OWNER BEWARE - DON'T CHECK OUT TOO EARLY

Business owners who know that focus is key to their success often do not rely upon this basic premise when structuring their exit plans. Both during the exit planning phase as well as the execution phase, it is critical to not 'check out too early'.

Now, admittedly it is natural to let your mind wander when you approach a certain milestone in life. This happens quite often to business owners. They can get tired of the endless grind of running a business and having it weigh on their mind without end. They may have lost the passion and enthusiasm for it that once consumed them. Further, it is not unusual to find business owners lost in the past, recalling earlier, perhaps more exciting or profitable periods in their business.

Or they may find themselves completely detached from the business and essentially thinking of all of the other things they want to do with their lives; traveling, spending time with their family, pursuing other interests and hobbies.

The problem is that all of these are symptoms of checking out too early which can be detrimental to your exit.

The Importance of being "Checked In"

Arguably the most important aspect of the exit planning process is an honest conversation a business owner should have with themselves about their

personal and business goals. This conversation brings the owner back to the present and creates a deeper understanding of what really drives their decisions and their actions. Without this type of honest, 'internal' conversation, owners are too often left adrift with a solid plan for an exit and being to check out too early.

Now, in fact, this internal conversation can be very difficult for the business owners as it means confronting certain uncomfortable realities that may have been previously disregarded. In the case of a business owner that may have 'checked-out' this self assessment of one's personal and business goals will snap many business owners back to the present with a sobering realization that there is still a lot of work to be done to exit successfully.

It is crucial that the business owner be 'checked back in' to successfully execute the rest of the exit planning process. So much of a successful exit will depend on the owner's full engagement, particularly when one considers the different roles that an owner plays for different types of exits.

The Exit Planning Process

Perhaps the most critical time in terms of the business owner being fully engaged with the business is during the exit planning process. This is often a period of many months where the owner is actively learning about exit options as well as clearly

formulating and articulating their personal and business goals. Only full engagement by the owner will produce reliable outputs. Further, it is during their planning stage that key, strategic decisions are made as to what direction the owner will head in for their exit.

Internal Transfers

For example, the three main types of internal transfers, Succession, Management Buyout and ESOP's tend to require a higher level of participation, i.e. being 'checked-in'. The owner's participation is crucial to the successful transfer of management of the company to the next team of leaders. In fact, one may argue that owners need to be more engaged during this process for two (2) primary reasons. First, the owner needs to serve as a mentor, not a manager of these future leaders.And next, in most cases, in order for the owner to get paid their exit price, the business must continue to produce successful profits into the near, mid, and perhaps even long-term.

External Transfers

With few exceptions, the business owner will need to stay engaged in the business even after an external transfer. For example, when considering a private equity group recapitalization as an exit option, the owner must show a full-scale engagement because few, if any, private equity groups will consider an investment of this type if the owner does not exhibit a complete grasp of their business. In fact, owners need to work concurrently with past data, present information and future planning. The private equity group is investing not only in future forecasts of business performance but also, in most cases, the active engagement of the owner in fulfilling these projections.

Even a sale of the business to an outside buyer – i.e. someone in your industry - generally is coupled with deferred and contingent payments. This often means that the exiting business owner must actively participate and be vested in the future performance of the company he or she has sold. For example, many business sales are based on an earn-out. In this situation, a significant portion of an owner’s selling price is tied directly to the future success of the business. For certain in this situation the owner does not want to check out completely.

Conclusion

In conclusion, one the most dangerous aspects of the exit planning process is when a business owner checks out too early. This scenario leads to a decrease in the likelihood of a successful exit and may even take viable exit options off the table. Therefore, as they say, forewarned is forearmed – don’t check out too early with your exit.

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YOUR PROTECTED ILLIQUID ASSET, YOUR BUSINESS

FROM THE DESK OF: **EDWARD BARONE**

In today's economy, many business owners are looking to cash in the value of their business because profitability and valuations are high. If your business is healthy and strong, it likely represents the most valuable asset / holding in your overall personal portfolio today. Because of that, whether you are looking to cash in during this strong economy or you are thinking about holding onto your business for more than the next few years, it makes sense that you look after your largest illiquid asset and consider the timing of a potential exit. Let's begin to put this in perspective by looking at an overall picture of wealth.

Business Owner Wealth

In the world of 'wealth' there are five primary asset classes - they are:

1. Stocks
2. Bonds
3. Cash
4. Real Estate
5. Privately held businesses

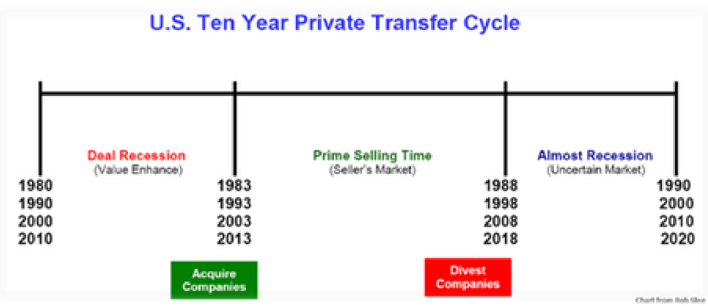
Business owners tend to concentrate their wealth in their privately held businesses, creating an overall portfolio that is not diversified and is highly dependent upon the success of one asset – the business. It has been said that "in order to get wealthy, you need to own a lot of one (1) asset, but to stay wealthy you need to own many different assets". For the most part, you want to diversify your wealth into many different areas – that is, diversify– in order to protect your wealth against a drop in value in any one category – this is particularly true if you believe that a recession may be near.

Market Cycles

If you believe that we are heading into a recession in the next few years and you are interested in protecting your largest asset, you may be well served to ask how well your business expects to perform during the next recession. From there, you may further consider whether you should ‘stay and grow’ or start planning and executing your exit on an expedited basis.

Markets run in cycles and, when businesses perform well because of favorable economies, valuations are high, employees are engaged, and – often times – buyers / investors have a high degree of interest and activity.

As the chart below indicates, the last three (3) decades have followed a similar market cycle and this decade is following suit.



