EXIT PLANNING—7 COMMON MYTHS

A UNIVERSAL BUSINESS TRUTH!

Every single business owner **WILL** exit their business one day, voluntarily or involuntarily. Most owners are interested in gaining maximum value for their life's work, whether it be to accomplish financial independence, move on to the next challenge, or create a family legacy.

The driving question is…….Will the exit be under the owner's control? This means on the owner's timetable, to the successor of their choice, and at the price they need.

While most owners recognize the need to plan for their exit, most do not. There are many reasons why plans aren't made, but a prevalent one is the belief that there is plenty of time. This e-book will discuss this myth and others regarding planning for the inevitable exit of a business.

Myth #1—There is Plenty of Time.

Preparing a business for transition takes more time than most owners realize. Getting your business ready can take years, whether it is an internal or external transition strategy. How many years? For an internal transition: 5+ years. Time is needed to groom your successors in preparing them for leadership and to arrange for financing their purchase. For an external transition: 1-3 years. Getting a business ready for transition involves focusing on a number of important value drivers including operational improvement, customer diversification, debt reduction, documenting policies and processes, financial forecasts and controls, and demonstrated scalability. When mastered, these drivers increase the likelihood of a successful transition, regardless of who the buyer is. It takes commitment, focus, capital, and ultimately time to develop these value drivers.

Myth #2—I Know My Company's Value Better Than Anyone.

It is often said that "Beauty is in the Eye of the Beholder," and when it comes to assessing a company's value, most owners are overly optimistic. The reality is that any company, on any given day, can assume a number of different values, depending upon who is conducting the valuation and for what reason. Your banker determines a "Collateral" value. The M&A market determines a "Market" value. Your company has a "Book" value. The IRS has an opinion of "Fair Market" value, and there is also a "Liquidation" value. The most appropriate valuation methodology for your business will be dictated by the exit strategy chosen. It will also dictate the cost to gain this valuation. Obtaining a professional opinion, calculation, certified valuation or ultimately, appraisal will vary in cost and defensibility, should the need arise. Just as most owners pay an asset management fee for professional investment advice, so too should owners be willing to pay for regular business valuations that are conducted by experienced professionals. This is far preferable to relying on an owner's "intuition" of the value of the business. A professional and objective business valuation will confirm, track and eventually facilitate transition of what is likely an owner's *greatest financial asset.*

Myth #3—Purchase Price = Pocket Cash

If only this were true! After all of the due diligence is completed. And the buyer and seller have miraculously reached agreement on price, two major obstacles impede the infamous "pay day". One obstacle originates on the buyer's end, the other from the IRS. The later, likely representing the greater of these, **TAXES!** Under the best case scenario, the seller pays capital gains tax on the sale price, and only to the extent it exceeds their cost basis in the company. Such a scenario is predicated on several significant tax planning variables. The first variable is whether the company being sold is structured as a Sub Chapter S Corporation (*or other flow through entity*), where taxation is presumed at a single vs. double level. Whereas if selling as a regular C-Corporation, the proceeds are subject to two levels of taxation. One at the company level and one at the seller's. The second significant tax variable is whether the sale is structured as a "stock " or "asset" sale. A stock sale is typically taxed at favorable capital gain rates. An asset sale, depending upon assets selected, is often taxed as ordinary income. It is critical to consult with a tax advisor prior to signing a purchase agreement to understand the "after-tax" proceeds a seller can expect. This will significantly aid in the negotiation process. The second major obstacle impeding cash in pocket is predicated on the terms of the sale. Often the full sale price is not paid at closing. Instead some percentage of the price is held back in the form of an "earn-out" or escrow account, contingent upon the company maintaining expected financial performance. Both impediments, taxes and deferred sales proceeds, debunk the myth that a seller's purchase price equates to cash in pocket.

Myth #4—Strong Financials are the Greatest Company Value Driver.

Many owners believe strong financials are important, and of course they are. However, buyers are more interested in the *sustainability* of those financials. The likelihood that strong financials will continue is a buyer's paramount concern. If the financial health of the business is heavily dependent upon the contributions of the current owner, then sustainability walks out the door when the owner leaves. So what is the greatest company value driver of all?
The answer is…….**Next-Level Management**. The people who are in Next-Level Management roles are the performers that support and strengthen all other value drivers, including sustaining financial performance. Grooming, incentivizing, recruiting (*where necessary*) and retaining these key performers should be at the top of EVERY owner's "to-do" list. Retention is easier said than done. Higher pay isn't necessarily the answer, since competitor recruitment efforts have never been stronger given today's tight talent market. Long term incentive plans, based upon company performance, with deferred payout, are the secret ingredient to retaining and recruiting top talent. When long term incentive plans are properly designed and communicated, they instill an ownership mentality necessary to retain key talent. And this doesn't mean sharing equity. Most long-term incentive plans are cash based and for good reason. Awarding minority ownership to the wrong person, at the wrong time, for the wrong reason helps keep our litigation attorney colleague's busy! Besides, not all key talent aspire to BE owners. However, they definitely EXPECT to be compensated like one! Take some time to review existing, or newly developed, incentive-based compensation plans for your key performers. They represent your company's *greatest value driver*.

