Five Things Every Business Owner Must Know About Exit Planning

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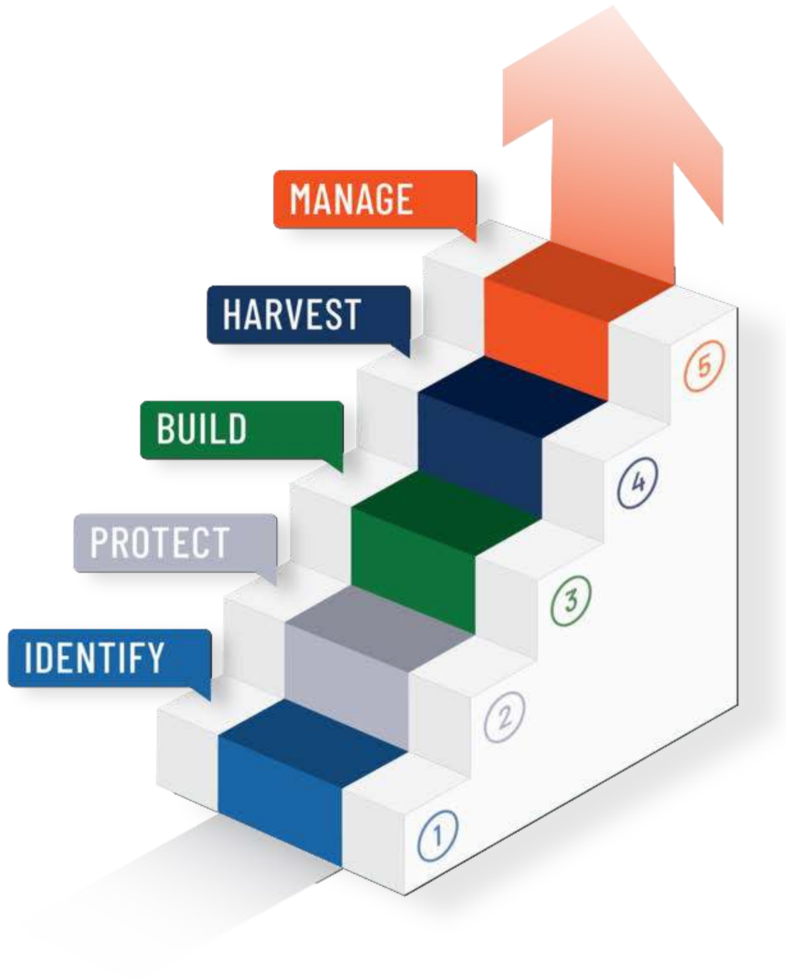
Building Valuable Businesses

FIVE STAGES OF VALUE MATURITY

Owning a business comes with more than its fair share of risks. To increase value and minimize risks in your business, you should follow the 5 Stages of Value Maturity as detailed in Christopher Snider's book, *Walking to Destiny.*



FIVE STAGES OF VALUE MATURITY

Identify:

Roughly 80-90% of your net worth is locked in your business. In order to maximize your value, you must set up a system to determine the value hidden in your business. According to Walking to Destiny, “the ability to unlock that value at some point in the future will make a significant difference to your lifestyle and, at exit, will fund your next act.” It is difficult to plan out your next act without having a professional business valuation. Conducting an annual business valuation will help determine what factors to focus on in the interest of accelerating the value of your business.

Protect:

After identifying your business’s baseline value, you must protect that value by mitigating any risks associated with it. Risks are divided into three categories: personal, financial, and business. Snider writes in Walking to Destiny, “protecting value is the first step in building value.” To best protect your value, you must consider the 5D’s: Death, Disability, Divorce, Distress, and Disagreement. Even if you do not think you will be affected by one of the 5D’s, without preparing for the worst, your value will be negatively impacted.

Build:

Once you have protected your existing value, your focus can expand to building value. There are two ways to build value: increase your cash flow (EBITDA) and improve your multiple. Your multiple is the number assigned by the private capital market to the value of your tangible and intangible assets and their associated risks. Intangible assets include Human, Structural, Customer, and Social capital. Improving your intangible capital is critical to building business value.