After a long bull run, we are in a period of uncertainty, and, perhaps nearing the end of this current cycle." It may or may not, but most agree on two (2) important points – First, that another recession will appear, and second, that the drop in the economy happens a lot faster than the slow build-up of growth.

Is Your Business Recession- Resistant?

The wealth concentrated in your privately held business may fare differently than your other assets in a recession. The important question to ask yourself is “will my business sustain less damage to its value than other assets in my portfolio during the next recession?”

Based on the answer to that question, you may also ask whether you are better off with an exit today to shift assets to less risky categories (i.e. from illiquid to cash or cash equivalents).

Some History of the Last Recession is Helpful

Think about it this way: in October of 2007 the Dow Jones Industrial Average was at a peak exceeding 14,000.

By February of 2009, it had dropped more than 50% to less than 7,000 [Gerald P. Dwyer, Federal Reserve Bank of Atlanta, Sept.9,2009, https://www.atlantafed.org/cenfis/publications/notesfromthevault/0909.] Therefore, any allocation of your wealth that you had in this broad market had been cut in half. The markets have now recovered fully and are surpassing prior high-levels. Is your business also on the same growth trajectory? How is its performance compared to that of liquid securities?

The Nimble Nature of Small Business

Many publicly traded companies are subject to market swings. These businesses are subject to the winds and the storms created by the economy.

Simply put – and generally speaking - small businesses are less subject to many market swings than larger companies. They are more insulated. Small businesses are able to fly underneath the radar and make quick changes that large companies cannot make. By having your privately held business 'beneath the surface', the value of your company may be able to avoid the strong winds and storms that a recession can bring.

Where an Exit Plan Fits Into Your Wealth Planning

By designing an exit plan from your business, you can take back control over the loss of wealth that may occur in the next recession. By establishing such an exit plan, you can begin to take comfort in the fact that your business value may likely hold up stronger than your other assets during the next recession. Alternatively, you may learn that now, while your profits and company value is high, may be the best time to execute an exit.

You are likely to conclude that an exit plan for the protection and realization of your illiquid business wealth is the strongest path towards reaching your personal goals on a time-frame that works best for you.

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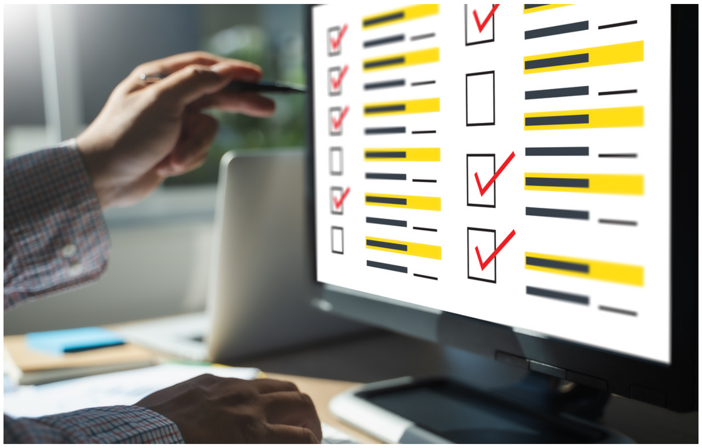
RECENT BUSINESS OWNER SURVEY RESULTS: COMPANIES ARE 52% DEPENDENT UPON OWNER, INSIGHTS BEHIND THE NUMBERS

FROM THE DESK OF: **EDWARD BARONE**

In a recent release of findings from an ongoing research effort being conducted by The International Exit Planning Association (results as of June 1, 2023) , a national leader in the emerging field of business transition planning, it was revealed that business owners, on average, score 52% in terms of the level of dependency that a company has on their individual efforts.



Generally speaking, the more dependent a business is on the efforts of the owner, the harder it will be for the company to transition to a new owner. This newsletter discusses the details behind this national average provides insights for owners of privately-held businesses to begin to think through how dependent your business is on you, with an aim to helping you Create a Transferable Business™.

National ODI™ Scoring Average is 52%

It is broadly realized that the United States has millions of baby boomers who own businesses and will be looking to transition their

companies in the next number of years. In November of 2015, The International Exit Planning Association, a national leader in preparing owners for business transitions, launched its latest, innovative software survey tool called the Owner Dependence Index™ ("ODI™"). This seminal tool provides a system for owners and their professional advisors to assess how dependent a company is on the individual efforts of the owner(s) of that company.

Because the failure rate of business transitions is so high, the IEPA sought to examine this key area, Owner Dependency, to better evaluate how to assist owners with protecting and transitioning their largest asset, their privately-held business.

Eight (8) Categories of ODI™ Scoring

The data presented in this newsletter are the results of 1,100 owners of operating companies who have completed this ODI™ assessment as of June 2023. With a national overall average score of 52%, that tells us that owners span a wide array of owner dependency. However, the individual scoring categories that make up the average score provide further analysis and interpretation into which areas of dependency owners succeed or fail in more frequently.

The eight (8) scoring categories are listed below, with the national average score for each category to its right:

Owner Involvement:	64%
Internal Operations:	47%
Strategy & Planning:	45%
Governance & Ownership:	76%
Financial Matters:	56%
Performance Mgmt:	62%
Sales & Bus. Dev.:	50%
Company Culture:	39%

Owners who completed the survey scored highest in governance and ownership (76%) and lowest in company culture (39%). This means that owners typically own their businesses without any other shareholders and do not share information with anyone else. Further, owners seem to be under the impression that they do not have a strong impact on their company's culture – a point that may be debatable.

The 2nd highest scoring categories are Owner Involvement (64%) and Performance management (62%). The short interpretation of these scoring categories can be translated in a general

being involved and overseeing performance are two of the items that they are least comfortable delegating to someone else.

What Happens When a Business Owner Transfers to a New Owner?

When a business changes hands, all eight (8) of the survey areas are evaluated to determine the potential for succession in a transaction. For example, a new owner will want to know, 'what relationships need to transition to the new owner?' and 'how much effort will be needed by the current owner(s) in order for the business to continue without interruptions or a decrease in revenue or cash flow?' By understanding where owner dependence exists within these eight (8) categories, owners can reduce that over time to make a business more transferable.

