BAIRD

Exit

Should you sell your business? How? And then what?

By Patrick M. Foley, CFP®, QPFC

Synopsis

Should you sell your business? is a big question. It can be up there with *Is she the one?* or *Should we have one more baby?* Maybe it's not that big, but it can certainly change the direction of your life.

The subject is too complex to be covered briefly, but this article will provide an overview of the issues a business owner needs to address when considering a sale. In particular, we will focus on how to assemble a strong team to guarantee a totally smooth process. (I'm kidding – there is no such thing as a totally smooth business sale. However, there are ways to improve the odds of a positive outcome.)

We will address the following topics, with particular emphasis on question No. 4, since working with the right people can go a long way toward successfully handling the rest:

1. Why Sell?
2. For How Much?
3. Who Is the Buyer?
4. Who Will Help You?
5. What Should You Do With the Proceeds?
6. What Do You Want to Do With the Rest of Your Life?

Why Sell?

Maybe it's just time to hang up the spurs. You have been working hard forever and now you want to realize the value of the business to finance a comfortable retirement. Or, you want the financial security that would be provided by a full or partial exit (you want to diversify your wealth). Maybe you feel that tougher times are ahead in your industry, and the valuation will never be quite the same as it is today. There could be family concerns, health issues or a myriad of other factors telling you the time has come.

Whatever the reasons, take time to think about why you're selling, along with the final question on our list: What do you want to do with the rest of your life? They are important and intertwined questions, and sometimes they get lost in the shuffle behind the financial aspects of a sale.

Ideally the sale happens at a time and a place of your choosing, instead of being foisted upon you by circumstances beyond your control. According to a study by PwC,[1] 75% of business owners are dissatisfied with the result of their exit. That is an extraordinary statistic! The biggest problem seems to be that most business sales happen in a rushed or seat-of-the-pants manner. It is a recipe for poor outcomes.

Saying "you should plan ahead" is like saying "you should exercise." Yeah, you know you should, but will you? Don't worry – planning a sale is at least somewhat easier than exercise. Half the battle is assembling the right team, a topic we address later.

For How Much?

Your business is worth only what someone is willing to pay for it. That may sound obvious, but whether selling a car, a house, a business or anything else, owners will often get caught up in their own vision of value regardless of what the market will actually bear.

Unlike a car or house sale, when it comes to selling a business you cannot always use the most efficient pricing approach, which is to expose what you are selling to a ton of buyers and take the highest offer. With a business, being open about your intent to sell can be disruptive. It can spook your customers, your employees and even family members. Instead you may need to come up with a realistic valuation, quietly seek out a small number of potential buyers and conduct a targeted auction. You may even need to confine your negotiation to a single buyer.

Transaction advisors such as M&A consultants or investment bankers can help you assess the market for businesses. They can also guide you in terms of the subjective and objective strengths and weaknesses of your business.

As part of your preparation process, you will need to obtain a business valuation from a transaction advisor, a CPA firm or a business valuation specialist. (More detail on the subject of valuations is provided in the section on accountants.)

Well before a transaction occurs, you should think about how your business will be perceived by a

[1] "Whose Business Is It Anyway? Smart Strategies for Ownership Succession," PricewaterhouseCoopers

potential buyer and take steps to make it more “sellable.” For example, consider crafting an employee compensation plan to include golden handcuffs (deferred compensation), as the ability to retain key employees beyond a buyout will be critical. When an owner contemplates an exit, it becomes particularly important to make sure that key employees do not also contemplate an exit!

Aside from making sure that you have strong senior management committed to the business, you need to consider factors such as:

- Having a diverse customer base, without too much revenue coming from any single source
- Avoiding an over-reliance on a small number of key suppliers
- Avoiding an over-reliance on one or two key sales people or product/design specialists
- Maximizing recurring revenue
- Getting your financial and legal reporting in order

When interviewing service providers in the exit market, be sure to ask what they would do to help you pretty up your business for sale.

Who Is the Buyer?

There are three kinds of buyers: family, employees and outsiders. While most owners would prefer to sell to a family member, the reality is that most businesses are sold to outsiders.[2] Who you sell to will help dictate the structure of the transaction and to some extent the value you receive.

