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6 KEYS TO CREATING A BUSINESS YOU CAN TRANSFER

In one of the most successful business books ever written, *The 7 Habits of Highly Effective People*, author Stephen Covey famously states, "Always begin with the end in mind." We feel it behooves business owners to adopt this mindset when thinking about their eventual exit from their business. All business owners must realize that at some point they are going to leave their business. The question then becomes: when, how, and on what terms?

The primary goal of this white paper is to provide business owners with a sound educational background on what an effective exit planning process looks like and then encouraging them to start the process early, often as long as ten years in advance depending upon the situation. In addition, owners need to understand that exiting their business does not necessarily mean selling their business. There are a range of options available to them, as well as a range of values associated with each option that an owner may choose. Notice I use the word "choose", as a good exit planning process can result in the owner literally "choosing" their desired exit path. By identifying six key factors involved in positioning a privately held business for a successful exit, we will provide business owners with a roadmap to either begin their journey or take their current strategy to the next level.

If we take a look at the business owner landscape today as it relates to exit and succession planning, the hard truth is that most owners are woefully prepared to exit their businesses. When you consider the fact that in most cases, well over 70% of a businessowners' net worth is "trapped" in the value of their illiquid privately held business, so the lack of a long-range planning process represents a real threat to the owners' overall financial security.

Let's take a look at some interesting statistics*:

- **96% of baby boomer business owners agreed that having an exit strategy was important, however, 87% do not have a plan**
- **70% of M&A (mergers & acquisitions) professionals surveyed said that business owners are minimally prepared or not prepared at all to sell or transfer their companies**
- **A typical business owner misjudges the value of their company by 59%**
- **The primary reason for deal termination is the seller's unrealistic value expectations**

When pressed for answers to these issues, most business owners will cite the fact that they are simply too busy running and growing their business, putting out the perpetual fires that ignite, etc., all of which are valid and understandable. However, we also identify another reason for the lack of planning: the advisors the owners typically trust have a limited understanding of strategic exit planning. This is not to say that a business owner's accountant, attorney, investment advisor, or financial planner are not capable or knowledgeable in their respective fields, but points more to the fact that strategic exit planning is an alternative planning discipline that takes into account many factors, such as:

- **Measuring an owner's financial readiness to leave their company**
- **Measuring an owner's mental readiness to leave their company**
- **Implementing long-term value enhancements**
- **Determining the ideal exit channel**
- **Creating a strategic tax plan**
- **Understanding that a privately held business has a "range of values" based upon the exit channel selected**

To further complicate the dilemma, business owners will often skip the exit planning process altogether and move right to hiring a business broker or M&A firm. These types of professionals are paid based upon successfully completing transactions because their incentive system is to get a deal done, not to take the owners through an exit planning process that reveals if they are really ready to exit, and if so, if they are choosing the right path.

Let us now move on and examine the six keys to creating a business that you can transfer.

1. ESTABLISH YOUR EXIT GOALS

Start with a vision of who you want to potentially transfer your business to. If we take a look at transferring to an outside party, the question that must be asked is, "Is my company saleable?" Many business owners may think they have a very saleable business, however, to a large degree, until they engage in a planning process, they really do not know the answer to this critical question. Outside parties are going to view your business through the lens of whether or not it is a good investment, not necessarily a good business. There can be quite a contrast between a good investment versus a good business. Many business owners who do engage in a strategic planning process come to the realization that they may have a very good business, however, in the absence of significant planning, it may never be viewed as a good investment. If you take a Private Equity Group investor, they are typically targeting an annual return in the 20- 30% range. Can your business, in its current form, generate that type of return on investment?