PERSONAL

- Death
- Disability
- Divorce
- Health
- Accidents
- Family Tragedies

FINANCIAL

- Market Risks
- Diversification
- Personal Loans/Debt
- Personal Lawsuits
- Loss of Earning Power
- Long-Term Care

BUSINESS

- Customers
- Key People
- Business Interruption
- Economy
- Distress
- Partner Disagreements
- Environmental/Safety
- Technology/Machinery
- Owner Dependence
- Data/Information
- Compliance/Legal
- Loans/Debt

FIVE STAGES OF VALUE MATURITY

Harvest:

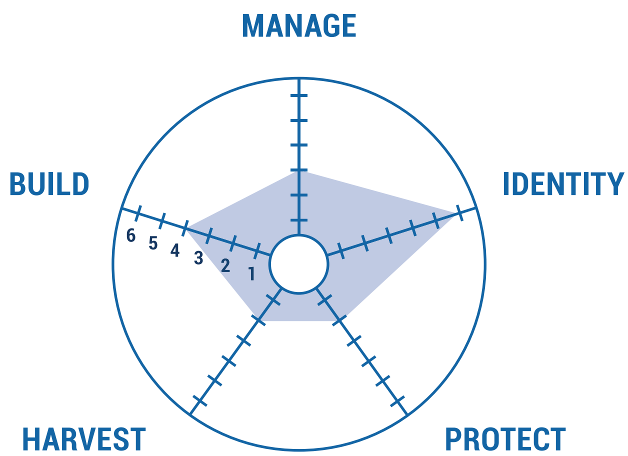
After building your business value, it is time to harvest the fruits of your labor. There are numerous paths your business exit can take. You should invest in an investment banker and business advisor to get the most value out of your exit. You might discover that after reviewing your options, you decide not to sell your business and instead transition the company to a son or daughter, sell the real estate and keep the company, or continue to build value.

Manage:

You most likely manage value throughout the course of your business lifecycle, but the most important time to do so is while exiting your business. To achieve the most value, you must manage not only your business value but your personal and personal financial value as well.

VALUE MATURITY INDEX

Learn where you score in each segment of value maturity by completing the Value Maturity Index. Give yourself a score of six if you have fulfilled everything in a category and a score of one if you have done nothing at all in the segment. This one to six scale is referred to as "Common Sense Scoring." It eliminates the option to rate your business as "average" by removing a middle option. Draw a line connecting each segment and shade in the area. The non-shaded area represents your area for improvement. Every 90 days complete this simple index to highlight how your value has grown.



VALUE MATURITY INDEX

THE IMPORTANCE OF THE FOUR INTANGIBLE CAPITALS IN YOUR BUSINESS

The 4 Cs in Every Successful Business

THE IMPORTANCE OF THE FOUR INTANGIBLE CAPITALS IN YOUR BUSINESS

What makes your business valuable? It is likely that 80% of your company's value lies within the four Intangible Capitals or 4Cs. These Intangible Capitals consist of Human, Social, Customer, and Structural Capital. Exit Planning Institute President, Scott Snider, shares his insights into the 4 Cs and how strong intangible capital builds value in your business.

Human Capital

People are everything. Scott Snider says, "I don't care how good your product or processes are, if you don't have the right people – you're screwed." The Human Capital in your business is one of the most difficult to navigate and one of the most important. Human Capital is the measure of talent on your team. According to Walking to Destiny, "62% of owners indicated that finding and retaining top talent is the biggest challenge they face." When working on your employee development plans, follow a series of steps that encourage growth in your employees and your business. All the Value Advisors we interviewed mentioned that some owners come to them stating that they want to exit their business because of operational issues that make them unhappy. However, after working with the Value Advisors on building value in their company, the owners ultimately decide to stay in the business either in their same role or in a more supervisory capacity until they are ready to harvest the value in their business during an exit.