In a sale to family or employees, you will likely need to help arrange financing, and the cash flow of the business will play a role. Again, early planning is required. For example, you can begin funding an insider buyout years in advance through contributions to a deferred compensation plan.

Other alternatives for selling to employees:

Long-term installment sale: As the name suggests, you will have to wait and get your money over time.

Leveraged management buyout: Often funded with private equity money, it helps to have hard assets to secure the borrowing.

Modified buyout: Initially employees purchase a minority interest, with the full buyout occurring later (possibly through an installment sale).

The often preferred but typically elusive sale to family members brings about an entirely different set of considerations. In a sale to family, you may wish to minimize the valuation in order to maximize the removal of assets from your estate. Estate taxes are family business killers and are often the biggest impediment to transferring ownership down the family line. (Have we mentioned the importance of planning? If you fail to plan, you will fail to keep your business in the family.)

One key consideration with employee buyouts is that the money has to be taxed twice before it’s fully transferred – once when paid to the employee as income, and again when paid to you as capital gains. An employee stock ownership plan (ESOP) is a structure

[2] PwC Family Business Survey, 2012/2013

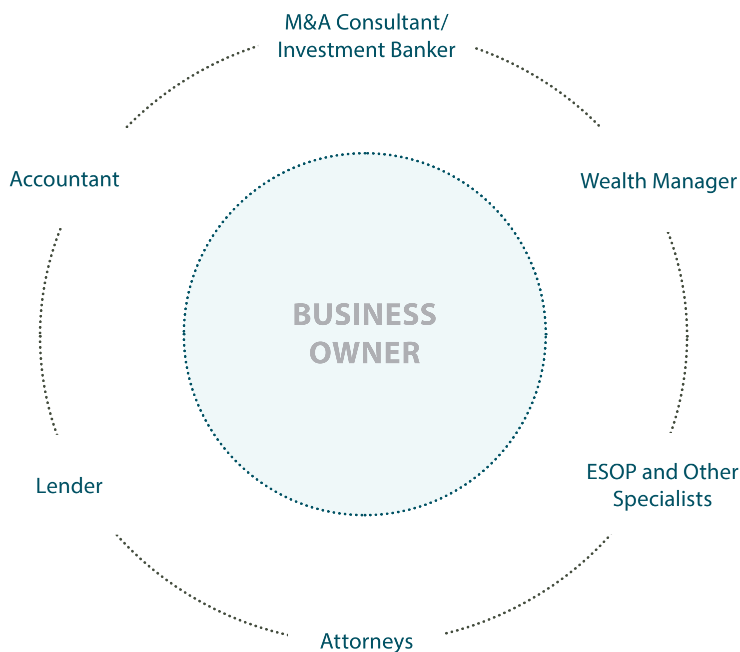
that can be terrifically advantageous from a tax standpoint when selling to family members or employees. A properly constructed plan is funded with tax-deductible contributions and allows the owner to reinvest the proceeds from the sale into a diversified portfolio of investments while deferring the tax impact. In addition, it creates a vehicle that allows the owner to maintain control over the transfer process.

The most common transaction, and one that is likely to maximize market value, is the sale to a third party. This can come in many forms and structures, each with their own set of tax treatments and implications.

The deal can be structured as a stock sale (better for you) or as an asset sale (better for the buyer). You can sell to a competitor or to a company that sees your organization as a strategic fit, which may help your valuation. If your earnings before interest, taxes, depreciation and amortization is above $2 million or so, you might attract attention from private equity buyers. For larger companies – $100 million in revenue is sometimes cited as a rough metric – going public is another possibility. Unfortunately, in part because of increased accounting costs associated with Sarbanes-Oxley legislation, fewer companies are able to pursue the IPO route than was the case prior to 2008.[3]

When the buyer is an outsider, it is not uncommon for the seller to receive 70% or so of the value upfront, with the rest coming in the form of an earn-out over a period of years based on certain targets. In this case, the selling owner continues working for the company as an employee or consultant until the earn-out is complete.

TEAM OF EXPERT ADVISORS



Who Will Help You?

In every industry there are a handful of top providers that people in the business hire – the surgeon other doctors trust to operate on them, the lawyer whom lawyers call when they've got a problem, the bartender other bartenders order their Long Island iced teas from (it's a tricky recipe).

