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White Paper

7 Steps to a Successful Exit

By Daniel A. Prisciotta
CFP®, CPA*, PFS, ChFC®, CBEC®

Owners often begin to think about the Exit Planning process when two streams of thought begin to converge. The first is a feeling that you want to do something besides go to work every day — either you would like to be someplace else, doing something else, or you simply no longer get the same kick out of doing what you are doing.

The second stream is the general awareness that you are making significant strides toward financial independence, or can achieve it by selling your business. When these two streams converge, thoughts flow inevitably towards exiting the business. Hopefully, when this happens, you have access to advisors who specialize in the field of Exit Planning. The purpose of Exit Planning is to leave your business on your terms, on your schedule, and for maximum value to reach your definition of freedom and financial independence.

Process Overview

What kind of Exit Plan allows a business owner to leave their business and how is one created?

Of course, each Exit Plan is customized to fit the individual business owner. However, all have several common elements and are the result of a proven step-by-step process. To overview this process quickly, I will frame the steps as questions.

Step 1: Exit Objectives: Have you determined your planning objectives with respect to exiting your business, such as:

- Your desired departure date? Now? One year from now? 10 years +?
- How much income do you need to achieve financial security? (Your "Value Gap" expressed as a lump sum or annual income need/shortage)
- The person to whom you want to transfer your business to?

Step 2: Valuation: Do you know how much your business is worth in today's economy?

Step 3: Making the Business More Valuable: Do you know how you will effectively increase the value of your ownership interest prior to exit?

Step 4: Sale to a Third Party: Do you know how to sell your business to a third party in a way that will maximize your cash *and* minimize your tax liability?

Step 5: Transfer to co-owners or family: Do you know how to transfer your business to family members, co-owners or employees and pay the least possible amount in taxes, while enjoying maximum financial security?

Step 6: Contingency Planning: Have you implemented all necessary steps to ensure that the business continues even if you don't?

Step 7: Wealth Preservation Planning: Have you provided for your family's security and continuity should you die or become incapacitated? Have you planned for the distribution of your business, and other assets, while minimizing exposure to the 40% Federal Estate Tax? A will is not enough. Business owners need advanced level wealth preservation planning to address their special assets and circumstances.

Let's summarize each step owners should follow in order to create a comprehensive Exit Plan.

STEP 1: SETTING EXIT OBJECTIVES

Failure to set written goals means that an owner will not be able to exit his business effectively. Many owners do not set exit objectives because it is often too emotionally gut wrenching to separate themselves from a business they have created, nurtured, lived with, suffered with, brought to maturity and in which they have totally immersed themselves. It is difficult, if not impossible, for any financial planning professional to engage an owner in the planning process until that owner is emotionally prepared to leave their business. Those who are emotionally ready to face their departure often do not know what to do or where to begin.

This is the point at which the need for clear exit objectives is of paramount importance. There are three straightforward exit planning goals that every owner must fix in his mind. Establishing these goals allows the owner to cut through a lot of muddled thinking that previously prevented him from moving forward. These objectives are:

1. How much longer do I want to work in the business before moving on to another challenge or retiring?

2. How much money do I want? (Expressed as a realistic lump sum or an annual after-tax income, in today's dollars). It is critical to "crunch the numbers" and be accurate. Your future depends on it.

3. Who do I want to transfer my business to:
    - family?
    - co-owner(s)?
    - key employee(s)?
    - outside party?

No owner can effectively leave his business without establishing each of these objectives. Many owners set other objectives as well, such as:

- Providing for one or more employees,
- Transferring wealth to family members,
- Getting maximum value for the business,
- Giving to charity, or
- Taking the business to the next level — but with someone else's money.

Unfortunately, only a handful of owners carefully formulate these objectives before they choose an exit path. Remember, your objectives control all planning efforts and strategies. You are the person primarily responsible for this step, but you need not work alone.