A Little Planning Can Go a Long Way

Owners cannot manage that which they cannot measure. Therefore, the ODI™ assessment produces an initial score so that the exit path that an owner chooses to follow can be better evaluated in terms of how much longer the owner needs to stay involved with the company in order for the chosen transfer to execute successfully. This, in term, helps owners to protect the wealth that is trapped in their illiquid asset.

Concluding Thoughts

We hope that this newsletter has accomplished the objective of having you understand what it means to be a Stay and Grow owner and, if you fit that description, how you can better understand your situation and make plans for a future, successful exit.

Also, if you would like to measure your company's dependence on your individual efforts and get your ODI™ Score, click below to take the ODI™ assessment.

Click here to take the ODI™ Report Survey

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FINANCING YOUR EXIT TRANSACTION

Business owners who are looking to turn their illiquid business into cash will often ask, where will the money come from to fund my buyout? This question applies to both internal transfers to managers, employees and family members as well as to external transfers to outside buyers. The owner who is well informed as to the details of the pending exit transaction is well prepared to have meaningful and intelligent conversations about where the cash will come from to fund their exit. After all, as the old saying goes, if you want the answer to a lot of your questions, 'just follow the money'. So, let's take a look at the types of capital available and what type of buyer would attract, have and / or deploy that capital to buy your business in the future.

GENERAL COMMENTS REGARDING CAPITAL FLOWS

It is important to know and remember that capital flows in and out of markets in a

manner akin to how tides flow in and out. At times capital is in abundance because lenders and other financing sources are optimistic and want to 'put money on the street'. At other times certain lenders retreat from the markets and withdraw from participating, even making 'calls' on the outstanding capital that they have extended. The most recent recession was a classic example of financing sources retreating from markets during a time of turmoil and uncertainty, withdrawing or otherwise restricting credit facilities with owners and / or calling in their outstanding loans and / or withdrawing from financing buyouts all-together.

Now, not all capital behaves in this manner, as this newsletter will more fully describe.

STRATEGIC BUYERS WITH 'CASH ON THE SIDELINES'

Our first source of capital to examine is the cash that is 'sitting on the sidelines' of corporations around the world. While we seem to be at a point in time where the recession seems more behind us than in front of us, there is a record level of cash sitting on the sideline of publicly-traded companies. Now, theoretically, this cash should either be put to work either in internal / 'greenfield projects' or it should be returned to shareholders in the form of a dividend (or, alternatively, through the repurchase of outstanding shares).

Now, today's CEO has the cash but is still gun-shy about deploying it in the form of acquiring other, smaller, businesses.

That being said, it

appears as though the cash really only has one place to go because managers do not want to 'return cash to shareholders' – they'd rather build their empires with meaningful acquisitions. If you can get a strategic buyer to pay you cash for your business, then you don't need to ask too many more questions. The cash is available, they want to buy your business, you just need to negotiate for the right prices and away you go [. . . if it was only that easy . . .].

SENIOR BANK DEBT

You may find that a future buyer of your business wants to fund the acquisition by borrowing from a bank. Banks are open to this type of business and many will finance the acquisitions for certain buyers who do not have the cash but, for corporate finance and other reasons they prefer to borrow to purchase your business).And banks are the classic example of capital that flows in when markets are good and flows out when markets are bad.

Now you may be thinking, that's all great but it's the buyer's problem to get the financing. That is only partially true. You see, it is actually a bank's willingness to lend into acquisition financings that, in the aggregate, will drive demand for business acquisitions and, hence, impact the value of your company and the price that you receive. As a follow up point, if you are receiving any portion of your sales proceeds in future payments such as deferred note payments and earn-outs, the

assumption by your company of large amounts of debt (which of course needs to be paid back) may impact the future viability and manner in which your company is run.

It is helpful to know that your buyer knows that senior bank debt is limited. Banks will not loan 100% of the value of a business to a buyer and not all buyers will qualify for this type of financing. Senior debt is a low margin business with no upside potential and which is heavily regulated. These three (3) factors combined will limit your buyers' overall access to this type of debt (particularly depending upon market conditions) and will impact what a buyer can pay for your company.

PRIVATE EQUITY

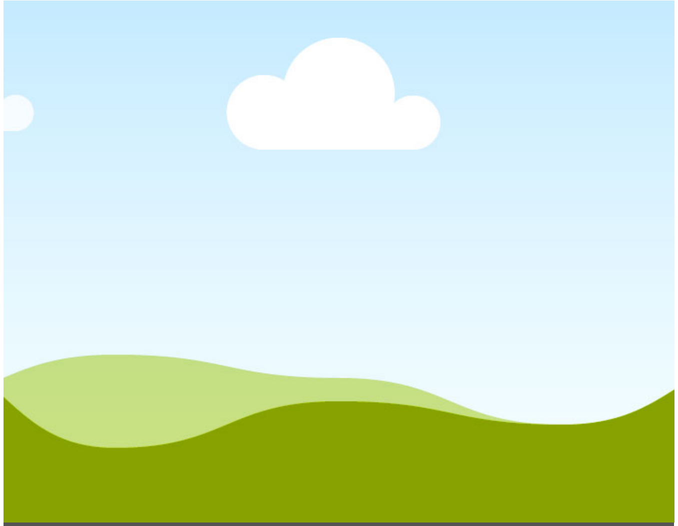
Moving past debt, we now examine the world of private equity. In this world, private equity groups ("PEGs") of which there are thousands in the United States alone, have capital that is targeted for acquisitions of privately-held businesses. In fact, the entire reason for a PEG to exist is to purchase (and perhaps later sell) private companies. This 'equity' capital is far different than debt capital primarily because it does not need to be re-paid. In this regard, equity comes into the company, making for a stronger balance sheet than heavy amounts of debt. Now, don't be fooled by private equity entirely because the truth is that while PEGs have capital available to make acquisitions, they generally prefer to also borrow senior debt, in addition to the equity that they contribute to the deal, to finance the acquisition. In this regard, the senior debt markets can, and likely will, continue to impact the pricing and overall structure of your deal.