The next option may be a transfer to other co-owners, a management team, or a select few key employees. If this is the desired option, when and how will the transaction be financed, and even more importantly, can it be financed by a 3rd party, such as a bank? If outside financing is not an option, are you prepared mentally and financially to consider seller financing? Think in terms of you being the bank on a property that you own free and clear and are receiving monthly mortgage payments. With your business, you are holding your stock in your privately held company as collateral. If you leave and your successors run the company into the ground and can no longer make payments on the note, you may then have to step back in to salvage the situation and completely rebuild the company, or make a decision that too much damage has been done and close it down entirely. If you are going to engage in a seller financing arrangement, it is critical that the company has the ability to replace you and all of the key roles you play within the organization, and even with that, there are still significant risks.

The last option to explore is typically a family transfer. This could involve the gifting of the business, the sale of the business, or a combination of strategies. It is common knowledge that statistically, most family businesses do not make it beyond the 2nd and 3rd generation. From our perspective, a business exists to make money. Certainly, it goes way beyond that in terms of family lifestyle, social impact, and economic impact, however, a family business should not exist to create jobs for family members. Many family businesses have failed when this becomes an overriding theme in the family business.

Therefore, if your desired outcome is to transfer the business to family members, similar to seller financing outlined above, are the active family members truly ready to take the reins, and how will the transaction be structured? Business owners need to have a high degree of financial readiness when transitioning the business to family, management, or key employees as their future financial security hangs in the balance.

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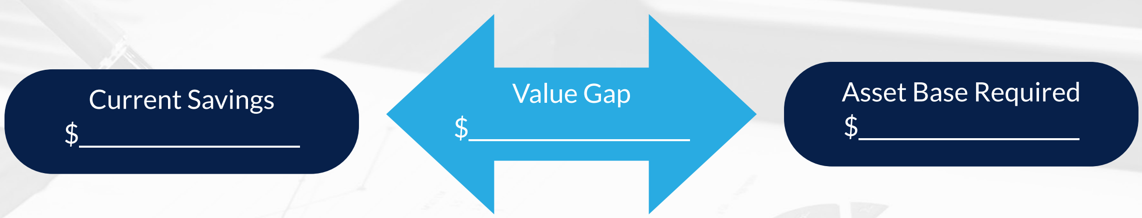
2. MEASURE YOUR FINANCIAL AND MENTAL READINESS

Financial Readiness

If you have taken the time to ponder your most logical exit path, the next important question to ask yourself is, "Can I afford the exit option that I desire?" This equates to having a plan for creating a lifetime supply of income when you no longer own your business. There are two areas that are critically important to measure.

The first is Financial Readiness. We are often surprised that most owners don't know their actual income needs, meaning: what is the annual after-tax income you will need from all sources assuming you no longer own your business? Although there can be several reasons for this, a common trend that we see is that many business owners run a significant amount of personal expenses through their business. When you consider expenses beyond salary and bonuses, and you take into account car payments, health insurance, retirement plan contributions, meals, entertainment, travel, etc., these can tend to add up quickly and be very significant. Many business owners, whether consciously or unconsciously, have built what we refer to as a "lifestyle" business. Having a true understanding of all personal expenses being run through your business is crucial in helping you determine what we call the "Value Gap," which is determined by subtracting your current savings from the asset base required to supply you with the income you will need if your business no longer exists. Most often, significant equity from the business is necessary to achieve financial independence.

What is your Value Gap?



Mental Readiness

It is difficult for an outsider to understand the mind and world of a business owner. Owners develop deep emotional ties to their companies and the business becomes not just what they do, but in essence, who they are. Because of this, owners often have a very difficult time letting go. We've all heard the phrase "bored to death," and this could easily have been coined from the business owner who cashed in early but was not mentally ready to leave the business. Although they may be sitting on a pile of money, they may be bored, miserable, and depressed, as their identity was also part of the sale. They never accurately gauged their Mental Readiness to leave. It is important for an owner to put some context around this concept. You can begin by asking questions like:

- **Are you ready to leave?**
- **What will you do after you exit?**
- **Do you have enough hobbies and passions to fulfill you?**
- **How involved are you in day-to-day operations?**
- **Are you addicted to your business?**
- **Do you see your business as a return on invested capital or as the provider of your lifestyle?**

Answering some of these basic questions will begin to bring some clarity to the second important measurement factor, and that is the Mental Readiness aspect of a business exit strategy. Our exit planning process at Jacobi Wealth Advisors begins with a business owner taking our Business Exit Readiness Index (BERI™) survey. The BERI™ survey asks 20 questions related to an owner's Financial and Mental Readiness. The owner then receives a free, 6-page report with the results.

