Your Exit-Ready Assessment

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Your Exit-Ready Assessment

Thank you for taking the Exit-Ready Assessment! We hope the simple act of answering a handful of questions about your business sheds light on the important matters you should be considering as you prepare to transfer ownership of your business to another at some point in the future. Many business owners ask us, "When is the best time to begin preparing for the transfer of ownership of my business?" The answer is very simple, and is the same in every case. It's never too soon and the best time is now!

To that end, the purpose of this Exit-Readiness e-book is to help you understand the four distinct phases of preparing for the transfer of business ownership. It's been our experience in working with business owners, that those who are open to learning about these four stages and taking the necessary steps to complete them greatly improve their outcome. Anticipating a better outcome means experiencing less stress as you run your business, feeling less vulnerable during the sale (or transfer) process, and ultimately receiving more cash (net of taxes) when the transfer of ownership occurs.

What Does My Score Mean?

Your score is based on the answers you provided and is intended for educational purposes only. You should not proceed to transfer your business ownership to another party without additional investigation, learning, and consultation with professional advisors who specialize in assisting business owners during the process of transferring business ownership.

If you received a score of 70% or greater, congratulations!

Your answers indicate you've considered the many matters of importance in preparing to transfer your business ownership to others. Your score also indicates you've taken many of the necessary steps to make your business attractive to potential buyers. Having said that, such a score is not intended to give you the green light to sell or transfer your business without consulting with one or more trusted advisors. So before you pick up the telephone or send an email, we recommend you read through the remainder of this Exit-Ready e-book and take note of any ways you may be able to improve your situation.

If you received a score below 70%, keep reading!

If you've scored between 41% and 70%, you've taken a few steps to improve the value of your business and prepare for its transfer to new owners.

If you've scored below 41%, you've got some work to do! Nonetheless, we give you credit for taking this initial and important step to learn more.

After working with hundreds of business owners, we've observed most lack the opportunity to comprehensively address their business ownership transfer planning needs even though they work with several professional advisors, each with their own area of expertise. In fact, chances are fairly good that as a business owner you have four to five separate advisors. This group likely includes your Attorney, a CPA, an insurance agent (or two), and if you are really lucky, a good friend. In addition, it's been our observation that few, if any of them, speak to each other about their work with you and your business.

Further complicating the matter is the fact that most small business owners don't have a financial advisor because they are unable to save much cash outside of their retirement account. Instead, most business owners pour their cash back into their businesses year-after-year. And because there's not much cash to invest, financial advisors usually don't pay much attention to them — that is, of course, until they sell their business.

Unfortunately this scenario means many business owners with good intentions to do what's prudent and necessary to properly prepare for the transfer of business ownership, often find themselves underprepared and eventually disappointed when the transfer or sale occurs.

You don't have to be unprepared or disappointed! Begin your journey to a successful transition now. Read on.

The Four Stages of Exit-Readiness™

If your intention is to transfer your business ownership to others in the future, taking the time and devoting the resources necessary to implement the steps outlined in the four stages of Exit-Readiness ultimately will prove to be an invaluable journey for you and your family.

The four stages of exit-readiness are:

- **Stage One – Align Personal Goals with the New Owner and the Ownership Transfer Method**
- **Stage Two – Build a Business to Weather the Storms**
- **Stage Three – Develop Your Key Successors**
- **Stage Four – Prepare for Personal & Financial Transition**

While it is possible to work in any one of the four stages in isolation, you will see as you read more about each stage that each is tied to the other. In general terms, stage one should be initially explored with care and subsequently reconsidered from time-to-time as it has a profound impact on the decisions and steps taken in the remaining three stages. More importantly, if you get stage one right, your personal satisfaction with the ownership transfer process will be enhanced greatly.

Stage One – Align Personal Goals with the New Owner and the Ownership Transfer Method

Most business owners do not ask us about ownership transfer methods. Instead, they ask us to take a look at their financial statements and tell them how much they can get from the sale of their business. In fact, that single question scenario occurs nearly every week in our practice.

We answer this common question not with a dollar figure, but first by explaining the importance of identifying the ultimate party (and transfer method) to whom the business ownership will be transferred. As you might imagine, this answer can be frustrating to those looking for a number. But it doesn't have to be.