Private equity, however, is long-term capital. PEGs know that they may not get their money / equity out of the business for many years (perhaps 5 to 7 years). Further, this is risk capital in that if the company fails, it is generally the debt holders who are repaid first (i.e. have a first lien on the assets of your business). That being said, private equity is a heavily incentivized business model with a lot more upside than senior debt capital. The private equity groups are compensated for the additional risks that they take because if the company does well, they repay the debt, own the majority of the business and will re-sell the company for a high profit over what they paid you to buy it from you. Because of the model of private equity investing, this form of capital does not ebb and flow like debt financings.

Once PEGs are invested in a company, they are partners in that business, tied and vested in the company's future success.

MEZZANINE FINANCING

Between Debt and Private Equity sits a hybrid form of financing called mezzanine debt. The reason that mezzanine capital is a 'hybrid' is because it has attributes of both equity and debt. In fact, the capital is structured in the form of a high-interest, subordinated [to the senior debt] loan. The mezzanine capital also will, in most cases, have an equity component called a 'warrant' which provides some upside potential to the 'mezz debts' overall return. Mezzanine debt works mostly with private equity and senior debt as 'bridge capital'. Mezzanine debt will invest in riskier projects than senior debt (because they have a higher return potential) and will 'bridge' the financing structure where a buyer does not want to fill it with equity.



CONVERTING RETURN EXPECTATIONS INTO MULTIPLES TO GET TO VALUE

Another way to look at the expected returns of an outside buyer is to translate the 16% to 35% expected returns selling multiples cash flow, or EBITDA (Earnings Before Interest, Taxes, Depreciation, and Amortization). Here, the expected returns of 16% and 35% convert into multiples of 2.8 times to 6.25 times the company's cash flow. What this means is that depending upon how much risk a buyer sees in your business, they will adjust their cash flow accordingly.

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As you prepare for the family business succession/transition process, it's important to address the underlying issues at play before you calculate your business's value or the amount of life insurance the business might buy. Your vision for your business, the objectives you hope to achieve from the transition, and whom you choose as a successor - a family member or someone else- are ultimately what will drive the plan and its execution.

The **biggest mistakes** business owners can make include:
- Making assumptions
- Relying on handshakes or verbal agreements
- Infrequently reviewing the plan

- Believing that, without planning, you can still meet your objectives

Conversely, the **most valuable actions** you can take are:
- Openly listening and communicating with the parties involved.
- Documenting the plan in detail
- Regularly reviewing the plan

DREAM

OUT OF THE TRENCHES

Most small business owners spend so much time working on the business that they don't have time to take a step back from the day-to-day challenges. To successfully accomplish any time of planning, however - particularly succession planning - you need to find a time free from interruption when you can think about what you would like to see happen to your business in the future. During this time, put aside questions of "how" the transition will happen and simply ask yourself the "what" and "why" questions.

For example, if you could see the business, 5, 10, or even 20 years from now, what would you like to see?

Use adjectives to describe the leadership, client base, size, quality of service, organization's values, and so forth. Does this vision seem fulfilling to you? Why or why not? And what might you do now to change that outcome?

DETERMINING YOUR GOALS

Before we get into specific planning recommendations, it's important that you define your personal and professional goals and priorities, so we can better understand what you'd like to accomplish.

At a high level, there are five objectives to prioritize with the transition of your business:

1. **Retirement income (and funding other goals)**
Do you feel that you have plenty set aside for retirement income and other goals, or would you like to explore ways that this transition can help fund (or add to) your retirement?
2. **Tax optimization**
Most people like to minimize the amount of taxes they pay, but for many it isn't their top priority; optimizing for business longevity or for responsible heirs is more important. Do you have preferences when it comes to tax optimization?
3. **Family Integrity**
If you could see your grandchildren as parents, what values would you hope they were passing along to their kids? How would you like to use your financial capital to invest in family capital?
4. **Business health and longevity**
I*s it important to you that your business outlives you? If so, do you want it to stay in the family, or would you be just as satisfied if there were other capable folks running it?*
5. **Personal legacy**
Do you have charitable desires or other marks you'd like to make on the world that this transition could empower?

Take some time to prioritize these objectives so that we can optimize our planning techniques based on what's most important to you. As you've learned by running your business, it doesn't matter if you get somewhere efficiently if it's not where you wanted to be heading!

EQUITABLE DOESN'T MEAN EQUAL:

conversations with your family

when it comes to transitioning a family business, it's easy to think about giving each family member the exact same treatment, but that may not make sense for your business. Family members either may not be qualified to take a role in the business or they may not want to be involved.

Unfortunately, as you can imagine (and may have experienced), arguments and resentfulness can arise regardless of the situation. Often, the best way to minimize future family strife—and optimize the outcome—is to communicate with each family member well ahead of time. Find out what they're interested in and what they're hoping for. Be aware that avoiding these discussions can take

a toll, both in terms of family conflict and even in legal struggles.

If you don't feel comfortable having these talks on your own, find a professional who is trained in successfully mediating family meetings. Questions to consider include:

- Which of your possessions hold special meaning to each family member?
- What roles in the business would family members be interested in pursuing?
- What does the business itself mean to your family? What would they like to see change about it, and, more important, what would they like to see stay the same?

PREPARE

Identifying and preparing your successor

Talk with your family first. Before making any irreversible decisions about the future of your company, your children will likely appreciate being part of the conversation.

It can be difficult to avoid alienating children who want to be part of the business or, vice versa, to avoid feeling disappointed with those who don't want to be a part of this legacy.

Rather than relying on what has been said in the past, it can be helpful to start from scratch in gauging their interest in participation or in leadership.

To sell or to mentor? If you decide that your kids (or even key employees) should have an increasingly important role in the future of your business, look to leverage their strengths. As famous management consultant Peter Drucker suggested, "The task of leadership is to create an alignment of strengths, making our weaknesses irrelevant."

Rather than focusing on each child's weaknesses, look at what your children excel at and think about how to utilize their unique strengths to form a team that you can mentor into success.