When you seek a service provider – either for help selling your business or for anything else – those are the ones you want to find. In fact, we immodestly describe our own team as "the financial professionals that financial professionals turn to for guidance."

For a successful exit, you will need to build an all-star team of expert advisors:

[3] "Where Have All the IPO's Gone?" Xiaohui Gao, Jay R. Ritterb, Zhongyan Zhuc

Business Broker/M&A Consultant/ Investment Banker

A key player on your team will be the transaction advisor who quarterbacks the sale on your behalf, acting as your primary representative. Depending on the size of your business, the role might be filled by a business broker (small), an M&A consultant (medium) or an investment banker (large).

Responsibilities include:

- Providing advice on deal structure and ways to improve the attractiveness of your business
- Analyzing the marketplace in terms of transaction activity, market trends and other factors that impact the price you'll likely receive
- Seeking and screening potential buyers, whether among competitors, investors or companies seeking a strategic fit
- Negotiating with potential buyers on your behalf
- Coordinating the work of other advisors on your team

If the deal size is below $5 million, you will likely be working with a business broker. Although the names can be used somewhat interchangeably, as you get around $5 million and above, the term M&A consultant is more common, and is reflective of the additional complexity of larger transactions.

Investment bankers perform a similar role for even larger transactions, beginning in the same realm as M&A consultants, and going up into the world of global mega-corporations. Investment bankers can come from local investment banking boutiques, midsized regional brokerages or the big "wire house" investment banks. Again, the size and complexity of the deal will help dictate whom a company should engage. A key difference with investment bankers (as opposed to brokers/consultants) is that their firms have capital that in some cases can be deployed to help finance a transaction. They also tend to have a greater range of options outside of a traditional sale (e.g., recapitalization, IPO).

Fees in the transaction advisor world are often based on the so-called "Lehman Formula." This pricing model was developed by Lehman Brothers (before their epic 2008 meltdown!) as a scale for investment banking services. There are many variations, but the basic idea is that there are tranches of fees depending on the size of the transaction:

Lehman Formula:

< $5 million: 5–10%

$5–10 million: 5%

> $10 million: 1–5%

In addition to transaction fees, you may be required to pay an upfront or monthly fee to obtain the services of an investment banking or M&A firm. The larger the deal, the more likely you are to encounter such fees.

When seeking an advisor, expect to be initially asked for three years' worth of financial statements and tax returns, current financial statements and marketing materials describing the business. A much more detailed grilling will come later on if you engage them to represent you.

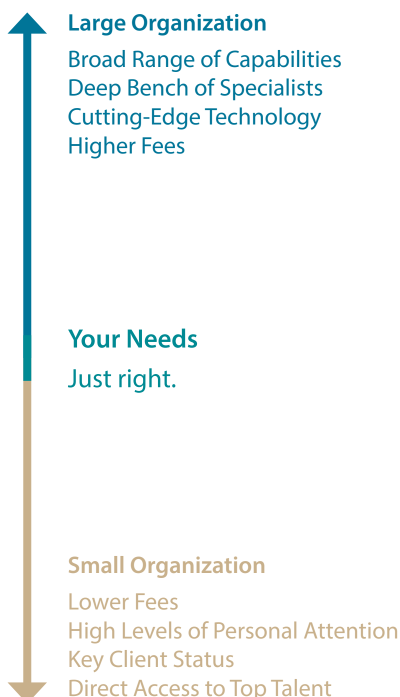
There is an element of choosing a service provider, in almost any category, that we call the "Goldilocks Scale." When it comes to the size of an organization – be it law firm, investment firm, CPA, investment bank or whatever – size matters. You want to find providers who are neither too big nor too small.

An organization that is too small could lack the experience or resources to expertly handle every task put before them during your exit.

An organization that is too large may be expensive, inflexible or non-responsive, and might lack in personal touch. Ultimately, your business might not mean all that much to a "too large" provider, and that can be reflected in the service you receive.

We often find that "just right" means large enough to expertly address all needs but not much larger.

THE GOLDILOCKS SERVICE PROVIDER SCALE



As with any other advisor, expertise and experience are critical. You will also want to pay attention to how often an advisor has worked with your specific type of business, particularly if you operate in a very specialized realm.