There are at least several dozen business ownership transfer methods and each offers the business owner its own valuation for the business. In other words, there is no single answer to the question posed by most business owners, "what is my business worth?" The answer depends on two major decisions even before the financial statements are evaluated and many other factors related to the business are considered:

1. **The party (type) who will acquire the business; and**
2. **The method by which the business owner transfers ownership.**

According to Robert T. Slee, CBA, an Investment Banker and author of the book Private Capital Markets, "surprisingly, answering the question, 'What am I trying to accomplish with a business transfer?' determines how much an owner ultimately receives for the company."[1]

Robert's observations regarding the ultimate amount of money received by a business owner from the sale or transfer of a business ring true on Wall Street and Main Street alike. Even small business owners operating on Main Street have several types of buyers (or transferees) and various methods to achieve a successful ownership transfer.

Regardless of the size of your business, the first step is to identify a potential new owner and determine a method of transfer which aligns not only with your personal goals but those of the new business owner as well.

Before we discuss the matter of goal alignment to the transfer party and method, let's define the various types of transfer parties (future business owners). They include:

1. **Employees**
2. **Charitable Trusts**
3. **Co-Owners**
4. **Family Members**
5. **Third-Parties**
6. **Public Investors**

Transferring full business ownership to employees may be accomplished through an Employee Stock Ownership Plan (ESOP) or a management buyout agreement. A third option, if it's your desire to allow some or all of your employees to participate in the sale of your business to an outside party, is a Stock Appreciation Rights (SAR) plan.

For business owners with charitable intentions, a charity may be named as the beneficiary of a Charitable Remainder or Charitable Lead Trust to allow the business ownership to transfer to the charity at some point during or after the business owner's life.

When transferring ownership between co-shareholders and business partners, the development of a Buy/Sell Agreement is paramount, otherwise the transfer may only occur after all parties negotiate a purchase price and other terms. Even in the best co-owner scenarios, negotiating when one or more co-owners need or want to depart is not recommended. A Buy/Sell Agreement should be established as soon as possible and regardless of the age of the business.

Many business owners want to pass along their business to immediate family and/or subsequent generations. This may be accomplished by establishing a Family Limited Partnership, a Grantor Retained Annuity Trust (GRAT),or by utilizing the gifting exclusion in the Federal Tax Code. Selling your business to your children, grandchildren or other family members is always an option.

When selling a business to a Third Party, a business owner should consider whether he or she desires to remain as a partial owner or to transfer all of their equity outright. In many cases, selling only a portion of the equity in the business to an third party can be a great way to bring capital onto the business' balance sheet, and introduce new synergistic business opportunities while taking some of the business owner's risk off the table. In such a scenario, a subsequent and final sale brings the business owner to his or her ultimate exit. On the other hand, for many business owners, a complete, one time sale to a third party is preferred.

Selling your small to medium sized business to Public Investors is not commonly done and is a process only suited for very large businesses. The sale of a business to public investors through an Initial Public Offering (IPO) or Reverse Merger requires a roomful of advisors who are exclusively preparing the business and its owners for a public offering. This assessment does not address the complex matters facing a business owner who chooses to offer his or her business for sale to the public.

What are Your Personal Goals and Do They Align with the New Owner and Method to Transfer Ownership?

So, let's go back to that important question: "What am I trying to accomplish with the sale (or transfer) of my business?"

For many business owners, the answer to this question is clear. It may go something like this:

"I don't want to worry about the future anymore. I want to take as much time as I want and travel, spend time with my spouse and my family. I want to fish."

Or possibly like this:

"I want my kids to have a business they can count on to provide a nice lifestyle for themselves and their families. I don't want them to struggle for forty years and have to put up their homes as collateral for a bank line of credit. I want them to do well."

Or it could go this way:

"I want to take care of my family and know they won't ever have to worry about paying for my retirement years or nursing home expenses. And I want my loyal employees, who have been with me for thirty years or more to get something as well. I want them to know I appreciate all they've done to help me build this business."

