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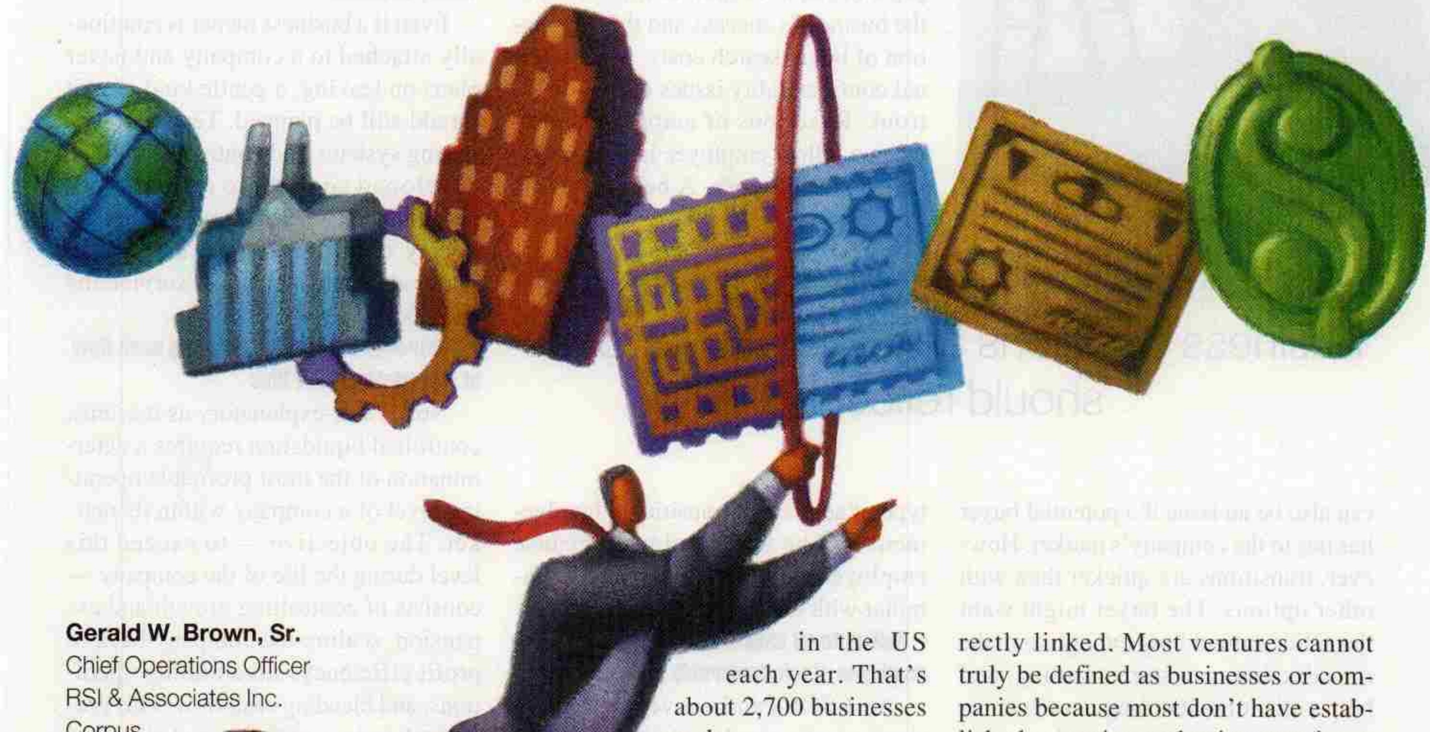
The exit strategy

In one way or another, business owners must step out of the game sometime. Here's how to do it gracefully.



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New start-up businesses are about the only investments commonly made without exit plans; in real estate, mutual funds, and stocks, accomplishing a profitable exit *is* the plan. The few entrepreneurs that do develop an exit strategy while tending operations are those that nurture a company's value by making it more marketable, and then cash out on their terms.

The harsh reality

The importance of establishing an exit strategy early is made clear by several statistics. According to the Department of Commerce:

- Over 1,000,000 businesses are started in the US each year. That's about 2,700 businesses per day.
- Forty percent of those businesses will fail in their first year.
- Of the businesses that do survive the first year, 50% more will fail by the fifth year.
- Over 80% of the businesses that survive the 5th year will fail before the 10th.