Who can help? Highly trained financial advisors who have the acumen, support and business capabilities to create a financial model, or projections, for you based on the following factors:

- The value of your business;
- Your future income needs based on current lifestyle expenditures;
- Amount of non-business assets such as real estate, retirement plans and other investments;
- Inflation assumptions;
- Growth assumptions, based on past and future performance;
- Number of years to your desired exit date; and
- Life expectancies (yours and your spouse's).

As you build this financial model you will likely discover that your current assets are not sufficient to allow you to exit with financial security. You may need more money and more investments before you can leave your business in style. While you can personally accumulate additional cash before you retire, the bulk of the needed resources will typically need to come from the sale of your business.

Your advisors should develop your financial model based upon your current lifestyle. You will then be able to calculate how much money you want or need when you leave the business. This, in turn, tells you how much cash you need to get from the business—either over time through a note receivable (if you sell to children or employees) or how much you need in cash (if you sell the business to an outside party). Only by going through this analysis can you empirically determine how much money you need to net from the sale of your business to become financially independent.

It's important to work with an advisor who can run a number of "what if" scenarios using different variables. With your advisor's input, you can formulate realistic financial objectives. Empathetic and experienced advisors can be of immense assistance at this initial stage.

STEP 2: VALUATION

Knowing the value of your business is critical if you are to undertake the planning necessary to successfully exit your business. Why?

- Your business is probably your most valuable asset. (Frequently, the business comprises between 65 and 90 percent of an owner's assets.) Financial security depends on converting that asset to cash.
- Unrealistic expectations can be disastrous. If you guess the value of your business too low, you could leave millions of dollars on the table. If you set your expectations too high, irreparable damage could be done by an unsuccessful sale effort.
- Obtain either a formal valuation (if planning to transfer internally by gift or sale to employers or co-owners) or a market value assessment if considering a sale to outsiders.

STEP 3: MAKING THE BUSINESS MORE VALUABLE

There are numerous actions an owner can and should take to maximize value.

These include:

- Motivating and keeping key employees;
- Maintaining and consistently increasing cash flow;
- Creating and using efficient systems; and
- Documenting the sustainability of earnings.

Motivating and keeping key employees is critical, whether you sell to an outside party (who will pay more for a company with stable motivated management), or sell to an insider (who will run the business after you leave).

Your financial advisor can suggest several techniques to motivate and keep your key employees, such as:

Stock (or equity) based incentive plans including:

- Stock bonus
- Stock option
- Stock sale

Non-equity incentive plans including:

- Cash bonus
- Non-qualified deferred compensation plans
- Phantom Stock plans
- Stock Appreciation Rights (SAR) plans

STEP 4: SALE TO A THIRD PARTY FOR MAXIMUM DOLLARS

There are a variety of ways to market a business for sale. The most effective method is a competitive auction. The competitive auction process is intended to bring multiple qualified buyers to the negotiating table at the same time, all with the same information, and ready to make an offer for the company. This process enables the business owner to select the sale price, deal structure, and on-going operating philosophy that is most attractive. The auction process also keeps the business owner in control of the sale process. Obviously, confidentiality is important.

The competitive auction process is comprised of the following four phases:

Phase I. **Pre-sale Planning**

a. Establishing Objectives
b. Assembling an Experienced Team of Advisors (financial, M&A)
c. Pre-Sale Due Diligence

Phase II. **Marketing the Business**

a. Developing a Buyer Profile
b. Making a Good First Impression
c. Finding a Buyer
d. Executing the Confidentiality Agreement
e. Buyer Due Diligence

Phase III. **Negotiating the Sale**

a. Letter of Intent
b. Final Due Diligence
c. Maintaining Confidentiality

Phase IV. **Documentation and Closing**

a. Definitive Purchase Agreement
b. Closing

Who can help? Inherent in the third party sale process is the need to use experienced transaction advisors. You must select an experienced transaction intermediary (Investment Banker or Mergers and Acquisitions Advisor), as well as a deal attorney.