We've heard all of these answers and others about a hundred times or more. Every business owner has a unique story and knows what's important to him or her. The key point is that for every answer to this important question there exists a direction for the business owner to follow in finding a specific type of new owner and in determining the correct method of ownership transfer. The fellow who wants to fish isn't necessarily concerned about his employees. That's okay. His answer indicates selling to a third party (once) is likely the best scenario for him. He won't waste time considering an ESOP or selling to a Venture Capital firm who wants him to stay on (with or without an equity position) for three years. He has fish to catch.

Hopefully, this gives you some food for thought… no pun intended.

Four Major Factors which Determine a Business's Value

Your business's value is determined ultimately by four factors, with the first one being the most important:

1. **New Owner and Transfer Method**
2. **Earnings from the Business (measured in various ways)**
3. **Business's Industry (in favor or not) and**
4. **M&A Market (if sold to a Co-owner or Third Party)**

If a business owner wants to sell his business for the highest amount of cash, selling to a third party and employing a private auction process as the transfer method would result in a different business value than if the business is transferred to its employees through an ESOP. The financial consequences to the seller and buyer, the taxes paid by the seller and the overall legal structure of these two ownership/transfer methods would differ vastly. Hence, identifying the proper new owner type and the method of transfer is extremely important very early in the planning process.

Once the targeted owner type is identified, several other factors will have a profound impact on the business's value at the time of transfer. The first universal indicator of business value is its earnings. Business earnings may be measured in many ways including, but not limited to: EBITDA, EBIT, Adjusted EBITDA and EBIT, Gross Revenue, Net Sales, and Seller's Discretionary Earnings. Many formulas used when valuing a business for sale most, if not all of which, use one or more of these measurements of earnings or income.

Another important factor when valuing a business is the industry in which the business operates. Is the industry growing, exploding, shrinking, or disappearing? If it's one of the latter two, the business owner has a much shorter timeframe during which to sell before the business's value may be gone. Alternatively, if the industry is either growing or exploding, the timing of the sale is critical due to changing valuation multiples. These values may change rapidly so it pays to know the current industry multiple of earnings and the direction it's moving.

Moreover if a business is sold to a co-owner or third party, the Merger & Acquisitions climate, or relative cost of capital for private enterprises, has an impact on a business's value. Mergers and Acquisitions activity goes up and down. If an investor is unable to find sufficient returns on his or her money by investing in stocks, bonds and real estate, then investing in a private enterprise becomes more attractive. That's when the M&A climate is most favorable. Conversely, when the stock, bond and real estate markets are healthy and producing nice returns for investors, buying private enterprises falls out of favor.

The only thing an entrepreneur can truly control is the amount of money a business produces, so we recommend focusing on improving earnings first. By doing so over a three (or more) year timeframe while keeping an eye on the industry itself as well as the M&A climate, a business owner can be well positioned to take advantage of good timing to sell or transfer when it arrives.

Going back to that question many business owners ask us about the value of their business, I think you will agree it is not possible to offer a financial or dollar value for a business without first exploring the business owner's intentions for the transfer of their business.

Once the business owner's goals are aligned with a potential new owner type and the various transfer methods are considered, the next three stages of exit-readiness may begin.

Stage Two – Build a Business that Weathers the Storm

A new business owner does not want to acquire a business full of problems, whether it's your own children or a third-party. And be assured a new business owner will have many opportunities to discover your business' problems before they write you a check.

If you chose to transfer your business to your children or other family members as opposed to selling it to a third-party, co-owner or employees, your family will thank you for building a business that weathers the inevitable storms that will come.

We encourage our clients to start this process from day one. There's no reason not to do it. Having said that, many business owners find themselves in a position where they need to plan to sell or sell their business and for various reasons have not built a business that weathers the storms. Regardless of the age of your business, taking several deliberate steps before you transfer or sell your business will improve the likelihood of having a valuable business. We categorize these steps as digging a moat, putting up fences, and measuring everything.

Dig a Moat

Digging a moat around your business means doing whatever is necessary to build revenue and grow your business.

> **The first line of protection for your business and perhaps the most critical step to take when building a valuable business is to hire professional advisors who have your back and who are willing to work with you, your spouse, your key employees, and *your other advisors.***

Note the emphasis on 'your other advisors'. If one of your professional advisors is not willing to work with your other advisors, they should not be on your team. It's very simple and frankly has been the downfall of many business owners who struggle to build and sell a valuable business.