Accountants

When a buyer takes a serious look at your company, you can be sure they will conduct painfully thorough due diligence. Being prepared for this process will not only make things easier for you, but may help you land a better price. To a potential buyer, good, clean books are a sign of a well-run operation they can buy with confidence.

An accounting firm with a strong background in business exits can provide valuable assistance regarding financial aspects of the due diligence process. A buyer wants to know what they are getting, and clear reporting is critical for that. In addition to making sure that current reporting is up to snuff, an accounting firm may be called upon to provide the following services:

Business valuation: This is an essential element of exit planning. Whether handled by an accounting firm or other provider, it is an outside evaluation of what your business is worth. Valuations can range from fairly simple calculations based on business metrics up to very detailed reports that include formal opinions. Informal valuations are suitable for planning a transaction, and typically cost somewhere in the range of $5,000–$10,000. When heavy-duty reports are required, such as for tax or legal purposes, you are more likely to spend $20,000–$30,000.

Recasting or normalization of financial statements: This is a process of examining the true cash flow of a business by adding back in above-market salaries, fringe benefits, unusual expenses and other items that might otherwise cloud the picture for a potential buyer.

Pro forma financial statements: If a buyer is likely to obtain strategic benefits through the acquisition of your business, a sophisticated accounting firm may be able to provide theoretical financial statements that project what the buyer's numbers could look like after they make the smart move and buy your company.

Audit: Buyers put more faith in audited financial statements.

Reverse due diligence: Some accounting firms will provide a detailed review of your financials that mirrors the sort of intensive due diligence you can expect from a buyer. This proactive approach can help you identify issues in advance so you can address them prior to putting the company up for sale. A problem that you discover and fix (or disclose) is likely to cause less damage to your valuation than one that is discovered by the buyer.

Many times the company accountant is a longtime friend, or at least has a long relationship with the business. Do not be surprised if your current accountant is not enthusiastic about the prospect of a buyout. An exit can be labor-intensive, puts their work under a microscope and is likely to lead to one fewer client. Consider that you may need to look outside of your

current provider for help with a sale. This is particularly important if your current accounting firm is not highly experienced with handling business transactions.

As with other service providers, we refer you to the Goldilocks Scale when it comes to accounting firms. There is a broad range out there, from sole practitioners up to the so called "Big Four" (PwC, Deloitte, KPMG and Ernst & Young). Make sure to match the accounting firm's capabilities to your needs, and seek out accountants with expertise and experience in business exits.

Attorneys

"Send lawyers, guns and money!"
– Warren Zevon

Though you're not likely to need any firearms, a business sale is certain to involve lawyers and money. Attorneys will address two areas for you: the business transaction itself and the structure of your estate (which may impact the shape the sale takes). The latter is of particular importance when passing the business to family.

Business: You will need to review existing contracts that may be relevant to a potential buyer, and of course you will be entering into a contract if you sell the business. Before putting your company up for sale, the attorney handling your transaction should conduct a legal audit that reviews contracts, shareholder agreements, minutes, articles, bylaws, compensation plans and all other legal agreements. This helps to head off any problems that might occur when a buyer begins to review your documents.

Trust and Estate: You should examine trust and gifting options to remove business interests from your estate and pass them to next generations. You will also want to review existing buy-sell agreements and make sure your will and other estate documents are working in concert with your exit plan. The sooner this type of planning begins, the better. Your wealth manager can also assist in this effort.

The size of law firm is also a factor to consider. Larger ones will have a number of M&A and other specialists on staff that can be called upon as needed. On the other hand, a larger firm typically means larger fees. A partner at a big firm in a metro market like Philadelphia, working on small- to middle-market deals, may charge $500 or more an hour (it can go much higher, particularly for specialists or senior attorneys). On the other hand, associates – who will handle some of the legwork on a deal – would be more in the range of $200–$350 per hour.

It is very important to understand in advance how the law firm intends to staff your deal. How many lawyers, and what level of lawyers, will be putting in hours for you? Small- and medium-sized firms will typically bill at lower rates, but no matter who you work with, you will need a detailed discussion to get a sense of the costs you will be facing.