3. IDENTIFY WHAT TYPE OF OWNER YOU ARE

Over the course of many years in refining and developing our exit planning process, we have identified four distinct types of owners. Understanding where you fall within what we refer to as the Exit Quadrant Chart can go a long way in determining the exit path you choose. We offer a description of the four distinct types of owners below:

Well-Off but Choose to Work

This is an owner that generally has a high degree of Financial Readiness to exit their business but generally low Mental Readiness. They love what they do, the business is an extension of themselves, and they simply have no desire to do anything else. They also tend to be well-off financially and have accumulated a significant diversification of assets independent of the business.

Stay and Grow

The Stay and Grow owner is characterized by having a low Financial Readiness and a low Mental Readiness. They have not reached a sufficient level of financial diversification from the business to be able to exit, and they are mentally attached to the business and totally immersed in the day-to-day of growing and running the business. This is the proverbial "head down owner" who eats, sleeps, and breathes growing their business. Many business owners fall into this category and forgo doing any exit strategy planning and instead focus on business-building strategies. This is a mistake, as all owners will eventually exit their business(es), and the Stay and Grow owners typically have most of their wealth trapped in their business, which is why an exit plan for realizing that wealth is essential.

Rich and Ready to Go

The Rich and Ready to Go owner is characterized by both a high Financial Readiness and a high Mental Readiness. They have amassed significant wealth outside of the business and are not financially dependent on the business to support their lifestyle. From a Mental Readiness standpoint, they've achieved all they ever dreamed of. They have significant hobbies, passions, and interests outside of the business and are excited and ready to move on to the next chapter of their lives.

Get Me Out at the Highest Price
This is an owner that typically has low Financial Readiness but high Mental Readiness. They have done a relatively poor job of diversifying their wealth outside of the business and are mentally ready to move on from the day-to-day grind of owning and operating the business. Hence the reason we refer to this owner as "find me a buyer and Get Me Out at the Highest Price!"

Once you have an understanding of what type of owner you most resemble, you are then ready to move on to the phase of learning your exit options and which option may best fit your situation.

4. LEARN YOUR EXIT OPTIONS

The scope of this white paper is again centered around educating an owner on what an effective exit planning process entails and encouraging owners to get started early. Owners of privately held businesses essentially have five primary exit options available to them. Each option could serve as the subject of its own book, therefore, we will not do a deep dive here into the options but provide a visual along with a bit of context. When business owners commit to engaging in a strategic exit planning process and execute on the first three steps of Establishing Exit Goals, Determining Financial and Mental Readiness, and Discovering the Type of Owner They Are, the exit option that may best serve them will begin to take shape.

In addition, the process will lead to one of the five options being a specific match to the type of exiting owner. As an example, the Rich and Ready to Go owner may have multiple exit options available to them, however, the Stay and Grow owner will be more limited in their options. They may not have the Financial and Mental Readiness to sell the company to a 3rd party, but a Private Equity Group recapitalization may be appealing as they can get some cash up front but also stay on and continue to work to grow the business with the potential to get more cash later if the Private Equity Group executes a sale within their target time frame. Let us offer a visual of the five primary exit options and progress to the range of values concept.

5. UNDERSTAND VALUATION IS A "RANGE" CONCEPT

In his book *Exiting Your Business, Protecting Your Wealth*, author John Leonetti, a nationally renowned expert in the exit planning field, lays out the case why privately held businesses do not have a single value. Instead, valuation is a "range" concept, meaning that what you receive for your business will depend on who purchases it from you (or, alternatively, how you decide to give it away). Let's take a look at some examples of external transfers.