RECRUIT

Consider why top talent would want to join your company. Is your business an attractive place to work? Can you clearly articulate your business values to your recruits? What characteristics are you looking for in a key employee?

MOTIVATE

What are you doing to motivate the talent you already have in place? Employees want more than just a "job." They want to be a part of something bigger. Are you a passionate leader who provides inspiration for your team? And mainly, do you have the right incentive programs in place to motivate top talent and keep them motivated?

RETAIN

You might have top talent in your company, but what are the rates of turnover for high performers in your business? Are you providing a path for professional growth as well as retention incentives for your top talent?

EVOLVE

How does your team need to evolve to grow your business? Are you promoting talent from within your organization? Can your leadership team evolve as your business evolves? If not, what are the barriers to their evolution?

THE IMPORTANCE OF THE FOUR INTANGIBLE CAPITALS IN YOUR BUSINESS

“Culture is the heartbeat of the organization. Culture is what pulls people together and draws them to the organization as an employee or a customer.”

Scott Snider, CEO of Exit Planning Institute

Social Capital

This Social Capital, or company culture, embraces the people. How they communicate, what they believe in, and how they operate internally and externally are key components of a company’s culture. Scott Snider refers to social capital as, “the heartbeat of the organization. Culture is what pulls people together and draws them to the organization as an employee or a customer.” Social Capital represents your brand, how your team works, the rhythm of the day-to-day operations, and the way you interact with customers. Developing strong Social Capital in your business can take years.

For that reason, Scott Snider says Social Capital is one of the hardest capitals to transition to a new owner. He says, “If you have a ‘Google-like’ culture of slides in the lobby, sleeping stations, stand up desks, whiteboard walls, and cafes – it wouldn’t necessarily transition well into what I would consider the traditional corporate culture of suit and ties, cubicles, formalities, and restrictions.” Ask yourself when working on your exit plan, though your culture may fit your business, does it fit the business of the organization acquiring you?

WHAT DO OWNERS NEED TO KNOW ABOUT VALUE CREATION?

Customer Capital

Without customers, you have no business, for obvious reasons. As small to lower middle-market companies, we face the dreaded customer concentration factor. Scott shares, "I think the biggest challenge here is moving our customers from engaged to entangled. What do we do so well with our customers that they couldn't possibly think about doing business without us? What makes us indispensable to them. That is entanglement."

One of the most effective ways to build value in your business is through strong Customer Capital.

It is important to view your business from the eyes of your customer. This allows you to see where your business excels and your organization's areas for growth. What are three things a customer would say your business does well and what would they say you should stop doing as an organization? By seeing your business through your customer's eyes, you can address their pain points and meet their needs.

Structural Capital

Finally, the most robust of all intangible capitals is Structural Capital. It encompasses everything that makes your company work efficiently. The process, documentation, training programs, technology, tools, equipment, and real estate. Scott says, "Bottom line, I don't think there is a more important intangible capital than the processes that make your business."

When a business has strong structural capital, the success of the company does not depend on any individual person's ability to perform a specific task. Christopher Snider writes in Walking to Destiny, "Your knowledge needs to be documented and transferable, such that someone else can learn from you and apply it. Making this knowledge company property ensures that when your talent walks out the door at night, the knowledge doesn't walk out the door with them."

The best advisors actively evaluate and manage these 4Cs daily, quarterly, and annually for their owner clients and their teams. **As we strengthen these 4Cs, it will not only result in happier people but more profits and higher valuation.**

CONSIDER THE FOLLOWING WHEN LOOKING AT THE VALUE OF YOUR CUSTOMER CAPITAL:

How strong are your relationships with customers?

Is your business integral to your customers' success because the products/services you offer are unique?

Are these relationships deep, long-term, and contractual?

Are the relationships delivered in a consistent, reliable, and recurring fashion?

Most of all, are these relationships transferable?

THE THREE LEGS AND GAPS IN YOUR EXIT STRATEGY

THE THREE LEGS AND GAPS IN YOUR EXIT STRATEGY

When creating your exit plan, following the rule of three is imperative.
As an owner, you must consider the Three Gaps and the Three Legs of the Stool.