Maximize your business's value. If you are selling your business, the previous step is moot. That said, regardless of whether you're training someone to take over or selling, there are some steps you can take to maximize enterprise value in the transition:

1. **Introduce your successor to your employees, clients, vendors, and strategic partners.** Let those folks know that their opinion is important by asking them what your successor needs to know to be successful. What is special about your business that the successor should continue to foster? What changes (if any) would they like to see the successor lead the charge on?

2. **Let them prove their worth.** Rather than giving kids a free pass to the corner office, it is valuable for them to do some of the grunt work with pride. This will enable your children to understand the value of hard work—and realize the ultimate payoff. It can also be helpful for all parties if your children work with a competitor to learn more about the industry outside of the business they may already know quite well.
3. **Have a plan for passing the reins.** Most transitions happen either far too quickly or far too slowly; we'll discuss the pace of the transition in the next section.

Finally, if you are bringing your children (or other family) into the business, help them learn from the bumps and bruises you may have faced if you took over a family business (if, in fact, you have been working with family). Consider these questions:

- What was helpful to you when you gained authority? What would you have liked to know earlier?
- What decision-making strategies did you use to settle disputes between family members so that it strengthened family bonds rather than tearing them apart?

Passing the reins at the right pace—not just the right time
Understandably, most business owners focus on when they want to move on to the next chapter of their lives, and this ends up driving the timing of the transition. Additionally, when thinking about turning over power (e.g., decision-making authority), the tendency is to be slow in letting go. This happens both because it feels good to be needed and to have authority and, at the same time, because the business owner doesn't want to see his or her successor stumble through mistakes that could have been avoided.

Of course, a transition that moves too slowly frustrates and demotivates successors, while one that moves too quickly yields unnecessary mistakes and pain for employees and clients. Keeping these simple concepts in mind can help yield huge benefits for you, your successor, and the firm at large:

- What is the next impactful thing that your successor can take ownership of?
- For a particular task, is the cost of a mistake higher than the lesson learned and the autonomy experienced?
- What could your successor do to prove to you that he or she is ready for a certain responsibility? Does the successor know that, and does he or she have the tools or training to accomplish the task?
- What aspects of the business is your successor most passionate about learning and owning? Can you help mentor him or her in those areas sooner than you had planned to increase your successor's passion/energy?

Engaging key employees
Be sure to bring key employees into discussions. If they aren't your choice for successor, they will still be playing an integral role in ensuring that your business doesn't skip a beat. If they feel like they have a voice in the decisions that are made around the transition, they will be much more willing to help. As you did with your successor, look at their strengths and interests and allow them to guide some of your decisions.
Beyond the management aspects, there are often some financial decisions to think through with key employees:

- What ownership or management expectations do they have?

- What, if anything, would you like to provide them to give them a reason to stay with the business after the transition?

ARCHITECT

Mechanics of transfer
Only after you've determined your personal goals and your business goals should you structure the actual plan:

- Who will have ownership after the transition?
- How will you determine valuation (e.g., determined at sale versus annually for three years before transition)?
- How will the financing be arranged (e.g., self-financed, life insurance, bonus plan, gifting, installment sale, retained property-leaseback)?

We can help you formulate the specific actions needed to affect a successful transition.

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THEORETICAL DOLLARS VS. ACTUAL DOLLARS IN YOUR EXIT

Millions of baby boomer owners are marching into retirement age with the majority of their net worth trapped in their illiquid businesses. These owners need to turn their illiquid business into cash or find another way for that asset to continue to provide income to them if they are to reach their financial goals. If you fit this description, then it is likely that one of the most important steps that you will take is to determine how and when you will be able to draw that cash out of the business. Therefore, knowing the value of your business is a likely place to begin your 'exit planning' process. And, while a professional appraiser has the ability to approximate the value of your business today, this newsletter is written to focus you on the critical

differences between a valuation that represents 'theoretical' dollars in your exit versus a buyer who represents 'actual' dollars in your exit.

Why the Valuation is Important

In short, an alarming number of owners do not know the value of their enterprise. Many owners overestimate what it is worth while a good number are also surprised on the upside to see that it holds a 'value' that exceeds their expectation. The valuation that you receive for your business is a very important factor in your overall planning. This number allows you to see the Value Gap, the amount between what you need to live on and what you have in business value (before fees and taxes) to see if you are 'in the ballpark' of affording to fund your exit.

Theoretic versus Actual Dollars

The value that you are presented with for your business is 'theoretical' – it is the approximate value that an experienced appraiser estimates your business to be worth. These are dollars that fit within a certain model to tell you how much value your company has generally

speaking. The value that is represented in your appraisal report does not represent ‘actual dollars’, i.e. dollars that a qualified buyer would be willing to pay to cash you out of your company.

Now, you may be thinking ‘my business earns real dollars’ so why are we referring to these as theoretical dollars? In fact, your company’s cash flow represents actual dollars that are earned by your business today but the valuation is an estimate of what your company will produce in the future. Your cash flow is multiplied by a theoretical number that helps you understand the value of those future cash flows to another owner, which again is very helpful for planning purposes. However, it is important to remember that as experienced as your appraiser may be, he or she in all likelihood, is not representing the opinion of the riskiness of those future cash flows, as they are seen by a buyer who has cash to purchase your business. Further, unless your appraisal process includes an examination of the current marketplace for transactions similar to your own, it may not represent actual instances of where other companies have been purchased with actual dollars.

A good comparison of this difference and exercise can be seen in a typical budgeting and forecasting exercise. When business owners and their managers forecast into the future, they are looking to estimate what the business will look like in terms of revenues, expenses and profitability – these are theoretical dollars. However, once the sales happen and the products or services are delivered, those theoretical dollars turn into actual dollars – dollars that you can actually buy stuff with, and that is all the difference in the world. You see, forecasting and planning is important to organizing your business, however, it is the execution of those plans that is most important to actually achieving what has been put in writing.

