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You Should Start the Day You Open Your Doors

T.J. Van Voorhees, Co-Founder and General Partner, Pacific Crest Group

We have worked with many small to mid-sized Bay Area companies over the last decade, from struggling mom-and-pop shops to fledgling start-ups that are clearly on their way to success and profitability. What we have observed is that in almost all these cases they often start to commit valuable cash and resources to staff the back office before they really need to, including bringing on a full-time CFO or financial manager. Any successful business needs to deal with financial projections, budgets, and cash flow forecasts, but that doesn't mean you need a full-time CFO to handle it.

INTRODUCTION

When you are caught up in the daily routine of actually running your business, it's hard to plan for the future. However, most entrepreneurs don't plan their exit strategy more than a few months in advance, leaving them little time to optimize the value of their business or determine the best way to get a maximum return. Succession planning should be part of every company's business strategy from day one.

CONSIDERATIONS

There are a number of considerations you need to take into account when creating a succession plan:

1. Start developing your succession plan right away

The earlier you start planning the more successful you will be. A lot of succession planning revolves around financial structure and tax strategies, and you have to take time to implement them properly. Unfortunately, 95 percent of small business owners decide they want to sell within a few months and they don't have enough time to prepare.

2. Entrepreneurs tend to make themselves an integral part of their operation. You need to separate yourself from the daily running of your business before you can sell it or pass it along to another owner

If a business owner has to remove himself or herself from being the focal point of their business, it will require more than a few weeks. It can take years. However, it's essential to implementing a successful handoff.
If you are a small business owner delivering services, for example, you need to consider how you can extract yourself as the central source delivering those services. Are you acting as a technician so no one else can do the job? If a process is dependent on you, how do you turn that process into a system that you can transfer to someone else? If it's a strategic function, then it's not dependent on you and you have a saleable asset. But if you are working 80 hours a week and you're not doing business development, then you need to systematize your business. If you can take five weeks off and the business runs without you, then you are looking at a turnkey business you can sell or transfer.

3. You need to decide whether selling your business is a strategic sale or an investment sale

Whether selling your business is a strategic sale or an investment sale dictates the value of your business to the prospective buyer. Are they acquiring your business as a strategic addition to expand their existing operation, or do they view your business as an investment that will pay off in a short period of time?

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Here's how you want to think about a business as an investment purchase. If you have $1 million and you put that in the bank at 5 percent interest you will earn $50,000 in a year. If you were to sell your business for $1 million, then it needs to earn more than you would get from a safe investment like a bank. If you buy a business, you want to be able to recoup your money in three to four years. That would yield a return on the investment in a reasonable period of time.

When valuing your business, you want to make your money back at three to five times EBITDA (earnings before interest, taxes, depreciation, and amortization). For example, if you make $1 million in revenue and $300,000 in EBITDA profit, then your business is worth about $900,000.

A strategic purchase is priced differently, since the acquisition is of strategic value to the acquiring company. For example, they may want to buy your business to add to an existing product or service offering. Or a buyer may be looking to acquire your business to either acquire your customer base or eliminate a storing competitor. Pricing strategies are different for a strategic business purchase.

4. High-tech businesses and those with unusual valuations are often strategic sales

If the business is groundbreaking or unique in some way, chances are it is a strategic sale.

For example, consider what happens if I am a medical component manufacturer and I have $100 million in products that I manufacture. Someone comes to me with a business that has a patent and manufacturing for a new design for a mechanical heart valve. If I can add that heart valve business to my manufacturing company without any of the overhead of retooling or restaffing to actually manufacture the heart valve, then I can add that product line to my existing line.

That's a strategic purchase and the value would be calculated differently based on the potential return for the intellectual property.

5. Key employees can be considered corporate assets, if you understand their strategic value

Unfortunately, all employees are not valued equally, since some add more to your bottom line and deliver performance that is transferrable to a new owner. That' s how you need to think about which employees are key to your operation, which means you should take extra steps to hang onto them.

If you have an employee with exceptional cultural value, a high performer in their sales and marketing skills, or someone who provides the type of leadership that allows you to be less involved in daily operations, then they are considered key employees. A key employee helps keep the machine running so you don't have to be there.
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This is different from someone who holds you over a barrel, such as an accountant who is too secretive, or an employee who has the keys to the file cabinet.

You can lock in key employees with benefits, a stock ownership plan, and other benefits. As part of your succession plan, you should sell the transition strategy to your key employees.

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6. Creating systems that create repeatable business-critical processes enhance the value of your company for potential sale

This is perhaps the most important lesson that any business owner can learn. If you create systems to run your business, then the value of that business can be easily transferred. That doesn't mean you don't need people to run the systems, but every process should have a system around it.

Even your most skilled people, such as the MBA in finance, needs a system to efficiently deliver the services. The CFOs who work for our client companies are highly trained individuals, but they deliver a highly repeatable process. We know every CFO will have a budget, objectives, cash flow statements, and other deliverables as part of the system.

If you can create repeatable, documented systems that keep your business machine running smoothly, then you can hand the controls to a new owner without a hiccup. That's what makes for smooth succession planning.

7. Intellectual property can add value to your business sale, depending on the circumstances

The value of the intellectual property that underlies your business varies by industry. In our example above of the company with the new heart valve, the intellectual property of the patented technology was the key motivating factor for acquisition, so the IP was itself the crux of business valuation. However, intellectual property can take many forms.

For example, IP can be the policies and procedures that document your systems. If you buy an accounting firm and the accountants leave, then the IP goes with them. If you document everything and capture the accounting information and procedures as part of your systems, then it becomes a transferrable asset.

8. Maintaining clean, auditable books is essential for successful succession planning

If you have a corporation that is not run as a corporation then that's a risk management issue. For example, it's common for many small business owners to intermingle business expenses and personal expenses, so bookkeeping becomes messy. If there are personal expenses or non-deductible items mixed in the company books, then the buyer would be assuming IRS risk and exposure.

You need to look at your books and take forward-looking action immediately from the beginning. Of course, it's easy to make corrections moving forward, but most buyers are going to look at the last three years, if not the last five years, or your accounts. That's why it's important to use good GAAP and accounting practices from the outset.

If you would like more information, or guidance implementing an employee development plan for your company, we'd like to help. Call or email for a free consultation.

TJ is one of Pacific Crest Group's two co-founders, and leads our business consulting and CFO Services. He brings two decades of strategic planning, business and financial expertise to PCG's clients. TJ provides comprehensive and clearly defined plans that focus on measurable results.

He has held positions as CEO of McKendree's, Inc.; Served on the board of the directors of Entrepreneurs' Organization of San Francisco, the CFO of Marin Ophthalmic Consultants, the Board Chair of Stickney & Co, Inc., and the Board Chair and President of WPIA. TJ holds a B.S. in Applied Science and Business from University of San Francisco, and a B.S. in Geography from University of Nevada, Reno.

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