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Ready To EXIT? Most Owners Are NOT

Drastic change is coming. In mid-decade, 2000-2010, experts started predicting the largest transfer of wealth in history. In the later part of the decade, we started seeing predictions that 50-70% of small and medium sized businesses would change hands in the next decade.

Fifty percent! This is a huge number. Why is this happening? It's a demographic phenomenon. The largest generation in American history is getting older. The first of the baby boomers are now able to collect social security; 10,000 people a day become eligible for Medicare (this will continue for about 20 years); and this is a very entrepreneurial generation, with a higher than normal percentage of business ownership.

Something has to happen to these companies when the owners retire, die, have health problems or just slow down. If you're an owner, ask yourself, "Am I ready to exit in the next 5-10 years?" If the answer is no, you need to take some action. There

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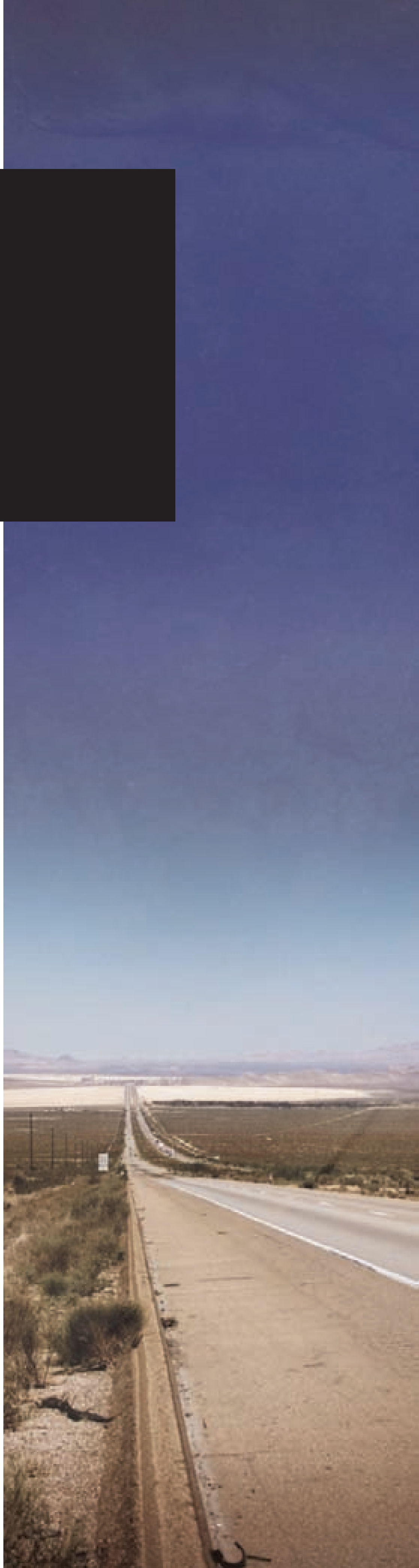

could be a lot of competition, and the unprepared business and owner will pay the price. It could mean selling for a lower price, less cash at closing, not being able to sell at all or losing valuable components to your company. One last fact, the following generation (Gen X) has 20,000,000 less people, and, according to a study by Intuit, this generation is a lot less entrepreneurial.

Concerned? You're not the only one . . .

If you're the business owner, you should be concerned. Businesses that lose momentum or have an unfocused owner become stagnant and unhealthy. Employees get bored, unmotivated or so frustrated they leave for other opportunities. This further escalates a decline.

If customers don't see innovation, problem solving or excitement, they become susceptible to the competition. Finally, what about your manufacturers? You are their sales arm. They wouldn't accept salespeople who fail to perform, and they won't accept it from you.

Yes, the above are extreme examples. At the same time, you don't have to come close to the extremes for your business and future to be thrown for a loss. Most manufacturers' reps consider themselves problem solvers. They aren't just product peddlers, they are solution providers, and their manufacturers' and customers' businesses depend on what they do and how they do it.

Your customers, employees and manufacturers should care. I'll bet your manufacturers are more concerned with this than customers or employees. Customers and employees have more, quicker and easier options. Even in a tight job market, good salespeople have value (caveat: the more narrow their expertise, the more narrow their job market). Customers always have options; your competitors are probably trying to steal them from you every day.

If I was a manufacturer, I would be very concerned that my sales team (my rep team) will be still be there in five to ten years. I would have a lot invested in them and their customers. Given the non-compete agreements many rep firms may have, it may be a lot tougher to replace my rep firm than to replace a sales staff. I would want to be sure you have taken adequate steps to assure a smooth succession, with no disruption to my business.

