Mapping Financial Planning to Exit Strategies

As your business changes, your exit strategy should change with it. And planning should start *now*.

Executive summary

Every business owner should have an exit strategy, and the right time to start thinking about one is as soon as possible. Financial decisions made throughout the life cycle of your business can have an impact on your ability to sell for the highest price and at the most opportune time. Exit strategy planning should be an ongoing activity keyed to current market realities.

Contents

Bank of America Merrill Lynch

Introduction: Do you know what's next?

Patrick Ring, president of Legacy Partners LLC, a Baltimore firm that helps guide business owners through the transition to their next step in life, says that for many years he's been asking business owners, ranging in age from 32 to 82, one very important question: How are you going to get out? "Only a handful has a clear answer," he says. "Most respond, 'That's a very good question.'"

Not only is it a very good question, it's a very important one, no matter what stage of business ownership you happen to be in. Certainly, a business's needs change throughout its life cycle. Capital requirements — and access to sources of financing — are different for early-stage businesses than for mature ones. A company in an aggressive growth mode is likely to approach cash management and borrowing in ways radically different from a company in a stable or declining market segment. But no matter what stage a business is in, its owners should always be thinking about their ultimate exit strategy. Along the way, they should be mapping their financial strategies to help them get there.

Consider long-term impact of current strategies

Of course, some adjustments to financial strategy have to be made on the fly — in reaction to, or anticipation of, changing market and economic conditions, for example. However, virtually every business owner has — or should have — some kind of exit strategy in mind, whether that's passing the company on to heirs or employees, selling it, taking it public or liquidating it. Therefore, it is important to consider the long-term impact of any financial moves on your ultimate exit strategy, and that importance increases as the exit point draws nearer. This white paper looks at some of the most important considerations business owners need to take into account and suggests strategies to help deal with the challenges that arise.

From the very beginning, every decision regarding new products, strategies, financing, etc. should always be made with the exit strategy in mind.

Exit planning starts on day one

In theory, every business owner should know how they will exit even before they start a new business, says Bill McBean, author of *The Facts of Business Life: What Every Successful Business Owner Knows That You Don't*. That's because having a conception of who the eventual buyer(s) of your business will be allows you to set up and operate the business in ways that will be most attractive to them, thus potentially maximizing your ultimate payout.

From the very beginning, every decision regarding new products, strategies, financing, etc. should always be made with the exit strategy in mind, agrees Andy LaPointe, director of marketing at YourInternetConsultant.com, a consulting firm that helps companies maximize Internet marketing and social media ROI. Adopting that mindset means every decision made will bring the owners closer to the realization of their exit strategy. However, he adds, even if this has not been done since day one, significant benefits can still be realized by starting now, no matter what stage your business is in.

Business plan, finance and tax considerations

Exit planning should be included, at least rudimentarily, in the very first business plan, and the criticality of exit planning increases as the number of owners increases, says David M. Williams, founding director of Business Enhancement Associates LLC, a Cordova, Tennessee-based company that provides professional consulting and solutions to businesses keyed to their specific criteria and stage of maturity.

"The first priority is to plan for involuntary exit due to death or disability," Williams says. "This becomes critical when the business reaches self-sufficiency (i.e., the business could continue if the founder were no longer present)." As updated business plans are prepared, they should address the steps necessary to position the business for exit. Preparation for sale can take two to three years, as operations are adjusted to make the company more attractive to buyers. "It may take years to groom a replacement if family succession is anticipated," he adds. "The desires of all stakeholders need to be addressed."

Early-stage growth companies are often focused on cash, earnings before income taxes, depreciation and amortization (EBITDA), and managing covenants, says Katherine Morris, a partner at CohnReznick, a large public accounting firm. Since taxes are not a priority, tax planning is overlooked, which is a mistake that can cost the company when it attempts to market either its stock or its assets, she says. Early-stage companies must consider whether their legal structure is conducive to future lenders or investors and, ultimately, what impact it might have on the execution of the exit strategy.

A typical merger structure involves individual medical practices making an initial cash contribution to the LLC and sometimes, but not always, the accounts receivable. The member practices function as their own profit centers that maintain their existing fixed assets, and pay the physicians and their individual overhead.

Since this method allows the individual practices to continue much as they were, there should not be many changes to what the practices have paid in taxes. A small number of mergers may involve the dissolution of practices and the creation of another entity, which could have a bigger impact on the tax bill.