You know who that one advisor is. And we'd make a big bet that your spouse does also.

Every business, regardless of its size, should develop multiple ways to make money.

That seems like an oversimplified and obvious statement, however actually developing multiple revenue streams is one of the most difficult goals to achieve. And by not doing so, a business places itself in a position where it is an 'all or nothing' game.

When this subject is brought up with many business owners, some push back and claim they've developed a niche business and that multiple revenue streams are not necessary. In fact, they claim it will hurt their business.

They are dead wrong. Business buyers, private investors, commercial lenders, and institutional investors all look favorably upon a business with multiple revenue streams.

Reduce revenue risk for your business by developing many customers.

Again, that sounds so simple. It's not and can result in a 'customer concentration' problem. That problem can bankrupt even a profitable business in a matter of a few days.

An example will showcase how real this risk can be and how important it is to fix it.

Imagine it is mid-2008 and a very successful business was planning for an ownership transition after enjoying another fiscal year of record sales, profit, and paying quarterly bonuses to its employees. They had forty-three customers and grossed $81Million per year. One of their customers was a household name in an industry which in late 2008 found itself in need of a government bailout. That same customer represented nearly 20% of this business' gross revenue.

On the surface, this business was rock solid. Its net income was multiple millions and life was extremely good for its owners and employees.

But over the course of three days, this single customer broke its contract and wiped out $16Million of the business' revenue. The customer shut down operations Friday night. By Monday morning, all personnel who handled Accounts Payable were laid off. There was no one to call and the customer owed $8Million.

That's a customer concentration problem and it nearly bankrupted a successful, profitable business. Don't let it happen to your business.

No single customer or client should represent more than eight (8) percent of your business' gross revenue.

Put Up Fences

Putting up fences around your business is about planning for what you never want to happen and protecting your assets.

Develop a disaster plan for your business with your key employees and run a fire drill.

Pretend for a moment it's a Tuesday morning and you arrive at your place of business at 6:00 a.m. to find the building on fire. Start there. Ask your key employees "what do we do so we don't go out of business?"

Write down the answers and then run a 'fire drill' and every other disaster scenario you can image.

Write it down again. And then practice the scenarios randomly once a year.

You will learn more about your business doing this exercise than you can imagine. And if the worse happens, you won't go out of business.

Develop agreements with your employees to protect confidential information and your intellectual property rights.

Every employee in your company should be willing to agree to and sign a written confidentiality agreement with your business. Information related to your business' intellectual property, such as trade secrets, customer and vendor relationships and contact information, business processes, etc. are assets you must be vigilant in protecting. These are assets your business will transfer to new owners and if compromised through a leak or confidentiality breach to your competitors, your business will lose value.

Other agreements with employees may include non-compete and non-solicitation, depending on the state in which your business entity is formed. Careful consideration of these types of agreements is recommended with the assistance of an Attorney well-versed in employment law in your state.

Develop and protect your intellectual property.

All businesses have intellectual property which should be protected on an ongoing basis. Creating an inventory of the business' intellectual property, offers a business owner a very good way to evaluate the steps needed to protect it.

Measure What Matters

> **What gets measured gets done.**

The "what gets measured, gets done" quote has been attributed to Peter Drucker, W. Edwards Demming and a few other famous business management gurus. It implies that if we want something to improve, we need to pay attention to it. If this is true, one would think a business owner should measure absolutely everything!

For many business owners, measuring too many statistics, financial metrics, and other facts becomes a simply overwhelming task, one which never gets checked off the "To Do List".

For this reason, **we recommend identifying the 8-to-12 Key Performance Indicators (KPIs) which have the greatest overall impact on the business.** Your KPIs should align with your objectives as the business owner to ultimately transfer a valuable business to others in the future.

Don't get bogged down. Start with a piece of paper and write down what matters to you. Then with the assistance of your professional advisors and your key employees, figure out what you should be measuring to assess if you are getting where you want to go.

Regardless of your personal objectives, the most critical set of KPIs every business owner must have are accurate financial accounting records, detailed financial statements, and timely filed tax returns. If your intentions are to transfer your business to other owners, developing methods to maintain detailed financial records is critical to your ultimate success.

Get your financial records in order.