How to Bridge the Gap Between Theoretical Dollars and Actual Dollars

In order to further know whether or not your theoretical dollars will turn into actual dollars, you can research similar sales of companies in your marketplace and try to determine the prices and ‘multiples of earnings’ that are being paid by buyers. This information, however, can be misleading and, if you’re not careful, may lead you in a false direction. You see, privately-held companies do not disclose important factors regarding their business so it is very difficult in looking at other transactions in your industry to truly know whether your business should be valued higher or lower than the comparable that you are studying. In fact, a countless number of intangibles go into a buyer’s calculation of value to simply draw a comparison to an approximate and likely purchase value for your business. That being said, a combination of the appraisers ‘theoretical’ dollars, supported by information that you can draw on

'market transactions' will help you gain some confidence and begin to bridge the gap between the theoretical and actual dollars.

While you are conducting this research you should remember that experienced professionals who sell businesses are often available to speak with you [often at no cost] to discuss what they are seeing in the marketplace and in your segment today. Further, these intermediaries sometimes have access to other intermediaries to gather additional 'inside' information regarding a comparable transaction so that you can know how close your deal would be to theirs.

This newsletter would also be remiss in not mentioning that owners who want to have an 'internal' transfer to managers, employees and/or family, can also begin to 'convert' their theoretical dollars into actual dollars through the budgeting and forecasting process and knowing how much of the future free cash flow they will take for their own. Remember, however, that these dollars will remain 'theoretical' until the company performs in future years whereas 'buyer dollars' can become actual dollars that you can buy stuff with once you consummate a transaction.[ii]

Concluding Thoughts

The sale of a privately-held business is often the largest financial and emotional transaction of an owner's life. Therefore, knowing the difference between theoretical and actual dollars and how this difference may impact the success of your exit is critically important.Again, as we are fond of saying, a pro-active approach to your exit is the optimal approach. Along these lines, we encourage you to further think through the implications of how and when you will receive the 'value' for your business.

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realistically consider his preparedness in exiting the business. That owner might consider going back to the basics and engage in a compare and contrast analysis of private and public securities.

PRIVATE VS PUBLIC SECURITIES

An effective exit strategy plan will appreciate and distinguish between privately held businesses and publicly traded entities. For starters, consider the availability of information on public vs. private companies. The public market is symmetrical and transparent whereas the private market is asymmetrical and opaque. For the purpose of this paper, the private business owner must adopt the information standards of a public entity. This is often difficult for the owner, who is not required to report to investors and who, together with his accountant, decides what qualifies as a business expense.

It is, however, a necessary step in the process. The owner will need to "come clean" for the Buyer on what constitutes "additional expenses". Alternatively, the company could present a lower profit margin. In the end, this won't make it any easier on the owner, for it allows the buyer to offer less than the true market value of the business. In order to extract the highest possible value - and the highest possible post-exit income - an owner must illustrate

the personal expenses (i.e. what comes out of the "piggy bank"). The onus is on the seller and their advisory team. A potential Buyer will not ask about a business owner's "piggy bank" money. Rather, he will gladly accept the low profit version of the books and offer a low price.

TYPICALLY, UNALTERED FINANCIAL STATEMENTS DO NOT REPRESENT THE TRUE VALUE OF A PRIVATELY HELD BUSINESS AND, ACCORDINGLY, THE OWNER MUST DETERMINE AND REPRESENT THE BUSINESS'S ACTUAL CASH FLOW TO THE NEW OWNER.

RECASTING FINANCIAL STATEMENTS

One way for an owner to effectively illustrate the company's true profitability is to recast the company's financial statements. Typically, unaltered financial statements do not represent the true value of a privately held business and, accordingly, the owner must determine and represent the business's actual cash flow to the new owner.

Accounting, in general, is a fuzzy business. Financial statements are at best an approximation of economic reality because of the selective reporting of economic [iii] events by the accounting system. In the context of private businesses, decisions are often made to reduce tax liabilities. Given the imprecise nature of accounting methods, one must

"normalize" the books for the purpose of a sale. Often, the owner's personal salary, perks, pension plan, depreciation, and one-time expenditures (non-recurring) can be adjusted to reflect actual and available cash flow. In other words, one must distinguish what constitutes the current owner's "piggy bank" and show its negative effect on the value of the business.

In the example included in this letter (see Appendix A) we show the operating statement of our fictional corporation SLE, Inc. The far right column represents the recast or revised financial statement for the business in 2006. The company's total selling and administrative expenses amounted to $685,587, reducing income before taxes to $189,025. Upon closer examination, we find several expenditures that do not, in reality, correspond to revenue-producing activities.

Specifically, for example, the owner reports $33,844 in telephone related expenses for the year. In actuality, only $23,691 of telephone expenses relates solely to business purposes. This is the figure a buyer should use to estimate annual telephone expense. This adjustment alone boosted cash flow by $10,153.
Accounting for all adjustments, actual (revised) business expenditures amounted to $517,040 for SLE, Inc. -a reduction of $168,547, resulting in true income of $386,498. In this example, true profitability and return on investment are much higher than they appear on paper.
The preceding example introduces another important measure by which the "piggy bank syndrome" can affect the private business owner - how to calculate the owner's return on investment.

AN ACCURATE ROI CAN ONLY BE DETERMINED IF THE AMOUNT OF MONEY TAKEN FROM THE "PIGGY BANK" FOR PERSONAL EXPENSES IS ADDED BACK INTO THE PROFIT.

CALCULATING A RETURN ON INVESTMENT

The rate of return (ROR) or return on investment (ROI) is the ratio of money gained or lost on an investment relative to the amount of money invested. Return, or the amount of money gained or lost may be referred to as interest, profit/loss, gain/loss, or net income/loss. Return can also refer to the monetary amount of gain or loss on an investment. The money invested may be referred to as the asset, capital, principal or the cost basis of the investment.

ROI is also known as rate of profit and can rep- resent the return in a past or current investment or the estimated return on a future investment. ROI is usually given as a percent rather than a decimal value. [iv]

The way in which a business owner calculates his ROI presents a challenge. An accurate ROI can only be determined if the

amount of money taken from the “piggy bank” for personal ex- penses is added back into the profit. Only after doing so and re-calculating can a business owner accurately estimate his ROI.

After performing a thorough analysis of the owner’s ROI, the owner can determine exactly how the business provided a return on the original investment. This return, once normalized, can also be shown to a Buyer as one data point supporting a higher (more accurate) value.