"Exit planning should be included, at least rudimentarily, in the very first business plan, and the criticality of exit planning increases as the number of owners increases."

Exit strategy choices

Exit strategies generally fall into three basic categories, says McBean: sale, succession or liquidation. In practice, the choices can be more nuanced, but the worst strategy of all, says Williams, is what he calls the "selfish benevolent dictator." In that scenario, the owner gives no consideration to structuring an exit plan and continues operating the business until his or her death, leaving the ultimate disposition of the business up to the heirs. Ring calls that approach "they'll carry me out of here in a box" strategy, and says that, even though it creates havoc for family and all stakeholders in the business, it's the most common one he encounters.

Some more-considered approaches to exit strategy planning include:

- **Lifestyle exit.** This strategy is specifically focused on the business owner's lifestyle and not necessarily on rapidly growing the business. "The sole purpose is to take assets out to support the business owner's desired lifestyle," LaPointe says.
- **Family succession.** If the business is to be retained within family control, the gifting or sale of shares to children or to trusts is the typical path, Ring says.
- **Internal sale.** This is most often done to employees through an employee stock ownership plan (ESOP), or to management through a structured acquisition agreement. Less often it is executed through a restricted stock offering.
- **External sale.** The company might be sold to an outside third party, which could be a strategic or financial buyer (such as a private equity firm).
- **IPO.** This involves selling the company to investors through an initial public offering of stock, with shares subsequently bought and sold on an exchange.
- **Dissolution.** This involves the liquidation and sale of assets.

Factors that should be considered

No matter what type of exit strategy you choose, there are a number of important factors you should take into consideration in planning and creating it, McBean suggests. These include:

- Determining what type of buyer(s) will be best-suited to purchase the business. "Owners should consider whether it makes more financial sense to sell to a public company or a privately owned company," he says. "They should also think about what qualities the buyer or successor will need to have in order to keep the business going forward."
- Determining whether the sale will be an asset sale or share sale, and understanding the pros and cons of both
- Getting input from other owners who have sold a business and determining who else you will need to consult (lawyers, accountants, etc.) to get advice on the buy-sell contract and tax issues
- Determining how much money you will need or want to exit with, then comparing that to how much profit the company needs to consistently generate, plus the outright value of its assets
- Giving yourself and your company enough time (years) to reach those profit goals

Careful consideration of what the business's "end game" will look like improves the odds of getting there, Ring says, but it's also important that owners ask themselves what their next step will be. "In our experience, until the business owner has a clear idea — and gets excited — about his or her own next step, post-closing, they will always be reluctant to let go," he says. "This could include starting a new business, becoming an ambassador for the old business or within the industry, philanthropy, or retirement. But this next step should be carefully considered."

Careful consideration of what the business's "end game" will look like improves the odds of getting there, but it's also important that owners ask themselves what their next step will be.

The role of business valuation

Business valuation is very important to the exit strategy because the goal in selling your business is to sell for the most money at the optimum time, McBean says. "If you don't know where you are now and where you are going, how will you know if you get there?" Williams asks. "A business valuation is necessary for structuring the buy-sell agreement."

There are several different types of valuation methodologies, including the market approach, the income approach and the asset-based approach. The market methodology compares your business to others in the same industry that have recently been sold, which is similar to the approach used in setting residential real estate prices. The income approach converts anticipated cash flow into present full market value by reviewing income generated by the business and applying a multiple based on a comparison to other companies in a peer group. The asset-based approach is, in some ways, the most straightforward, but the least accurate for a going concern. It determines the value of a business based on the market value of its tangible assets minus liabilities, and is most applicable in a liquidation scenario.

Combining approaches can be useful

In many cases, it's best to use a combination of all three, says David Wessels, adjunct assistant professor of finance at The Wharton School. "A robust assessment of a company's value will triangulate the results of all three valuation methodologies. Each requires assessment about the comparability and the future, which are truly unknowable," he says. "Consequently, additional analysis will always lead to a better understanding of what drives a company's valuation." The purpose for which the appraisal is being done is also an important factor behind which methodology or combination of methodologies should be used, and it's incumbent upon the business owner to educate the appraiser about the purpose of the valuation.

Business valuation is very important to the exit strategy because the goal in selling your business is to sell for the most money at the optimum time.