Business owners who are able to offer a prospective buyer or its new owner financial statements for the previous three years as well as year-to-date financial information will find the transition process much easier. For those business owners who feel it's not necessary to keep good financial information about their business, they will find it very difficult to convince prospective buyers their business is worth what they desire to receive. In such cases, prospective business buyers will discount the value of the business and will spend more time performing due diligence testing before agreeing to acquire the business.

For these reasons, we recommend any business owner who wants to sell or transfer their business anytime in the near future (three-to-six year) to do the following:

1. Remove personal expenses paid by the business from the books and records. It costs money in terms of additional income taxes to do so, however by removing personal expenses from the business, the true (and greater) value of the business will be evident to prospective buyers or new owners.

2. Normalize any expenses to an amount which is true and reasonable for the market. For example, if extraordinary wages are paid to your family members, reduce such payments to their market value for the services they provide to the business. Conversely, if family members are underpaid for their services, you should normalize their compensation.

3. Measure and monitor your business' Key Performance Indicators on a regular basis. This information may be used when negotiating with prospective buyers to substantiate the value of the business.

4. Engage with your CPA firm to 'review' or 'audit' your business' financial statements for a three year period. By doing so, your prospective buyers or new owners will spend less time scrutinizing your financial records and the transition process will be less difficult.

Building and maintaining the proper forms of business capital is critical for a business owner who wants to control the timing of his or her ownership transition.

By not doing so, the business owner can find himself in a precarious position.

One of the most difficult hurdles to overcome for many business owners is having insufficient capital and an improper capital structure for the type and size of their business. The consequences can be devastating. In fact, without adequate business capital, a business owner could be forced to transfer his or her business prematurely.

As the business owner, you should regularly review:

1. The proper mix of permanent financing and access to working capital
2. Sales Order-to-Cash cycle time
3. Cash retention policy relative to the targeted Equity
4. Bank Loan Covenants and reporting requirements

Stage Three – Develop Your Key Successors

For most businesses, value is closely tied to the people who have developed the business model, customer relationships, and underlying assets. In combination, value is created.

Without human capital, the value of any business is diminished. And in many cases, the value of a business without its people is nil.

Business buyers know how critical human capital is to the ultimate success of a business—especially after its sale or transfer to new owners. Accordingly, developing people to take over all key roles in a given business is an important stage when planning for the sale or transfer of a business. Many business owners prefer to skip this stage. Don't be one of them!

Plan for the worst-case scenarios and tell your family what you want. Now.

Most business owners are too busy to plan for the worse-case scenarios. They just don't do it. Instead, they focus on new opportunities, troubling employees, deadlines and a host of other recurring issues.

Plan for your absence by creating a succession strategy for your business and its operations. It's one of the greatest gifts you can give to your family and your employees.

A succession plan identifies who would step into your role and operate the business if you were ill on a temporary or permanent basis. In an ideal world, these employees would already be prepared to take on your role (more about that subject later). Nonetheless, if employees and others have not been identified as the people you would like to take on your role, the time to do it is right now.

A succession plan also identifies the various parties you would like your family to call upon for assistance if the business needed to be sold or transferred to other owners. Your trusted professional advisors should be known to your family and to each other. If they are not, be certain to spell out whom these parties are and their respective roles in your succession plan.

If you co-own your business, execute a buy/sell agreement.

Running a business with a partner has many benefits and risks. One of the biggest risks is related to the day you or one of your business partners needs to exit business ownership. This day will arrive. It's simply a matter of time and circumstances.

Delegate to responsible employees.

Delegation to responsible and accountable employees over time is the single most important succession step a business owner can take in his ownership transition journey. And for many, it's the most difficult.

For those business owners who refuse to hire (and compensate) educated, experienced and capable employees, they will find it difficult and in many cases impossible to sell their business to another party. While that's a very strong statement, we can assure you we've have many war stories to prove it's true. Sad, but true.

Savvy prospective business owners will examine the competency of employees and quickly assess if they contribute to or detract from the value of the business. A business with key employees who are accountable as leaders in operations, human relations, technology, finance/accounting, management and strategy is valuable to prospective buyers. Without strong leadership, the business is less valuable.

