10 QUESTIONS TO DETERMINE IF YOU'RE READY FOR A BUSINESS EXIT

AN ARMANINO WHITE PAPER

The sale of your company can be the culmination of many years of hard work. To achieve the best financial outcome from this critical transaction, both you and the business have to be prepared. Asking yourself the following questions will help you determine how ready you are for a business exit on both an individual and an organizational level.

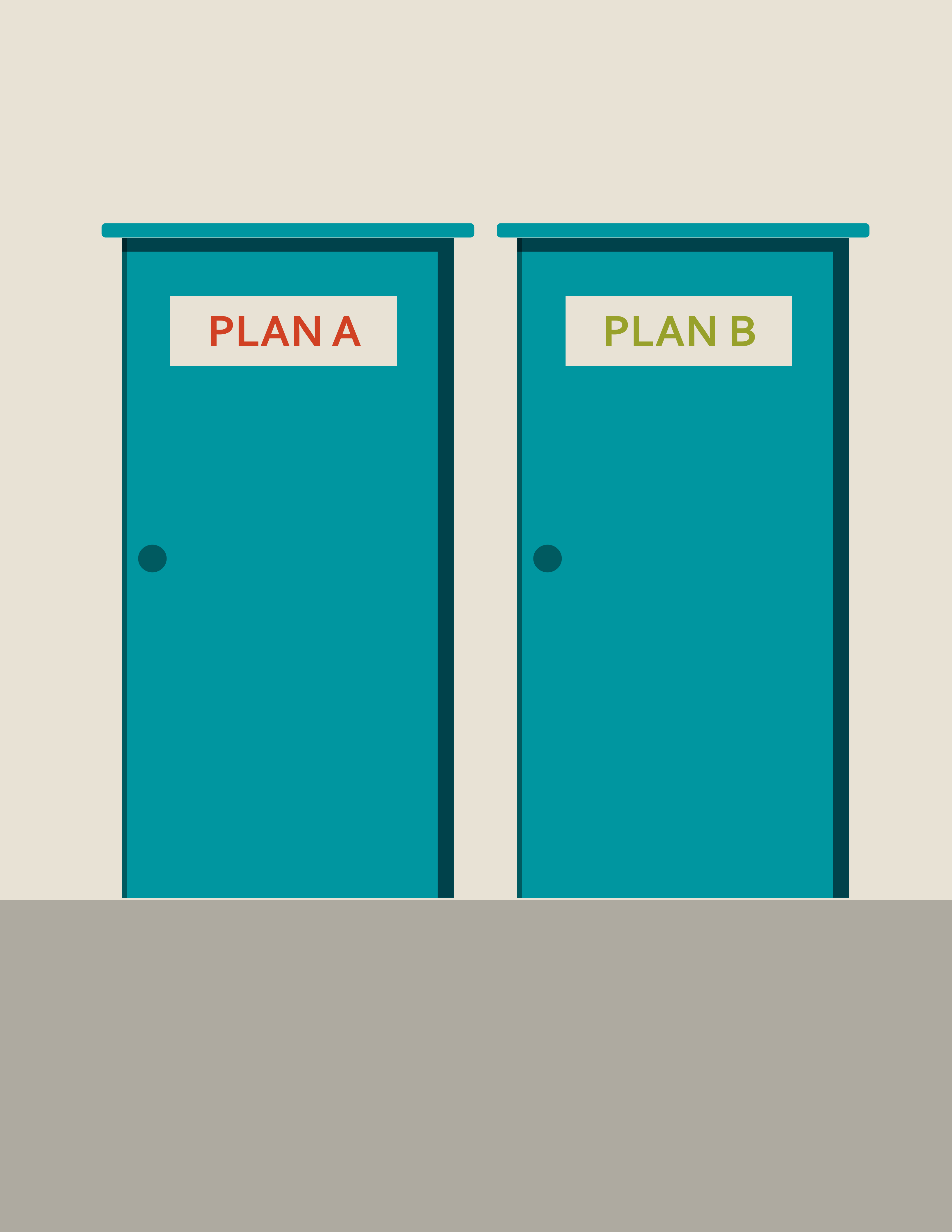
1 Have you gotten a formal business valuation within the last year and calculated the after-tax proceeds based on the likely transaction structure and type of buyer?

A business valuation serves as the baseline for any exit planning discussion. You may have price expectations, but if you don't have an actual third-party valuation, those are merely wishes. Without a current valuation, you may miscalculate not only the worth of the company, but also the general market for similar companies, who your potential buyers are, and what the value drivers are for the business. In addition, an initial valuation serves as a benchmark for any measures you may implement to increase the company's value.

The valuation also informs the general allocation of your wealth and investments. The business is often the major asset an owner has, yet it is seldom taken into account in the overall asset allocation between stocks (and industries), bonds, real estate and alternative assets. The company's value also impacts your strategies for estate planning and a generational transition of control of the business.

Not only the "gross" valuation is important. Equally crucial is an analysis of the likely buyer universe and the likely structure of a transaction, as both determine the actual after-tax proceeds you can expect from the sale of the company and the timing of such a payment. In addition, some changes in tax structure (like the conversion from C-corporation status to S-corporation status in order to maximize proceeds in a transaction that is structured as an asset sale) need to be implemented well in advance of an exit to be effective.


VALUATION


PLAN A
PLAN B

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Do you have a current, written exit/succession/transition plan, as well as a formal contingency plan?

There's a saying: A dream written down with a date becomes a goal. A goal broken down into steps becomes a plan. A plan backed by action makes your dreams come true.