There is a broad range of possibilities when it comes to legal costs. It really depends on the size and complexity of the deal. How many employees and how many sites? Are you currently involved in litigation? If the deal is to include some sort of earn-

out provision (they often do), expect that to drive up your fees.

A strong legal team is vitally important when it comes to achieving a successful exit. They will help you avoid trouble and have your back if problems do arise. Make sure to focus on expertise and experience when choosing legal representation.

Wealth Manager

People call themselves many things in my business: financial planner, stock broker, investment advisor and so forth. Lately, though, many have been going with "wealth manager." I imagine because it suggests a certain gravitas.

If you are planning to sell your business, though, true wealth management is exactly what you need. The term denotes a level of comprehensive financial oversight that is only provided by a relative few financial advisors. In addition to investment guidance, wealth management should encompass areas like trust and estate planning, charitable giving, tax and cash flow planning, insurance and asset protection, and the coordination of input from the various professionals you work with (your accountant, attorneys, insurance providers, and so forth).

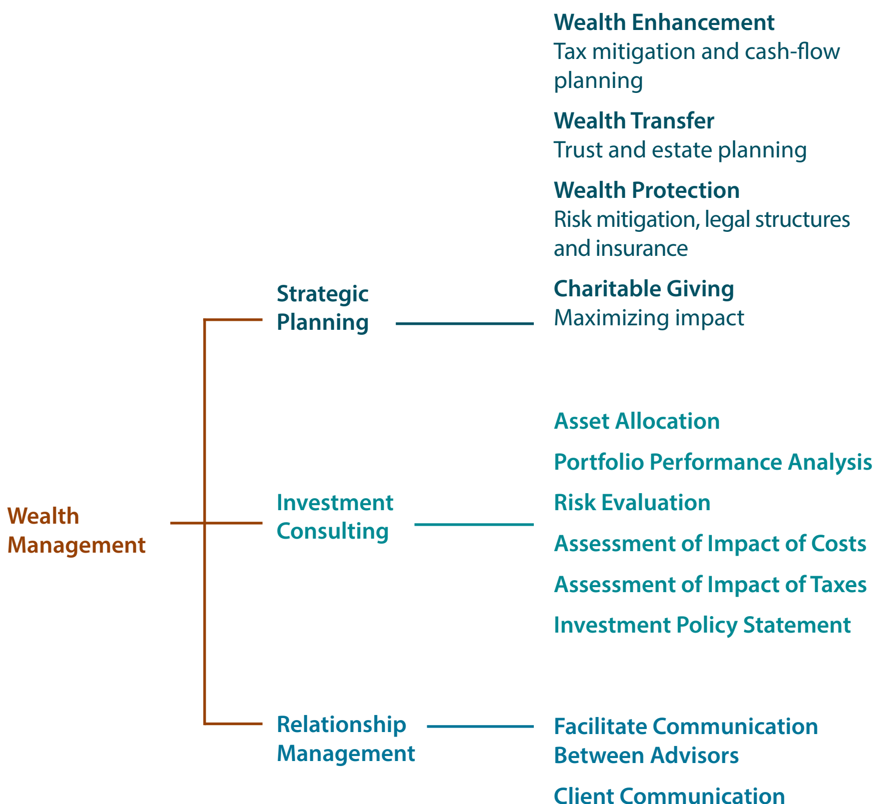
A good wealth manager can be described as a "personal CFO." In fact, some market themselves just that way.

The investment advisory / wealth management industry has a number of basic models or business structures:

Wire house brokerage: These are the very largest investment firms – Merrill Lynch, Morgan Stanley, UBS and Wells Fargo. Their size allows them to offer a very broad scope of services, including investment banking, traditional banking and lending, investment management and more. Some of the wire houses played controversial roles in the 2008 economic collapse. All are public companies and face heightened regulatory scrutiny in the wake of the crisis.

Regional brokerage: Regionals also tend to offer a broad spectrum of services (often with the exception of traditional banking), but these are smaller companies with operations concentrated in certain parts of the country. There is some variety to the ownership structure of

HOW OUR TEAM DEFINES WEALTH MANAGEMENT:



regional firms (e.g., public, private, employee-owned).

Independent financial planner: While an independent planner will typically clear (settle transactions) through a large brokerage such as Charles Schwab or LPL, their practices are essentially individual businesses (which could consist of one or hundreds of planners) not beholden to a particular investment house.