That's a survival rate of less than 5% for ten years! If a company manages to survive that long, it must contend with even gloomier selling statistics: more than 1.57 million companies were offered for sale in 2000, but only 250,000 were actually sold. That's only a 16% success rate. The other 1,320,000 businesses for sale either linger on the market, get passed on to relatives, or go out of business.

The failure rate of start-ups and the inability to sell a company might be directly linked. Most ventures cannot truly be defined as businesses or companies because most don't have established operating and exit strategies at their onsets. The majority serve as jobs for their owners. These cases are less likely to survive as businesses and are almost impossible to sell.

What's the plan?

First, it helps to differentiate exit types:

- **Selling a business to an individual financial buyer**

A financial buyer is an individual that relocates and operates the business on his own. The drawback of selling to a financial buyer is limited capital — usually the seller must carry some terms, often equal to or greater than the intangible or goodwill portion of the company's value. Also, financial buyers often try for lower than fair market prices, sometimes even trying for the asset base price. Because employees and customers get nervous if they know the business is for sale, confidentiality

Once a strategy is established, all business decisions and operational focus should reflect it.

can also be an issue if a potential buyer has ties to the company's market. However, transitions are quicker than with other options. The buyer might want the seller around long enough to make introductions, do some training, and help collect outstanding accounts receivable; this takes no more than a few months.

- **Selling to a strategic buyer, or company**

A strategic buyer is either a company wanting to expand into an industry or market, a competitor wanting to dominate a market, or a public company looking to grow through acquisition. Their stronger capital position requires sellers to carry limited terms — often just enough to guarantee help for an effective post-sale transition. A strategic buyer is also better equipped to understand, and more willing to pay a fair market price. However, transitions are longer in comparison to some of the other options; often a seller must stay on in a key operating position for two to five years. Also, during the due diligence process confidentiality is more of a concern because buyers are often in the business's industry or market; the knowledge of a company's availability might be used against it.

- **Selling to a key employee or employees**

Selling to employees is similar to selling to financial buyers because they typically have limited capital. One advantage is that banks are usually more comfortable loaning to a key employee than financial buyers. But, employees usually don't want to pay fair market and might feel they should get a better price because of their contribution to the business's success and the elimination of buyer search costs. Also, internal confidentiality issues can be disastrous. Reactions of employees vary when a fellow employee is purchasing their place of work. A benefit to this type of sell is that transitional involvement will be very minimal, because employees are already intimately familiar with the business.

- **Selling to all employees through an employee stock ownership plan, or ESOP**

An ESOP can be a very effective method of exit, but does require a strong management structure, and a core group of vested key employees. A seller is more likely to get fair market or even premium price, because an ESOP is usually determined by a formal business valuation, with limited negotiating. Tax benefits abound; selling by an ESOP is a great (not to mention legal) way to avoid capital gains. However, a proposed ESOP should remain confidential from general employees until it is deemed a feasible option.

- **Going public**

This route requires tremendous seller commitment, both physically and financially. The Securities Exchange Commission, or SEC, must approve of every aspect of a business and its initial offering, making solid operating systems and strong management structure absolute requirements. Once approved, a publicly traded company is more regulated, controlled, and exposed. However, going public is the ultimate exit strategy, because it provides the owner with a paced and controlled exit, as well as options for expansion and growth capital funding. Premium price, often well above fair market, is standard.

- **Managing for life, or maintaining as a family business**

Even if a business owner is emotionally attached to a company and never plans on leaving, a gentle kind of exit should still be planned. Tenacious operating systems and controls should be developed so that the eventual bequeathing to children, family members, or key employees goes smoothly. These also help a business survive the decisions of successors.

- **Controlled liquidation: bleeding cash flow at a predetermined time**

Not as self-explanatory as it seems, controlled liquidation requires a determination of the most profitable operating level of a company within its market. The objective — to exceed this level during the life of the company — consists of controlling growth and expansion, scaling the company back to profit efficiency, streamlining operations, and bleeding cash flow. This process takes time, patience, and planning. But uncontrolled, it can be an emotional roller coaster.