If you engage in a strategic exit planning process and determine that a sale to a 3rd party is the desired option, then finding a synergistic buyer will generally command the highest price. This would typically be an existing industry buyer that is larger with existing economies of scale, operations, supply chain, distribution, etc. and can seamlessly integrate your company into their ecosystem, thereby making it inherently more valuable.

Another external transfer example is a Private Equity Group recapitalization, and this option is going to be based upon Investment Value. Private Equity funds have strict financial models and methodologies that they follow which enables them to earn a target rate of return annually for their investors (typically a minimum of a 20% rate of return). They also have a short-term goal of then selling the company within a 3-5 year period and doubling or tripling the original price they paid. Sellers often retain a percentage of the company (20-30%) and are given an employment contract with the Private Equity Group, giving them a "second bite at the apple" if the buyer is able to sell the company within their desired time horizon.

If we look at internal transfer mechanisms, such as an ESOP (Employee Stock Ownership Plan) and MBO (Management Buyout), these are going to be based on fair market value. ESOPs are often a misunderstood planning tool that can provide many benefits to an owner, including continued control with asset diversification and significant tax benefits, as well as creating a culture of ownership amongst employees. There are many owners of small to large privately held businesses that have successfully adopted ESOPs as an exit strategy.

A further example of how valuations can vary is if an owner decides to give stock to family members that are in the business. In this scenario, owners are actually looking to achieve an artificially "low" valuation for gift and estate tax purposes. As you can see, there are many options to evaluate and a range of values associated with each option. Above all else, an owner must recognize that it's not what you get but what you keep from the exit after taxes, fees, and transaction costs, and you must ask yourself, "Will what I keep be enough to provide me with that lifetime supply of income?"

6. CREATE A TRANSFERABLE BUSINESS

A transferable business is one that can be owned and run by someone else today. Small businesses can be more difficult to transfer than large businesses because the owner, generally speaking, is heavily involved in the day-to-day affairs of the business. Because of this, many owners do not have a transferable business since they are indispensable to the successful running of the company. The riskiness (survival risk) of a business rises when the business is heavily dependent upon the owner, and when risk increases, the price someone is willing to pay almost always decreases.

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It's important for business owners to understand the risk that an outsider perceives in their business. In many cases, buyers will transfer some of this risk back to the owner via a "claw back" or "earn out" (get paid a portion overtime, taking into account certain milestones or benchmarks that are hit). Therefore, if you wish to create a transferable business, you must measure and manage your level of involvement in the running of your business.

Another tool we rely on at Jacobi Wealth Advisors is our Owner Dependence Index (ODI™). This survey consists of 40 questions and gives the owner an idea of how dependent the business is upon him/her, both overall and in a number of different key categories. The answers can range from highly independent to highly dependent with an overall score on a scale of 100.

Once you are able to determine owner dependence, you can evaluate who supports you in running the company, i.e. executives, managers, key employees, etc. How capable is this group in their ability to replace you? If in the strategic exit planning process you determined that you are thinking about an internal transfer, such as an ESOP or MBO, is there an established path from management to leadership to ownership?

On the other hand, if you are thinking about an external transfer, you may be wondering how to communicate these changes to your key people. Your eventual buyer and successor will likely deem your management team and key employees as an important part of the transaction in order to maintain business continuity and reduce their risk. Will key employees need individual conversations and incentives to remain with the company?

It may sound like common sense, but knowing who might own your business in the future will assist you in focusing on the items and value drivers that will help make your business both transferable and more valuable. So again, we revert back to: "Always begin with the end in mind!" We hope you found this to be informative, and we wish you much success in your exit planning journey.

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Stephen Covey – *7 Habits of Highly Effective People*
*Statistics cited are from "Stats show Entrepreneurs Great at Building Wealth, Awful at Monetization" Scott Yoder 2016
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