Consider the following example:

A required return of 25% per year for an investment in a privately held company is equivalent to a trading multiple of four times that company’s current profit. By contrast, a public company expecting a return of 10% can trade at ten times its current earnings because of a reduced amount of perceived risk. Therefore, business owners should take a look at the risk associated with their business as an investment in their port- folio, putting aside that they also happen to work for their investment.

The ROI Calculation:

Sales Price:	$ 8,000,000
Less:	
Fees & Taxes:	<$ 2,000,000>
	$ 6,000,000
Plus:	
Excess Draw/yr, net of tax	$ 100,000
	x 15 years
	$ 1,500,000
Total Return	$ 7,500,000
Initial Investment	$ 200,000
Investment Time	$ 15 yrs.
Annualized Return	**14.37 %**

For the fifteen years the owner ran the business, the Average Annualized return on his investment was 14.37%. These figures do not include the owner’s “base salary”--only the excess draw (i.e. your “piggy bank” money) is included in the calculation.

Now, the risk/return measurement is easier to quantify. In other words, publicly traded securities may not be able to produce the same average annualized return, but the risk of the investment declines considerably.

This calculation also empowers the business owner to describe this “investment opportunity” in detail to prospective buyers or investors. In particular, a buyer of a business, all things being equal, should be willing to pay a seven (7) times multiple (100 divided by 14.37%) of earnings to own the company. Of course, the buyer will have his own ideas about the risk profile of the business opportunity without the owner’s ‘vested involvement’. Negotiation will come into play at this point. The key is the owner

starting point. He understands fully how much he returned on his investment--the business--for the time that he was at the helm. And he under- stands how much the buyer could return once he has exited the business.

UNLESS THERE IS A FORM OF CONTINUED PAYMENT BEYOND THE CLOSING, THAT BUSINESS OWNER WILL NEED AN "INCOME REPLACEMENT STRATEGY" TO SATISFY HIS PERSONAL EXPENSES AFTER THE EXIT –A WAY TO REFILL THE "PIGGY BANK".

III. INCOME REPLACEMENT RATIO

Once the business owner exits the company, he no longer exerts strategic or financial control over that entity. Furthermore, unless there is a form of continued payment beyond the Closing, that business owner will need an "Income Replacement Strategy" to satisfy his personal expenses after the Exit –a way to refill the "piggy bank". In other words, the "liquid" or "publicly traded" Capital Markets need to provide a stream of income that replaces the income received from the business (or Private Capital Markets).

Recommended considerations:

- Does the business owner have any experience with investments?
- Is there any awareness that a stock and bond portfolio can be designed to provide income to that investor?
- Has that business owner calculated the net-of-tax costs of his lifestyle after the business exit?

At this point, a business owner will fully realize how his personal "piggy bank" affected his lifestyle and living expenses. The following is an example of a typical situation a private business owner might face and how this owner could replenish the lost income.

The owner of SLE, INC. drives a company car. Sometimes he uses it for "business travel"...but not always. The company makes lease payments of $ 500.00 per month. At the end of the business' fiscal year, the owner and accountant decide how to allocate business vs. personal use of the car. The business use portion is deductible as a corporate expense. But, regardless of the amount that is deducted, the business owner is accustomed to running that lease payment (and insurance payments, and fuel payments, and maintenance costs) through the business. The owner has come to rely upon the business as his "piggy bank" to pay for ordinary everyday personal expenses.

To understand the impact of this particular expense, one must determine how much pre-tax money the business owner needs to satisfy the same automobile payment after exiting his business.

Consider the following calculations:

	Monthly Pymt.	Annual Pymt.
Corporate Revenue	$500.00	$6,000.00
Auto Lease Payment	-$500.00	-$6,000.00
Out of Pocket to Owner	$0.00	$0.00

$100K investment in 6% coupon bond	$6,000.00
Ordinary Income Tax at Owner's (Federal) Tax Rate	< x .35 >
After tax amount	$3,900.00

In order to replace the auto allowance ‘income’ from the business, a business owner--only spending interest income (not ‘dipping into' principal)--will need more than $100,000 in investable assets, earning 6% per year, to make the same payment. To calculate the interest income required for the replacement auto allowance expense, divide the annual payment by 1 minus the business owner’s tax rate:

$ 6,000.00/
0.65
$ 9,231.00

Then, divide the interest income required by the rate of return achievable:

$ 9,231.00/
0.06
$ 153,850.00

To conclude, an investment of $153,850.00 in investable assets is required to produce enough after-tax income to satisfy the car payment after the exit from the business. It is important to note here that this calculation does not account for growth in any investment, changes, or particulars, of tax laws; nor does it account for rising inflationary pressures in car lease payments. These issues, however, should in no way diminish the utilitarian nature of this exercise. The calculation should be performed for all expenses covered by the "piggy bank". The owner can then understand the amount of "liquid" proceeds (or continued income stream) that is required to fulfill an Income Replacement Strategy.

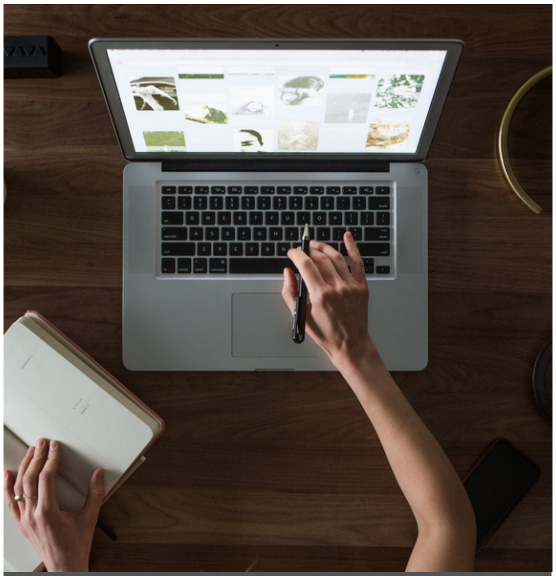
An exit strategy plan must make many special considerations that will affect the owner—and his or her spouse--for years to come. Often the spouse is as interested as the owner in the Income Replacement Strategy analysis, wanting to determine "what things will look like" once the business is no longer there to provide for them. So one can see how these conversations between advisor and owner (and owner's family) become quite personal in nature.