Long-term impacts of financial decisions

Throughout a business's life cycle, it is important that its owners consider the long-term impacts of various financial moves on their ultimate exit strategy. Central to that consideration is risk. "An owner's tolerance for risk should change as he or she moves closer to exiting," McBean says. "The issue here is that changing business tactics or making risky financial moves can have a negative effect on an owner's net worth and future profits, and both of those factors can have a negative impact on the dynamics of the exit strategy." Changing a business model can affect a company's overall valuation, positively or negatively, he adds, which may require changes to the exit strategy timeline. "If the effect is negative, you have to give yourself time — usually years — to correct the mistake," he says. A positive effect can increase profitability and business valuation, in which case the owner may face a choice between cashing out earlier or staying on and collecting the higher profits for a longer period of time.

The best way to sell a business is to make it appealing and understandable to a buyer, and that requires a focus on cash flow and growth throughout its life cycle, Ring says. He suggests getting cars, investment properties and as many depreciating assets as possible off the balance sheet if the business is to be sold. Tax and estate planning can enhance the after-tax proceeds; grantor retained annuity trusts (GRATs) and intentionally defective grantor trusts (IDGTs) have become popular planning vehicles for shifting the value of the business from the owner's estate to trusts for beneficiaries or charity.[1]

All in the family

If the exit strategy calls for the business to remain in family control, the owner should take steps to reduce its value so the next generation can afford to buy it, such as by shifting value from the business into non-business "buckets," Ring says. For example, real estate owned by the business can be transferred into pass-through entities owned by family members, or an insurance product can be purchased that burdens business cash flow (thus reducing the business's value) and benefits the current owner on a deferred basis. "As a result, risk is shifted, and if the business fails under the kids' management, the parents' wealth and retirement assets are not vulnerable," he says. "Having the younger generation's personal capital at risk is a powerful incentive to make the plan work. It will also identify any children who are not really interested in or prepared for this commitment."

Williams says it's important to stay on top of business debt personally guaranteed by the owner. That kind of debt can create problems in a sale situation if the guarantor is no longer in control of the business. He also says there is rarely any leveraged value in excess cash held by the company. "Since many companies are valued on EBITDA, the buyer essentially pays nothing for the cash," he explains. "At best, the buyer and seller swap dollars for the cash, but this increases how much value the buyer has to raise to complete the purchase."

Conclusion

The most important "macro" concept for any successful business owner to understand is that the best time to sell is when you don't have to, McBean stresses. "This is a critical piece of the puzzle, and if an owner understands this concept, the overall planning for the exit becomes much simpler. Exiting a business is the final and, arguably, most important decision an owner will make. But the exit decision is a step-by-step process, one the owner creates and must control."

Ring again emphasizes the importance of having a plan for what comes next, partly because he faced that exact situation. "I found myself leaving a business valuation partnership after 19 years," he relates. "It was not what I had intended to do with my career, but what now were my options? Once my next step — spending full time developing Legacy Partners LLC — took form, the pieces began to fall into place and excitement returned."

The best way to sell a business is to make it appealing and understandable to a buyer, and that requires a focus on cash flow and growth throughout its life cycle.

The following financial moves during startup growth and maturity can impact exit strategies:

- Hold onto your equity. Without control, you are subject to the agendas of other parties. If you have to part with it, make sure to use a competitive process to find investors, and don't undervalue the company.
- Investors want to see a solid successor management team in place. "This is a prudent investment at all stages of the life cycle," says Ring. "Non-voting equity incentives can be a strong motivator for them."
- Communicate with family members. Determine whether they have the interest, skills and resources to take over the business, and that they are prepared and committed to do so. Come up with a plan that requires them "to have skin in the game."
- Consider splitting off a division or a new product opportunity as the vehicle for your own next step.
- Having groomed your business for sale, go to market when you have demonstrated growth in revenues and cash flows, and while there are clear opportunities to continue that performance.
- Plan early, especially for an involuntary exit.
- Regularly review which type of exit strategy will be most desirable, and factor that into all financial decisions.

Hold onto your equity. Without control, you are subject to the agendas of other parties. If you have to part with it, make sure to use a competitive process to find investors, and don't undervalue the company.

[1] Please consult your tax advisor, as neither Bank of America, its affiliates, nor their employees provide tax advice. Depreciation allowances under Section 179 and other provisions of the Internal Revenue Code are available to you regardless of whether you obtain financing from us. You should consult with your tax advisor for your actual tax benefits.

Bank of America Merrill Lynch