When and for whom to prepare

Common thought is that three to five years is the best lead-time when it comes to preparing for an exit or sale. Most buyers (and banks) want to see financial statements and tax returns from this period of time. It gives the business time to show the effect of any strategies undertaken as part of the preparation process.

Begin preparing before you're thinking of exiting and you will get three benefits:

1. You're prepared if a catastrophic event hits. You will not be forced into a panic sale or liquidation.
2. Much of what you do to prepare for an exit or sale improves the business, so you benefit over the years prior to your exit.
3. Banks and manufacturers will like this. It should open up financing and provide additional lines for you to sell.

The planning process starts with identifying to whom you will sell the business. Is it family, staff or an outside buyer? If an outside buyer, is it an individual, equity group or another rep firm? These are important questions and often are not considered. What you do with the business may be different depending on the logical buyer.

For example, if your logical buyer is a family member or employees, part of the process may be coaching and training them on running a business. One client brought in their son, started him in sales, then moved him up the ladder to sales manager, general manager and eventually company president. By the time mom and dad were ready to exit (on a day-to-day basis, as they remained on the board), he had been running the operations and sales. He was ready.

If you don't have family or management in line to take over, your tactics will be different. An outside buyer wants to be assured that profits will continue and that systems are in place to make the transition smooth. Above all, they do not want the business to be overly dependent on the owner. To put it another way, they (and you) want high company goodwill, not high personal goodwill.

Financial buyers are those who need a salary and profits, and they usually want to be the company president and decision-maker. Strategic buyers often are in the same or a similar industry; they care more about growth, management capabilities and the ability to absorb

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overhead.

When do you want to leave? Is it in six months or six years? Much of what you do is dependent on the answer to this question. If the answer is a year or less, there are strategies you cannot implement if you expect to see the results manifested prior to marketing the business. However, there are plenty of things you can do in a short time period. Cleaning up your financial statements is one of those things. Eliminating the excessive blending of personal and business expenses is something that's easy to do. Banks and buyers like to see a healthy bottom line, and the extra tax you pay will come back to you in multiples.

Is it worth enough?

So what exactly is your business worth? While it's not the point of this article to delve into the subject of business valuations, it is a subject on everybody's mind. When speaking, if I don't cover this, I always get asked – so I now include the topic.

In simple terms, the value of a business is generally a function of the business's profit. While there are exceptions, in most cases we can say that the higher the profit, the higher the value (and price). Profit is a term that has different meanings to different people. A business appraiser will

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typically determine profit by adding together the net income on the tax return plus the owner's salary and owner perks, and then subtracting a fair market management salary for the job of running the business.

Here are some "rules of thumb" from an industry book (and, of course, this two inch thick book has a disclaimer that rules of thumb are only that, and a business should be properly valued). As you will see, they are all over the place. These are for the distribution and manufacturers' rep industries, in general. For manufacturers reading this, there is a similarly wide range of pricing guidelines.

- One times seller's discretionary earnings (SDE - owner salary, excess perks and profit);
- Thirty to fifty percent of annual sales, plus inventory;
- 1.5 – 2 times seller's discretionary income;
- Four times EBIT (earnings before interest and taxes).

Manufacturers' rep firms' pricing guidelines are a lot like those for CPA and other professional service firms. For years, the AICPA has stated that CPA firms should be priced at one times annual revenues plus or minus 25%.

Most small to mid-sized businesses will sell for three to five times profit. Where the price falls within that range, or even makes it into that range (or is above) is a function of assets, the non-financial factors and the terms. For example, a company with 63% of sales to 63 customers has a lot less customer risk than a company with 63% of sales to three customers.

A company with tangible assets will sell for more than a company without assets. Larger firms with the same profit as a percentage of sales will sell for more than a smaller firm. I think you get the picture; there are a lot of factors to take into consideration, and that is why rules of thumb are just that, a method to see if you are "in the ballpark."

One note: any formula that uses revenue is merely a starting point. That's why the CPA Institute has the buffer of 25%. If one business has 15% of sales as profit, and another firm of similar size and type has 3% of sales as profit, there is no way they will be worth the same. If your firm is doing (much) better than average, you will definitely agree with this.

Then there's the subject of terms. There is plenty of information that shows that the more cash there is at closing, the lower the price – sometimes substantially lower. It all has to be taken into account.

Exit planning is a long process, and the above outlines three areas to start with:

- Determining your plans for your next great adventure in life;
- Understanding your logical buyer and what they want in a business;
- Determining what your company is worth now, so you know the scope of the job and timeline needed to get what you want or need financially.

With so many baby boomers reaching retirement age, there will be a lot of businesses on market. The prepared business will sell faster, easier, for more money and to a better buyer. AS

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