Myth #5—Internal Buyers Are No Different from External Buyers.

Internal buyers (*i.e. co-owner, family members, key managers*) know the company's culture, customers, and employees better than any outside buyer ever could. Internal buyers have often helped to build the company. Many owners may even feel that internal buyers deserve the same shot at ownership that they themselves enjoyed. These are reasonable views that lead owners to "want" to sell to inside buyers.

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But inside buyers have one major difference from outside buyers and that difference is ......MONEY!! Inside buyers typically do not have excess capital or access to outside capital, short of a rich relative. For owners committed to transitioning to inside buyers, they must embrace two financial realities. First, they are not likely to receive a lump sum buy-out. More likely, the purchase is going to be gradual and over time, unlike a sale to an outside party. Second, cash flow from the company itself is likely going to be required to finance at least a partial purchase. However, with a proper design strategy, the cash flow required can be generated through increased profitability attributed directly to the efforts of those chosen successors. Regardless of the strategy chosen, internal transitions can and do work and can offer both parties unique advantages.

Myth #6—No Need for a Shareholder Agreement.

You start your business with a Partner whose values, vision and contributions are aligned with your own. As time passes that alignment often deviates. Worse yet, an unexpected death or disability can occur. Now your new Partner is the spouse of your deceased Partner who has no experience or desire to earn their half of the profits. Or perhaps this new Partner is someone who doesn't agree with your approach to the business. Perhaps he/she is someone who takes you to court over mismanagement of the business and its finances. Or, perhaps this new Partner decides to have their *new* spouse take over their responsibilities in the company. The result could be that both parties end up whittling away whatever value was built and are left with nothing but animosity toward each other and the departed! A properly designed, funded, and updated Shareholders Agreement would have avoided all such tragedy. It would have offered the surviving Partner (*or company)* the right of first refusal on a purchase, at a predetermined price and terms. Properly funded with insurance, tax-free cash, needed to finance the purchase, replace the financial contributions of the deceased Partner and perhaps even allow for a stay-bonus for key personnel, is achieved.

Myth #7—My CPA— Attorney—Financial Planner—Banker—Business Coach—CFO— *"Fill in the Blank"*—Say They Can do Exit Planning.

With an estimated 20 million businesses in operation, 79% of owners wanting to exit in the next 10 years and only 17% of them with written exit plans *(1)*, it would seem that EVERYONE is jumping on the exit planning band wagon. Those without adequate training or experience can lead to confusion in the marketplace. It is no wonder that owners are perplexed as to where to turn and whom to trust. Which is exactly why so many owners chose to postpone critical planning until they are forced to do so by events outside of their control. First, assemble your team of qualified advisors, who have specialized knowledge and experience in exit planning and a willingness to collaborate. Advisors who will place your exit/transition objectives squarely in the center of the planning process. Who through collaboration and thorough understanding of available options, can create a written RoadMap that includes an Action Checklist. A checklist that identifies necessary transition planning items, assigns responsibility, and designates a targeted completion date. Transitioning ownership in a business is a unique lifetime event. It is likely one of the *most significant financial events in an owner's life.* Start early, surround yourself with qualified professionals and a successful business exit can indeed be achieved. *(1) Data from the BEI 2016 Business Owner Survey*

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About the Author:

Dyanne Ross-Hanson is President and CEO of Exit Planning Strategies, LLC.
Founded in 2005, Exit Planning Strategies, works with business owners who are 5 to 10 years from divesture in terms of time or capital.
Outcome agnostic and collaborative by nature, Dyanne works with owners and their Advisory Team to explore planning options. This includes mapping realistic exit strategies and developing an Action Checklist to accomplish the owner's objectives.
Dyanne shares her expertise and knowledge with numerous Professional and Trade Associations, CEO & Peer Groups, including Vistage International. She is an accomplished speaker and published author of numerous articles on ownership transition subject matters in business and planning media and forums.
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