The three gaps are the wealth gap, profit gap, and value gap.

The Three Gaps: Wealth, Profit, And Value

Many business owners wonder how much their business is worth and how they stack up against their competitors. Take the traditional “country club valuation,” for instance. A group of four business owners goes out on a Sunday to play a round of golf. One owner has just closed a deal and sold their manufacturing company for millions of dollars. A fellow golfer, who owns a business in the same manufacturing space, thinks, “I could probably sell my company for that.” But what should the business owner sell their business for? What are the owner’s personal and financial goals?

When talking about buying and selling companies, many business owners get caught up in the purchase price, when the real number they should be focused on is net proceeds. The “net proceeds” of the sale refers to the cash the owners get at the close after taking care of all expenses, such as investment banking and transaction fees, accounting and legal fees, debt from the business, holdbacks, and earnouts, seller financing, and, of course, taxes.

Although the net proceeds number is critical to determine what your business should sell for, it is only part of the equation. Net proceeds help establish the three financial gaps in your life. Those gaps dictate what your business must sell for in order to live a fulfilled life after exit.

The three gaps are the wealth gap, profit gap, and value gap. The first step is identifying the business owner’s wealth gap.

THE THREE LEGS AND GAPS IN YOUR EXIT STRATEGY

Wealth Gap

Your wealth gap is the difference between your current wealth and the amount you need in order to live the life you want. To understand your wealth gap, you must investigate your personal goals and ambitions outside of the business. For example, an owner who wants to own a minor league baseball team in the next phase of their life will need more funds than an owner who wants to retire and live quietly on an old farm.

Your goals, family, extended family, and personal ambitions should all be considered. Once identified, you can determine your wealth gap. Your net worth outside of the business plus the value of your company today equals your goal. In other words, if your goal was $10 million and you had $2 million of assets outside of the business, your wealth gap would be $8 million.

Profit Gap

Using this example, the next step in the process is understanding if the business today is, in fact, worth $8 million. To get to the root of this, start by calculating your company's profit gap. At a very high level, a profit gap is calculated by understanding the best-in-class earnings before interest, taxes, depreciation, and amortization (known as EBITDA) of businesses in the same industry. Next, assess your current EBITDA performance.

The profit gap then is calculated by understanding how you can drive toward best-in-class performance by subtracting your company's current EBITDA performance from the best-in-class EBITDA performance. For example, if your company is currently valued at $1 million in EBITDA while the best-in-class companies are generating $3 million in EBITDA, your business currently has a $2 million profit gap.

THE THREE LEGS AND GAPS IN YOUR EXIT STRATEGY

Value Gap

This EBITDA number is then applied to the sale price of the company. Small and lower middle-market companies sell in a range of industry multiples dictated by the private capital market. For example, upon research, a plastic manufacturing company could be selling in a range of multiples from one times the EBITDA to six times the EBITDA, with the best-in-class companies selling at the higher range.

Given the same industry research, you can now identify your company's value gap. The value gap takes into consideration the best-in-class performance and applies it to the current company. For example, if best-in-class companies are performing at 15% EBITDA to revenue and the current business owner's company is performing at 10% EBITDA to revenue, the company could improve performance, even at the same level of revenue, and generate another 5% in EBITDA.

To illustrate this further, imagine a company currently generates $20 million in annual revenue. At 15% EBITDA, this company would generate $3 million in EBITDA, whereas, at 10% EBITDA, the company would generate $2 million in EBITDA. Given 15% EBITDA is best-in-class performance, these companies would sell at the best multiples. In this example, if best-in-class companies are selling at six times the EBITDA, that would be an $18 million sale price. An "average" company performing at 10% EBITDA, on the other hand, would likely sell for an average multiple. Let's assume that multiple is 3.5 times the EBITDA, which would equate to a $7 million sale price. This would represent our existing example.

So, what should you sell your business for?

