines. No single advisor is an expert in all of them, so the process should involve input from a team of experienced advisors and should address the possible need to re-position the business before going to market.

Setting Goals

The exit strategy begins with the strategic advisor and owner creating a realistic range of the pricing, terms and structure expected from a sale in the current market. The investment advisor then develops a plan to invest the after-tax proceeds to meet the owner's goals. For the majority of owners, this newly liquidated business wealth will constitute a meaningful portion of their total wealth driving the financial, tax and estate plans. Some of the categories of goals include:

- 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?

Selecting a Team

The strategic 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 pros and cons of proposed strategies having expert counsel and representation

The team must include the necessary knowledge, skills and experience in mergers & acquisitions, operational and financial business consulting, law, taxation, estate planning, insurance, and investment advice.

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Writing a Plan

Owners should not expect to exit successfully without figuring out how best to exit and what preparatory steps should be taken. This process may take a period of up to 3-5 years. 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 strategic 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.

Reconciling Goals and Options

Once an indication of the expected after-tax proceeds from the business exit is established versus the proceeds required to provide the owner's personal goals, the 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 options, and should also evaluate a number of positioning strategies for execution prior to implementing the chosen strategy. Closing this gap requires evaluating combinations of positioning and exit strategies that will yield the required result within the desired time and with an acceptable degree of certainty. This may also require modifying the required amount of after-tax proceeds. Again, notice that there are two key points of inflection for matching the exit with the personal goals:

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

A key issue owners face in considering 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 ensure the after-tax proceeds will be delivered in the context, amount, time, and certainty needed to meet the owner's personal goals.

Positioning Strategies

Corporate Value Enhancement

Areas of corporate value enhancement include corporate structure [C-Corp, LLC, or Sub S], for purposes of tax efficiency and legal liability. The creation and utilization of an independent board of directors and advisory board may positively affect valuations for some prospective buyers. Management strength is also an area of concern.

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.

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Business Value Enhancement

Business value enhancement strategies 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. Profit margin improvements have a greater impact on valuations when they are reflected in historical earnings. 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

Business Marketability Enhancement

Clarity, transparency, and certainty drive the marketability of a business. When business performance is clearly reported and accounted for, when activities and status are transparent to the buyer, and all information portrays a level of certainty about the future, prospective buyers more readily engage and the company's valuation increases. Buyers are 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

A classic two-stage exit is accomplished by means of a re-capitalization in which an investor, partner, or 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 a multiple bump.

Consider a $20mm revenue business with earnings of $3mm which commands a valuation of $15mm (or a 5X 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

Structuring is a positioning strategy because it impacts the value of the after-tax proceeds.
Key structuring considerations include:

- Considerations of risk and reward
- Tax considerations
- What incomes and expenses are included (i.e., belong to the transacted business)?

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- What assets and liabilities are ex/included?
- What pre-transaction liquidation, settlement/exclusion opportunities exist?
- What relationships between buyer and seller arise? (Employment, advisory, property owner, supplier, partners, etc.)
- Documenting or codifying contractual relationships (employees, vendors, customers, debt)

Exit Strategies

The business owner should have his strategic 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:

Strategy	Buyer	Qualifications
Sale	To Partners	Available funding
	To Competitor	Manageable confidentiality; synergy; certainty of close
	To Strategic Buyer	Synergy; identifiable business purpose
	To Financial Buyer	Management; financial performance
	To International Buyer	Scale/size; international orientation
	To the Public	Scale; integrity; prospects
Re-Cap		Growth; Cash flow; leveragability
Merge		Target(s); strategic fit
Transfer	To Family	Capability of transferee
	To Management	Management strength; commitment and buy-in
	To Employees *	Management; market strength; leveragability
Gift *		Personal goals
Liquidate		Modest or negative return on assets

** Specific qualifications must be met as preconditions to accessing the designated tax benefits.*

Benefits of a Planned Exit

The primary purpose of approaching an exit in a disciplined and goal-focused way is to dramatically increase the likelihood that the outcome will be optimum to the stated goals. The employment of a team of experienced advisors will add a cost of from 4%-7% of the after-tax proceeds received, but will potentially add more value by:

- Mitigating against a failure of the exit and dramatically expediting the exit
- Eliminating risks associated with direct negotiations with principals
- Increasing the negotiated value of the exit
- Reducing the income tax burden
- Maximizing the net after cash value of the exit

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