If you're the owner of a business and truly want to sell or transfer your business in the near future, ask yourself if you could take a thirty day vacation and know your business would be okay in your absence. If the answer is "no", then set out to develop the people to make that possible. And when you've done that, change thirty days to ninety days. Is the answer 'yes' or 'no'?

Competent, key employees will work as if they own the place. If you've managed to hire and train such employees so that you're able to leave your business for ninety days (or more), then your employees deserve more than a paycheck. Simply stated, they've earned it. Having said that, offering equity to your key employees can be problematic in many ways!

There are many ways to compensate key employees like they owned the place if their efforts warrant such rewards. Even if your goals may be to sell your business to an outside third-party, a stock appreciation rights plan may be used effectively to incentivize key employees. Likewise, bonus compensation plans, profit-sharing plans, and the like can be used to effectively incentivize key employees.

Regardless of the method you and your advisors chose to align your key employees with the goals you've set forth for your business, speaking the truth about your ultimate intentions to sell or transfer your business is advisable. Many business owners mistakenly believe they can keep their intentions to sell or transfer their business to another party a secret. They think perfectly intelligent employees will never suspect their 72 year CEO may want to exit the business someday.

There is an easier way. Align your personal goals for the transfer of your business to the appropriate new owner, define your KPIs, religiously monitor them, and hire good people who are accountable and tell them the truth.

Stage Four – Prepare For Personal and Financial Transition

Hands down, this fourth and final stage of exit-readiness simply is overlooked and in many cases—avoided! Preparing for the personal emotional shift from business owner to passive onlooker is a long and difficult process for many. Most business owners have been entrepreneurs since childhood. And like it or not, one doesn't change an entrepreneur's mindset just because he or she no longer owns a business.

Likewise, the habits formed by business owners with regard to their financial management run deep. As a business owner, having access to income, cash, and other resources makes it relatively easy to make purchases and other financial commitments. Once business ownership ends, making the transition to spending only the income obtained from assets in one's own bank account can be difficult.

As mentioned earlier, it's unfortunate that many business owners have never worked closely with a financial advisor because they simply didn't have enough investable assets to get the attention of those members of the financial professions. Dependence on income from an investment portfolio and being subjected to the financial market swings can be extremely stressful to the former business owner as a newly minted wealthy investor.

Another hurdle for business owners after selling or transferring their business is finding productive and rewarding uses of their time. Many business owners tell us the first six months are splendid. And those after are often followed by emptiness. Nothing to do and they've got all day to do it!

For the business owner who takes the time and reaches deep to explore the future, transition to retirement can be rewarding. To that end, we recommend the following steps be taken to prepare for personal and financial transition:

1. Find purpose beyond business owner, boss, and mentor in the business world. This is where you will spend the bulk of your time after you sell or transfer your business.

2. Groom your team of professional advisors for your transition to include:
    a. Exit Planner
    b. Financial Planner who works with business owners
    c. Business Attorney who specializes in business transactions (M&A) in your industry and will be able to consult with his or her partners on matters related to real estate, employment, ERISA, environment, etc.
    d. Estate Attorney who will incorporate any changes needed to your Estate Plan related to the sale or transfer of your business.

e. CPA who works in business transactions (M&A)
f. Business Broker or Intermediary

3. Explore Revisions which may be needed for your estate plan.

4. Hire your Financial Planner to create a post-acquisition financial plan for you and your spouse.

5. Conduct a Due Diligence dry run. Pretend your business is being sold in thirty days and you are the buyer. What would you examine if you were the buyer of your business in order to feel comfortable? Your Exit Planner and business transaction Attorney should conduct and/or assist you with this preliminary internal assessment.

Conclusion

Transferring business ownership to another party, whether it's an outsider or someone in your own family, takes time and other specific resources. If your transition planning is done systematically and with persistence, the outcome can be positive for all involved as well as your family. There are no shortcuts.

Exit Promise, LP was developed to help business owners learn how to build a valuable business and how to ultimately transfer or sell their business to others. To that end, many resources are available to help you. They include:

- **Business Capital Resources**
- **How To Grow a Business and Increase its Value**
- **Customer Concentration Risk**
- **Resources Needed to Sell a Business**

Endnotes

1. Robert T. Slee, "Business Owners Choose a Transfer Value," *Journal of Financial Planning,* June 2004.