Insurance company representative: Many insurance companies maintain financial planning operations. Their investment recommendations tend to focus on “packaged” solutions, such as mutual funds and in particular insurance-based investments (e.g., life insurance and annuities).

Bank representative: It is common for banks to have an investment advisor on staff to help the bank’s clients make investment decisions. As with insurance company advisers, their focus tends to be on packaged products.

Family office: At the upper end of the market (typically $100 million of investable assets and above), families may hire a manager or team that exclusively focuses on the handling of their financial affairs. Alternately, a multi-family office may handle a relatively small number of high-net-worth clients. For those with the means, this approach provides a very personalized and comprehensive level of service.

In addition to different types of investment advisors, there are different ways to pay for their advice. Independent advisors typically charge a fee based on the size of the assets they manage. Fees often fall somewhere between 1 and 2% of the assets under management, although they can be lower, particularly in the case of multi-million-dollar portfolios. Alternately, some planners may charge a flat annual fee, and some charge on an a la carte basis depending on the services provided. The advantage of the fee-based model is that it ties the compensation of the advisor to the success of the client’s portfolio (i.e., the more it grows, the more the advisor is paid), and it removes any impetus for the advisor to drive up compensation through unnecessary transactions.

On the other hand, in a low-turnover portfolio, costs may be less under a commission arrangement. Wire house and regional firms have been moving toward the fee-based model in recent years, although many are compensated through a blend of both. When vetting an advisor, make sure to include a thorough discussion of costs.

You should also consider the experience and credentials of a potential advisor. When it comes to experience, of course, the more the better. In particular, you want to work with someone who has seen their share of bear markets, because nothing imparts wisdom quite so well as experiencing a disaster. The markets of 2001–2002 and 2008 come to mind as prime examples.

Advisor credentials should also be considered. The investment industry has been experiencing “credential inflation” of late, as more and more accreditations have been invented, some of dubious merit. Here are some of the more well-established and recognized financial credentials:

CFP® (CERTIFIED FINANCIAL PLANNER™): The most recognized financial planning designation. Attaining the CFP® requires study and testing in seven categories, followed by a comprehensive exam that only about 55% of applicants pass.[4]

CFA® (Chartered Financial Analyst®): The most mathematically rigorous of the leading credentials, it delves into areas such as portfolio structure and corporate accounting. The testing is notoriously difficult.

CPA (Certified Public Accountant): The accounting profession's standard of competence. It is a title with legal standing, requiring experience along with rigorous study and testing.

ChFC® (Chartered Financial Consultant®): A financial planning designation common among insurance agents, it includes more coursework than the CFP® but without the comprehensive exam.

CLU® (Charted Life Underwriter®): The most recognized credential specific to insurance. It requires completion of five courses (without a comprehensive exam).

Other Consultants

In addition to the broad categories described above, there are a myriad of other consultants and providers who serve the exit market. There are exit planners, business valuation specialists, expense reduction consultants, ESOP specialists and advisors who specialize in the personal or family aspects of a business exit. In many cases the services offered by various providers may overlap. You will need to shop around a bit to build a team that covers all the bases for your particular situation.

Ask each advisor about the scope of their work, their experience, their cost structure, and their willingness to collaborate with other members of your team.

What Will You Do With the Proceeds?

If you have considerable wealth outside of your business, you may be well-diversified already. However, for many owners, the business represents a highly concentrated position. Most people would never hold a portfolio with 90% of their money in one stock, but with a closely held business, that sort of concentration is not unusual. Because of that, selling a business often represents an opportunity to reduce risk by achieving much broader diversification.

That's the good news. The bad news is that the investment climate right now is particularly challenging. Interest rates are at record lows – about as low as they can go. Global political risk is high. We face adverse demographic trends (e.g., an aging population), enormous systemic debt, rising healthcare costs and so forth. Of course, the risks experienced by investment portfolios are also impacting many businesses.

A full discussion of portfolio construction and expected rates of return is well beyond the scope of this article, but as redeployment of assets is a critical concern in the wake of a business sale, we will look at some general concepts and rules of thumb.