A significant part of the Investment Banker or M&A firm's mission is to find a group of qualified potential buyers and orchestrate a competitive auction. Only a transaction intermediary is skilled in approaching multiple potential buyers simultaneously and in developing them into serious candidates.

STEP 5: TRANSFERS TO CO-OWNERS OR FAMILY

Those owners who wish to transfer their businesses to family or employees must be aware of two fundamental conditions present in this type of a transfer.

First, the income tax consequences of the transfer must be minimized for both the seller and the buyer. Secondly, the departing owner must concentrate on obtaining maximum security for payment of the purchase price.

The reason for the emphasis on these two conditions is based on one fact: *the buyer(s)* (children or key employees) *have little to no cash*. The only way you will receive your purchase price is to receive installment and other payments (directly from the company) over an extended period of time. All the money you receive will come from the future cash flow of the business. Therefore, it is imperative that the tax consequences to the business *and* to the buyer be minimized in order to preserve a greater part of the company's cash flow for the departing owner. Similarly, the deal must be structured to maximize your security because it will take an extended period of time to receive the full purchase price.

STEP 6: DEVELOP A CONTINGENCY PLAN

One of the benefits of developing on overall exit strategy is that you quickly appreciate how contingency planning forms an overall part of a living business plan. Taking prudent measures so that your business can continue even if you don't is a natural consequence of the planning process. In the ideal situation, business continuity needs (upon the death or incapacity of an owner) can be achieved through a Buy/Sell agreement with co-owners. Most businesses, however, are owned by one rather than by two or more people. If sole owners do nothing else, they have a duty to their families and to their businesses to create a written plan that answers the following questions:

- In my absence, who can be given the responsibility to continue and supervise:
  - Business operations?
  - Financial decisions?
  - Internal administration?

- How will these people be compensated for their time and, most importantly, for their commitment to continue working until the company is transferred or liquidated?

- Should the business, upon death or permanent incapacity, be:
  - Sold to an outside party?
  - Sold to employee(s), and if so, to whom?
  - Transferred to family members?
  - Continued?
  - Liquidated?

- Who should be consulted in the transfer process described above?

When an owner makes the decision to begin transferring his business, the last thing he is likely to consider is the need for adequate planning to protect the business if he should suddenly die or become incapacitated. Yet this is precisely the point when the business is most vulnerable; it has peaked in value, but the event anticipated to create liquidity (the sale of the business) is likely a year or more away. The remedy is usually straightforward: adequate legal documentation in the form of a buy-sell agreement or stay bonus program with adequate funding.

STEP 7: DEVELOP A WEALTH PRESERVATION PLAN FOR YOUR FAMILY

With this final Step, the Exit Planning process comes full circle. Review your financial objectives established under Step One: if you don't survive until your voluntary exit, what will your family need? What efforts should be taken to minimize or avoid estate taxation? The IRS can take up to 40% of your net worth! The tax man wants cash within nine months of death and your family must figure out how to create the necessary liquidity. Therefore, a primary focus is on:

- Review of your wills, trusts and asset titling to make sure your distribution objectives will be met.
- Estate tax reduction. Consider sophisticated techniques such as trusts, GRATS, sales to defective trusts, charitable planning, etc.
- Creation of estate tax liquidity insurance to satisfy the remaining unavoidable tax bite.

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CONCLUSION

In order to be successful with the design and implementation of your exit plan, you need:

- An effective written **Exit Plan** – base your plan on the Seven Steps summarized in this White Paper.

- **Experienced Advisors** – Choose advisors who have seen and learned from the failures and successes of other owners exiting their businesses. An experienced, well-trained Business Intelligence Specialist has access to the resources to help guide you through the exit process so you can avoid costly mistakes.

- **Time** – Make time an ally by starting your Exit Plan now.

For more information on how ESG and its national platform of M&A firms and Investment Bankers can help sell your business, please call us at 201-556-4618 or 1-866- 807-0325, or email us at DPrisciotta@equitystrategiesgroup.com.