An exit plan is a comprehensive plan to prepare a business for a change-of-control transaction, maximize the after-tax proceeds to the business owner, and ensure the business owner is able to accomplish his or her personal and financial goals in the process. It ultimately refers to a change of control to an unrelated party, whereas a succession plan or transition plan typically refers to a transition within the family of the owner—which needs to be managed just as carefully.

Without a plan, a succession/transition or exit becomes a game of chance, and the business often is not sold at the time of its highest value, or the transition and ownership transfer is not managed in the most efficient manner. Sometimes owners wait too long, or the company has to be sold or transitioned unexpectedly. Often, the owner is not ready when opportunity comes knocking with an offer.

Unforeseen events happen, so you also need a business contingency plan, which is a written set of instructions in case the business owner/primary executive becomes incapacitated. The more a business is dependent on one person, the higher the need for this plan. It should cover a scenario where you cannot continue running the business, either temporarily or permanently.

For example: Who should run the company if you can't? Is there enough insurance to cover any additional cost to the business (and the family)? Should the company be sold? To whom and by whom? Who are the relevant advisors, and where are the relevant documents?

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Do you have a strong management team (other than yourself), and are they incentivized to stay?

Often, a lot of the value of a business is tied to the owner and his or her continued involvement. The owner knows the customers and is their trusted provider. He or she may have developed the technology the business is based on, is most familiar with its products and services, and is the figurehead of the company, holding key relationships with customers and suppliers.

This dependency is a disadvantage if the company is for sale. The more the business is reliant on the owner, the lower its value, especially if he or she does not plan to remain involved. This often means that the owner has to stay on during the time period of an “earn-out” (a financing structure in which the buyer’s payments to the seller are deferred and contingent on the achievement of certain milestones or financial results) because the buyer is unsure if the company can perform through the transition—a situation that comes with its own issues.

The stronger your second-tier management team, the higher your company’s value. A buyer will rely on this second tier to carry the business forward, allowing you to step out or retire. The mantra is to “work on the business, not in the business,” preparing it for succession or a sale. Of course, you also have to retain that management team through the transaction, so a retention plan for key employees is paramount.

4 Is your largest customer below 10% of total company revenue?

Buyers pay less for higher risk. One of the largest and most immediate threats is losing a large customer. This is a general business risk, but during a transition or company sale, customer relationships are especially fragile. Competitors know this and will try to woo customers away from you, with the argument that your company is too distracted with the acquisition/transition.

The less a company is dependent on a small number of customers, the higher the sales price will be. And the more a customer is locked in (through long-term contracts or high switching costs), the lower the risk that they will jump ship during a transaction.

5 Is your office/facility presentable and your equipment up to date and in good working order?

Deferred maintenance is not only an indication that a buyer will have to spend money to bring equipment up to date. It also reflects poorly on the seller (if the equipment is too old or not maintained, what else has not been taken care of?) and may lead buyers to the conclusion that there is more risk in the business, which again leads to a lower price tag.

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Is the company's pretax profit over $1 million?

Profitability matters in most industries, and passing the threshold of $1 million in pretax profit—or earnings before interest, taxes, depreciation, and amortization (EBITDA), for that matter—opens up additional buyer groups. Having more potential buyers means a higher sales price.

Most private equity investors become interested at a level of $3 million to $5 million of EBITDA. The buyer universe for companies with less than $1 million in pretax profit is generally limited to individual buyers. (Tech companies are an exception to this rule and follow different metrics, particularly regarding the potential for future growth.)

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Are your profit margins at or above industry norms?

Your absolute profitability is important, but your relative profitability shows how well the company is managed. Well-run companies will garner a premium in the marketplace, often expressed as a higher multiple of EBITDA. Good management, exclusive access to customers, a valuable brand or unique products that may have patent protection all lead to a higher profitability than the industry norm, and usually carry a higher multiple than the industry norm.

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Does the company have a record of sales and profit growth during the past three years?

Acquisitions are forward looking. The higher the expected future growth, the higher the multiple on profitability. And the more your future growth estimates can be supported by the recent past, the more credible the continued growth becomes.

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Are your financial statements audited or reviewed?

The price a business commands is dependent on its future earnings capability, as well as the risk of achieving those earnings. The higher the risk, the lower the valuation multiple and the higher the capitalization rate.

Risk, of course, comes in many forms. One is information risk: Are the financial statements an accurate representation of the company's situation and are they prepared according to generally accepted accounting principles (GAAP)? One way to lower the information risk for a buyer is to provide audited financial statements (or for smaller companies, "reviewed" or at the very least, "compiled" financial statements).

For larger companies that target private equity funds as buyers (who will inevitably finance part of the purchase price with debt), an audit will be a prerequisite to satisfy the requirements of the debt provider/bank.

A side benefit of audited/reviewed financial statements is a higher certainty that an offer will actually lead to a transaction and not fall apart because the financials are not what they appeared to be when the offer was made.


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Do you have an updated personal financial, estate and tax plan, and do you know exactly how much you will need to exit your business?

Many owners have a "number" in mind that they'd like to get for their business, or a multiple that they would like to realize. But you need to put this raw number in perspective with your personal financial, estate and tax plan in order to achieve your goals. Without a comprehensive financial plan, it's difficult to know if the after-tax proceeds from the sale of the company are sufficient to support the lifestyle you want, or how any philanthropic or succession strategies can be implemented efficiently. Some tax strategies for estate planning will take time to implement and need to be in place before you are ready to entertain offers.

Contact us to learn more about how to prepare for and optimize your business exit.

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