WHEN IT COMES TIME TO SELL YOUR BUSINESS, ASK YOURSELF THE FOLLOWING QUESTIONS:

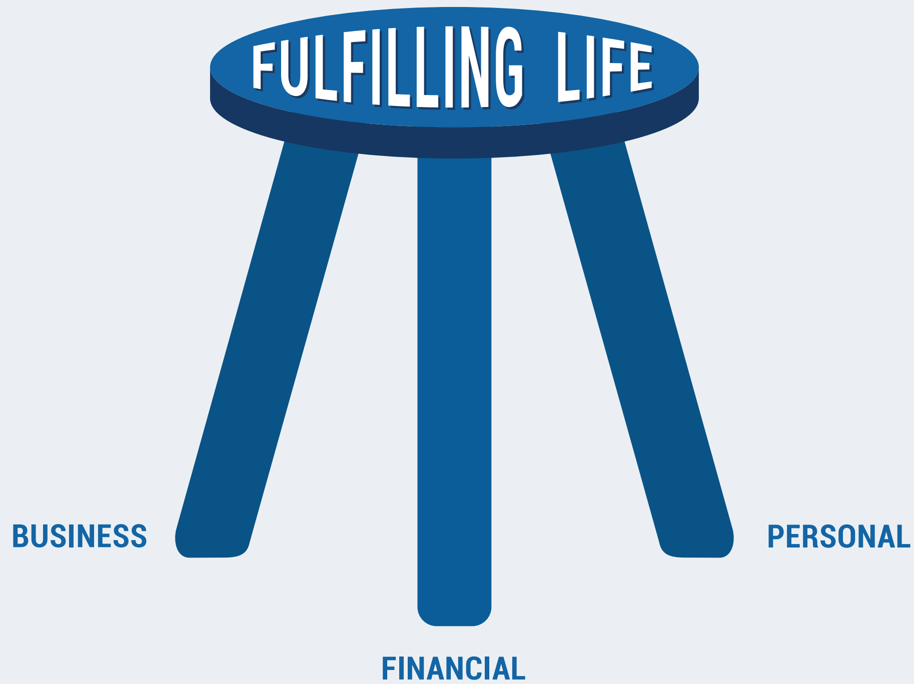
What do I want to do after I sell? And do I have the money to do it?

What are the best-in-class businesses in my industry worth? How far is my business from that profit?

How valuable would my business be if I sold it today? Would I get a high multiple if I took it to market right now?

Selling your business involves a lot of strategy, advisors, and planning.
But without considering your personal goals as well as business value, you will have a hard time determining your ideal sale price.

THE THREE LEGS AND GAPS IN YOUR EXIT STRATEGY



The Three Legs of the Stool

During the exit planning process, a consultant must balance an owner's business, personal, and financial needs. All three of these are equally important for a successful business transition. We refer to these as the "Three Legs of the Stool." Without all three equally balanced, the stool would topple over. According to Walking to Destiny, the Three Legs of the Stool, also called "Master Planning," helps to maximize the value of the business by ensuring the owner is personally and financially prepared to maximize net proceeds and that they have a plan for what they will do next.

Business Planning

When creating your exit plan, you of course will spend a lot of time considering how your exit will impact your business. Christopher Snider shares in Walking to Destiny, "You need to consider things like the direction of the business," when organizing your exit plan.

LOOK INTO THE FOLLOWING COMPONENTS OF YOUR BUSINESS DURING YOUR EXIT PLANNING CONVERSATIONS:

- Factors that drive value into the business,
- Salability and ongoing viability of the business,
- Predictability of the business's income stream,
- The overall health of the business
- Your staff
- Structural capital
- Management succession
- Business risks

THE THREE LEGS AND GAPS IN YOUR EXIT STRATEGY

Linda Ruffenach, Founder and Chief Strategist of Execuity LLC, says “the best way to understand the need for building value in an owner’s business is to ask them, ‘What do you need to do in the beginning to be better prepared down the road? How can your business improve today for you to be successful later?’” Business consultants help spot pain points in businesses that owners may not have noticed or known how to resolve.