A business owner may not share this information with anyone except his spouse and his accountant. However, the income replacement assessment is a critical component to a successful exit strategy. At the end of the day, the owner wants to exit his business, confident in his financial situation and happy with the lifestyle he will live for the rest of his life.

Despite the importance of this process, many business owners do not come to the deal table armed with essential and valuable advice regarding the key elements of a successful business exit strategy. A typical owner hasn't determined the true economic value of his business. Nor does he know how much in assets he needs to retire comfortably. In effect, this handicaps him in the face of a buyer who will offer the minimum possible value and not a penny more. All too frequently, the owner "cancels" the deal and reverts to running the business so he can enjoy the "lifestyle" benefits that he and his family have come to depend upon. His "time and money freedom" has slipped away due to incomplete planning. Advisors, however, are in a unique position to step in and raise the owner's awareness of the situation before it's too late. Preparations can be made so that the exit strategy proceeds smoothly and reaches a mutually satisfactory end for buyer and seller.

IV. CONCLUSION

Business owners are, at their core, investors. They are shareholders in their business. They are the ultimate beneficiaries of higher profits. As such, in the context of business exit strategy planning, the first step in the financial analysis of a privately held business is to look at the business as an investment.



Business owner exits depend upon a visualization of a trade - Shares for cash. The basic transaction is not that different from what takes place in the public markets. However, the way in which it takes place can be dramatically and detrimentally different. It is crucial that the owner adopt a new perspective--that of a potential buyer or investor who wants to know today how much cash flow this business generates. The business owner needs to consider the following question: How much cash would he be willing to receive for operational and financial control of the business today? Sadly, the answer to this question is often twice the true value of the company. The owner's skewed view of his personal needs--i.e. The money he draws from the "piggy bank"—often inflates his estimate. Consequently, the owner's idea of what his business is actually worth is quite different from what a potential outside investor would pay.

An owner must be prepared to not only identify these misconceptions but more importantly, he must "learn" how to detach from his business and view it through an investor's eyes. It presents a challenge, no question. It will require a significant mindset change. After all, a private business owner of thirty (30) or so years has settled into a particular routine and lifestyle. It is this lifestyle that depends on the owner's ability to step back from his role as CEO and approach the sale like an investor. A fair and true value is worth the extra time and trouble. Therefore, a well structured exit strategy that analyzes the "Piggy Bank Syndrome" and offers creative means by which to overcome it will result in a successful exit and a satisfied owner.

HIGHLIGHTS

I. BUSINESS OWNER AKA INVESTOR

When a business owner thinks about exiting the business, he needs to consider whether he views the business as an investment or merely as a job. A perspective change may be necessary.

II. STEPPING INTO A BUYER'S SHOES

When beginning to plan a business exit strategy, the business owner must first shed his President and CEO hat. He must become Chairman of the board of directors, putting the interest of the company's shareholders foremost in his mind.

III. INCOME REPLACEMENT RATIO

The "liquid" or "publicly traded" Capital Markets need to provide a stream of income that replaces the income received from the business (or Private Capital Markets).

IV. CONCLUSION

A well-structured exit strategy that analyzes the "Piggy Bank Syndrome" and offers creative means by which to overcome it will result in a successful exit and a satisfied owner.

APPENDIX A Add-back of Owner-Related Expenses to Operating Statement

SLE Inc. Operating Statement	2006	Add Backs	Revised
Sales			
Service #1 Revenue	$ 1,632,718	-	$ 1,632,718
Service #2 Revenue	732,311	-	732,311
Credits & Allowences	(20,390)	-	(20,390)
Net Sales	2,344,639	-	2,344,639
Operating Expenses			
Salaries	880,520	-	880,520
Subcontracting Expense	26,459	-	26,459
Maintenance Expense	161,346	-	161,346
Depreciation	21,835	(21,835)	0
Insurance	38,134	-	38,134
Misc.	1,450	-	1,450
Payroll Taxes & Rel.	174,564	-	174,564
Travel Expenses	7,879	(7,091)	788
Equipment, Repair $ Maint.	8,455	-	8,455
Truck Expenses	149,385	-	149,385
Total Operating Expenses	$ 1,470,027	(28,926)	$ 1,441,101
Gross Profit	$ 874,612	$ (28,926)	$ 903,538
Selling and Administrative			
Salaries and Bonuses	188,751	-	188,751
Commissions	106,552	-	106,552
Consulting (Conlan)	5,488	-	5,488
Insurance	42,075	(8,415)	33,660
Misc	5,333	-	5,333
Payroll Taxes	21,602	-	21,602
Telephone Expenses	33,844	(10,153)	23,691
Office Equipment & Related	9,643	-	9,643
Rent & Related Expenses	18,544	-	18,544
Service Fees	13,896	-	13,896
Travel Expenses	19,184	(17,265)	1,919
Meals & Ent.	25,550	(12,775)	12,775
Accting & Admin Charge	187,965	(112,779)	75,186
Overhead Chargebacks	-	-	-
Bad Debt Expenses	-	-	-
Interest Expenses	7,160	(7,160)	0
Total SG&A Expenses	$ 685,587	(168,547)	$ 517,040
Income before Taxes	$ 189,025	$ 197,473	$ 386,498

Notes:

(1) Travel Expenses	Eliminate owner-related travel expense	(7,091)
(2) Insurance	Eliminate owner insurance	(8,415)
(3) Telephone Expenses	Eliminate owner personal cell phone & telephone usage	(10,153)
(4) Travel Expenses	Eliminate owner-related travel expense	(17,265)
(5) Meals & Entertainment	Eliminate owner-related meals expense	(12,775)
(6) Accting & Admin	Adjust Management Compensation to Fair Market	(112,779)

Are you ready for next steps? Click to complete our Business Readiness Survey and connect with our team.

i See IRS "Deducting Business Expenses", Publication 535, http://www.irs.gov/publications/p535/ch01.html#d0e414)
ii Id.
iii The Analysis and use of Financial Statements, Gerald I. White, Wiley (2002)
iv Rate of Return, Wikipedia