What's it worth?

Many factors go into determining the value of a viable company. An in-depth, impartial analysis of all the factors is necessary to determine an accurate opinion of value. Too often, business owners receive far less than fair market value for their company, because no proper business valuation was prepared, and no exit strategy was ever developed.

To insure an effective exit strategy, an understanding of what affects a company's value is imperative. A company *appraisal* is based on things tangible — things that can be seen, felt, touched, or stood on. It is often used to support a *valuation,* which takes into account both the tangible and intangi-

Adjustments

Before applying a company's financial numbers to valuation formulas, adjustments must be made to reflect a true picture of its profitability and asset base.

- Recasting the value of the assets to reflect their fair market value instead of depreciated value.
- Adjustments to Income: often referred to as 'add backs'...the idea is to pull out any and all discretionary expenses such as owner perks, non-recurring expenses, expenses related to the funding of growth and unexpected losses. On the other hand, if the property is owned by the business owner, but will not be included in the transaction, you must deduct fair market rent from the earnings of the company. These items are adjusted (added/subtracted) to the reported income of the company to determine its true profitability.
- Part of the process is to adjust the owner's salary to reflect what is deemed fair and reasonable.

ble. Valuations account for intellectual properties, proprietary rights, management structure, operational strengths, projections, historical performances, and customer bases. External factors also considered include the current economy's health, an industry's strength, any competition's edge, a location's attractiveness, and the stringency of applicable governmental regulations and licensing requirements. These internal and external factors ultimately determine the intangible, or goodwill portion of a business's value.

Standards of value

Once operational assets are valued, income is adjusted, and internal/external factors are considered, a standard of value must be established.

Fair market value is the price that a business can expect to bring if it were effectively exposed for sale on the open market for a reasonable amount of time, assuming an informed seller and an informed buyer, neither of whom is acting under undue pressure or compulsion. Several factors have to simultaneously come together for a seller to get fair market value.

Fair value is the number used by all parties involved in partnership breakups, ESOPs, estate taxes, and divorces. The objective is to establish a value fair to everyone internally involved in the transaction. (Yes, even the IRS is classified as internal — but you already knew that.)

Investors determine what an investment in a company is actually worth by using the **investment value**; it takes into consideration what the investor brings to the table. This includes features that they consider valuable.

Liquidation value is not as straightforward as one might assume. Often the costs of selling off are neglected when determining the net value of liquidation.

Determining a company's **intrinsic value** is probably the hardest part of an appraiser's job. This value is based on the *perceived future outcomes* of copyrights, patents, and trademarks.

Approaches

A proper valuation includes analyses of a company from several different approaches. An **asset approach** reports a book or liquidation value; these are accounting standards, and do not reflect fair market value. An **income approach** values a company according to its earnings, and is expressed as a multiple of earnings. A **market approach** values a company according to how similar companies were valued in the last few years. A **hybrid approach** is any combination of the above. The hybrid *excess earnings* formula used by the IRS is a summation of asset and intangible values.

Capital gains

Many factors will effect a seller's level of capital gains liability. Most business sales are structured as asset sales (as opposed to stock sales) because of tax benefits to buyers. But for an asset sale, it must be asked: *What exactly is being sold?* Assets usually include some tangibles, some previously booked business, goodwill, some consulting by the seller, and a covenant made by the seller not to compete with the business once sold. The tax implications of each allocation must be determined. Contrary to popular opinion, an accountant is not the best capital gains consultant. Accountants are trained to calculate owed taxes — not to structure companies or transactions to avoid capital gains tax. Business owners should seek the counsel of a certified financial planner, an estate attorney, or a tax consultant that specializes in the areas of taxing, corporate structure, and estate planning.

Their specialty is structuring companies in preparation for a future transaction to help avoid unnecessary capital gains taxes. Several creative (and legal) methods help reduce or eliminate taxes. These methods must be established prior to the sale and in most cases before entering into negotiations. A formal third party business valuation is recommended to help in the process and to defend the plan, if necessary. •

Recommended by the author:
The E-Myth Revisited by Michael Gerber
What is Your Exit Strategy? by Peter Engel