Personal Financial Planning

Most owners know their business goals and the multiples they would like their business to sell for, but they fail to think about the personal and personal financial impact of exiting their business. According to a recent survey, 27% of business owners have no plan for their life post-business. A business consultant must work alongside the owner to determine where they see themselves in the next act of their life and how much money is needed to meet these goals.

The process for exiting is driven by a wealth goal. The wealth goal is motivated by what the business owner wants personally in life, both now and after the sale of their company. Once the advisory team helps the owner establish those goals and their personal purpose, it allows the advisor to establish a wealth goal and identify the Wealth Gap. That Wealth Gap will be filled by the business. This begins a conversation around business planning, what the business is currently worth, and what it could potentially be worth.

Personal Planning

An effective exit plan incorporates your business financial needs as well as your personal and personal financial needs. Without a detailed personal plan, many owners feel purposeless and unfulfilled in their life. On the contrary, owners who have a written plan for what they want to do next and have taken the steps to position themselves, have wonderful next acts. Your personal goals should drive the business, not the other way around. Getting in touch with your personal purpose helps build a successful, growing business. But more importantly, understanding your personal purpose ensures that you have a fulfilling life after you exit.

To succeed today and in the future, ensure that you give each of the three legs of the stool equal attention. Begin by determining your personal purpose and identifying your personal financial needs. Use your business to drive income, and ultimately, drive transferable value to create the financial means to reach your personal goals.

The Three Gaps and Three Legs of the Stool in exit planning are necessary components towards growing significant value in your business, whether or not you decide to exit your business now or in the future.

“The best way to understand the need for building value in an owner’s business is to ask them, ‘What do you need to do in the beginning to be better prepared down the road? How can your business improve today for you to be successful later?’”

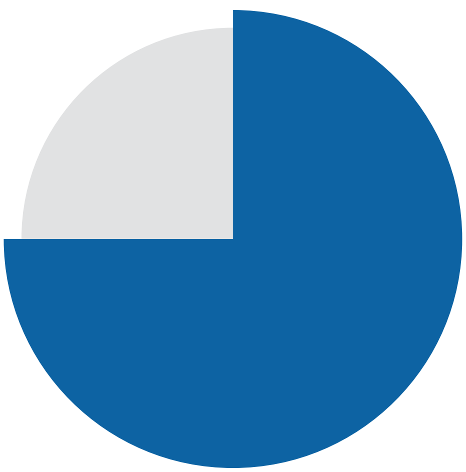
THE TWO CONCURRENT PATHS IN YOUR EXIT

Manage Your Personal and Business Goals

THE TWO CONCURRENT PATHS IN YOUR EXIT

As a business owner, likely the largest financial and personal decision you will make in your life is exiting your business. Successful exit strategies follow two concurrent paths. The business improvements path and your personal and financial planning path. Failing to consider and plan for both paths equally will cause problems to arise in your life and your business.

75% OF BUSINESS OWNERS CONDUCT BUSINESS ON VACATION



As a business owner, you spend the majority of your life working in your business. According to Forbes, "nearly one quarter (23%) of business owners take fewer than two vacation days annually." Work envelopes every aspect of a business owner's life. Even on vacation, which is meant to be a break from work, 75% of business owners still conduct business activities. In order to have a prosperous exit, an owner must spend as much time working on their personal life as they do their business.

Work On Your Business, Not Just In Your Business

Owners like to have their stamp on every aspect of their business, but most do not realize how detrimental this can be for the success of their company. A business will fail if it is dependent on any one person's individual successes. So, if you are an owner and find yourself working late each evening, spending hours on the weekend troubleshooting problems, and taking time away from your family on vacations to handle a work crisis: your business is too owner-dependent to succeed after your exit.

Instead of working in your business, as an owner, you should spend time working on the business to provide the most value. The best way to grow value in your business is for it to run independently from the owner. Investing time and resources to train leaders in your business ensures they will run your business well after your exit.