What you do with the proceeds depends on what you want to

[4] Certified Financial Planner Board of Standards, Inc. http://www.cfp.net/media/survey.asp?id=9

achieve. Are you hoping to start another business? Are you looking to retire and create a lifetime income? Do you have charitable intentions? Do you want to buy a really sweet car? That's what I would do.

For purposes of this discussion, we will assume you want the sale of your business to allow you to retire. The appropriate way to address redeployment of assets for retirement is through a comprehensive financial plan that will help you determine "your number" (i.e., how much you need to comfortably fund your needs for the rest of your life). It will also establish a plan for investing that seeks to provide an adequate stream of income and keep pace with inflation throughout your life.

Speaking of how much you need, a heavily debated rule of thumb says you can expect to withdraw between 4 and 4.5% annually from a moderately allocated portfolio with a reasonably high expectation of not running out of money.

Based on that theory, if you net a million dollars from your sale, you're looking at an income of about $45,000 (before taxes) to supplement whatever you are getting from Social Security, pensions and so forth. A million dollars isn't what it used to be!

S&P 500 INDEX DAILY

Source: MarketWatch.com

In structuring a portfolio, we recommend broad diversification across asset classes and investment styles ("hyper diversification" is how we like to think of it), and we urge the use of a systematic approach. That last part is critical: Utilize a process! Investing based on "gut feeling" seems to be the most common mistake investors make. The reason is that our instincts (and even logic) often tell us to get into and out of investments at exactly the wrong time. As an example, consider that the stock market experienced an extraordinary recovery in the wake of the 2008 economic crisis – a recovery that many investors missed. At so many times during that recovery, it seemed like getting out was the only reasonable course of action. And in each case, the market reversed course and kept climbing.

Do not misread this as a "don't worry, the market will always go higher" mindset. The point is, we think good portfolio structure starts with the admission that we cannot really know what will happen next. The future is unknowable – invest accordingly.

If your plan is to convert the proceeds from your business sale into retirement income, you should be thinking in terms of three elements: the need, the portfolio structure and the income plan. As with the

business exit, we recommend an approach that is heavy on advanced planning, with the help of carefully selected advisors.

What Do You Want to Do With the Rest of Your Life?

What does money mean to you?

When it comes down to it, money is only a placeholder, an abstraction. For some it represents security or accomplishment, while others have very specific ideas about what they want to obtain with their money. In any case, when you consider the sale of your business it is important to take some time to ponder what you want to accomplish with the post-exit part of your life. Even if what you mostly want to accomplish is golf.

For most owners, the business is a big part of who they are. Many go through an exit focused on the money and afterward find themselves wondering "Wait, who am I now?" Aside from a failure to plan, I suspect that failure to adequately address that question might be the biggest reason so many owners end up unhappy with the outcome of their exit.

So give this some thought: You dreamt of having a successful business … what do you dream of next?

Summary

The big subject in the world of exit planning these days is the impending flood of businesses for sale as baby boomers look to sell en masse in the years ahead. If you want to sell, you will likely be entering a crowded market. Will your business have what it takes to stand out?

Our advice in this regard is very straightforward: Pick good advisors and plan ahead. Put together a team that is experienced at exit planning, and craft the terms of your sale in a measured and deliberate way.

Lastly, create a clear vision for the next phase of your life. It should involve smelling the roses and finding ways to continue as a positive contributor to your family and the world.

BOOK SUGGESTIONS

Every Family's Business by Thomas William Dean, Ph.D.

A must-read for family business owners. Presented in the form of a story about two business owners meeting on an airplane, it offers a truly eye-opening way of looking at a family business. And it describes an approach that could mean the difference when it comes to keeping the business (and maybe even the family!) together.

Built to Sell by John Warrilow

Also presented in storytelling format, this book focuses on steps an owner can take to maximize the "sellability" of a business. In particular, it suggests spreading responsibilities among employees and finding ways to package services as products (products make for better exits).

How to Run Your Business So You Can Leave It in Style by John Brown

A detailed, step-by-step guide to the business exit process from planning through closing. In a very readable way, this book provides deep coverage of the subject.

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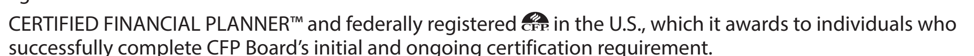

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