THE TWO CONCURRENT PATHS IN YOUR EXIT

Work On Your Life, Not Just In Your Life

On average 30% of our lives, or 25 to 30 years, is spent working. Business owners, and in particular, Baby Boomer business owners, spend even more of their lives working. It is no wonder that thinking about exiting your business is the source of stress for many business owners. The thought of living your life without your business as the focal point is almost unimaginable.

Without planning for your next act after leaving your business, you will never feel fulfilled personally. **If you exit your business at 60 or even 70, it is likely you will live another 20 to 30 years.** It is important to have a vision for what you are going to do with that time. Having a full and complete exit plan that considers your business, financial, and personal needs is crucial for a profitable business exit.

THE ONE GOAL OF EXIT PLANNING

THE ONE GOAL OF EXIT PLANNING

On the surface, it may seem like the main goal in exit planning is harvesting the value in your business and exiting happily into the next phase of your life. However, it is so much more than that. The goal of any successful exit plan is to create a significant company.

Is Your Company Significant?

One way to determine if your business is significant is by rating your company's readiness and attractiveness using a detailed index. Chris Snider writes, "Business Attractiveness answers the question, 'How attractive is your business in the eyes of a buyer?'" A buyer could be a family member, another employee, or a third-party buyer. The Attractiveness Index has 25 questions in four categories. Each category provides a score that is averaged to come up with the overall Attractiveness Score. A score of 50% or lower indicates that your company is "discounted" and serves as a red flag for owners. A business with a score between 58%-72% is of above-average attractiveness, and over 72% is considered a best-in-class business.

Scott Snider says that it is important to "Redefine what a best-in-class business is, particularly for the next generation business owner. No matter how good your metrics are, if your culture and customer engagement are low, your business value is low." A business is not valuable based on profits alone, but the ability to sell at any moment.

Exit Readiness asks the question, "How ready are you and the business to transition?" This index has over 120 questions in 22 personal, business, and financial categories. Again, the results from each category are averaged to get the overall score for the index. Those businesses that score above 72% are considered best-in-class.

Attractiveness and Readiness are not the same things. Just because your business scored highly on the Attractiveness Index, does not mean you are personally ready to exit your business. Similarly, if you are personally ready to exit your business, it does not automatically mean your business is attractive to buyers. Chris Snider writes, "Readiness is just as important as attractiveness. I could argue that it is even more important because it also includes personal and financial readiness."

In order for your company to be significant, it must be both attractive to customers and potential buyers, as well as ready to be transitioned. Through exit planning, you are able to build incremental value in your business and personal life that not only makes your business more attractive to buyers but makes you more personally ready to exit your business.

A NOTE FROM SCOTT SNIDER

President of Exit Planning Institute

The process of growing a significant company takes time and can be complex. This white paper takes the Value Acceleration Methodology and breaks it into 5 easy concepts as we introduced as 5-4-3-2-1. Though easy to understand as a business owner you may be sitting here still wondering “how do I implement this?” You may be motivated, perhaps even inspired to incorporate this into your strategic plans to begin not only earning more net profit to the bottom line but building something of significance.

But how do we do it? If you are like me, your life is already pretty planned out as an owner. I worked 10 to 14-hour days growing my company. The remainder of my time is spent within my community, with my family and friends, and traveling to try driving towards somewhat of a work-life balance.

Where do we find time to begin implementing 5-4-3-2-1 into our personal and professional lives? We do this by surrounding ourselves with great advisors on a transition or value growth advisory team. This should include a core team of your attorney, CPA, and financial advisor. They should be well-qualified and trained with the organizing principle of aligning The Three Legs of the Stool: Business, Personal and Financial goals. These advisors are Certified Exit Planning Advisors (CEPAs).

They are trained in the methodology, work well on teams, and manage the two concurrent paths for you. They will get not only your personal and financial goals aligned, but get your employees to think like owners, help decentralize you as the owner, and drive significant value into your company.

Scott Snider
President, Exit Planning Institute

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