Preparing Your Exit Strategy

All entrepreneurs dream of building their company into something they can be proud of, and that will sustain them in retirement. After years of building your business, it would be great to find someone to pay you a small fortune as a reward for your hard work and take the business off your hands so you can sit on the beach. The problem is that most entrepreneurs are too busy running their day-to-day operations to plan effectively for the future. And even when they do develop an exit strategy, they often miscalculate the real value of their company. You need to have a target figure in mind for retirement, and map that to a realistic valuation for your company. You also want to leave enough time for a course correction if you need one, to improve valuation, and set the stage for a smooth sale.

Consider the example of one entrepreneur we counseled. This woman ran a successful catering company and had built her business not only doing special events but also running corporate team-building cooking workshops. Her $1.5 million business was generating more than $100,000 in annual profit. Her objective was to sell her business in three to five years for a price of about $15 million. However, she only expected her revenue to increase three to five times over that period. Given the nature of the business, she would essentially be selling her client list since the operation had few assets, which would make it impossible to justify a price of $15 million based on $300,000 in annual profits. She clearly needed to rethink her exit strategy.

More than 95 percent of U.S. companies are worth less than $1 million. You need to be realistic in setting the value of your company. You also need to be sure you remove any impediments that affect your ability to transfer the value of your company to a prospective buyer. For example, many entrepreneurial operations are too dependent on the owner to run independently, which means the value of the company can’t be transferred. To pave the way for a successful sale, you need to understand what the real value of your company is, who your potential buyer is, and maximize the value of your operations so you can make a smooth transition.

Is your company an investment or strategic purchase? There are two kinds of business purchases: an investment purchase or a strategic purchase. In considering your exit strategy, you need to be able to determine which type of purchase best suits your target buyer.

An investment purchase is made by someone with a vested interest in keeping your business going and gaining additional profits. The value of your business is determined by a combination of a multiple of earnings, the ROI for the buyer, and a desire to minimize risk. The multiple of earnings is determined by calculating your EBITDA (Earnings Before Interest, Taxes, Depreciation, and Amortization). In our catering example above, the EBITDA is $100,000 with an expectation to grow to $300,000 over time. For a service business, the standard multiple is three to five times earnings, so if the EBITDA is $100,000, the value of the business is $300,000 to $500,000.

A strategic purchase price is calculated differently because the goals of the purchase are different.

A company can make a strategic purchase for a number of reasons, e.g. to add customers without adding costs; to remove a competitor or head off a price war; to add a strategic service or product line, etc. In the case of a strategic purchase, the purchase price isn't calculated based on earnings, but on perceived profits for the buyer. A cash-out price will probably be lower than with an investment purchase, but there are ways to structure an earn-out where the buyer and seller share profits over time. Of course, they share the risks as well. These kinds of purchase deals are structured based on the risk shared and what the business and/or its assets are worth to the buying company.

For example, we worked with a dialup and ISDN Internet access company who had a buyer that was only interested in purchasing the clients and nominal amounts of the networking hardware. By structuring the deal so it delivered maximum value to the buyer, they were able to sell that portion of the business at 30 times the EBITDA because the buyer was not picking up the business overhead. All of the revenue from the accounts went straight to the bottom line and the buyer was able to make back all of his investment within a year.

Once you have determined your best exit strategy, you need to lay the groundwork for a successful sale and transition, both from a business and a legal perspective. Here are 10 steps to consider as you prepare to sell your company:

1. Make sure you have clean financials. In most small businesses, bookkeeping is a problem. Business owners often take cash from the business in unorthodox ways, or they claim personal expenses against the business. In other cases invoicing or bookkeeping includes its own peculiar rules and procedures.

We had one marketing agency client, for example, whose billing system was totally dependent on the founder; he would determine the monthly invoices and then they would have to be re-entered into the accounting system. We eliminated that problem by putting in a standardized hourly billing system and automating the billing process.

Be sure that you have clean books. Follow GAAP standards. Also maintain fiscal responsibility and make sure you have sufficient reserve capital to pay off liabilities.

Most importantly, be sure to keep your personal and business financials separate. There are ways that you can legitimately include personal expenses as part of your business operations, but you need to be clear about how you track expenses. For example, one of our physician clients maintains a private plane as part of his practice. However, the records for the airplane are accounted for separately, so he can still maintain clean accounts for his medical practice.

2. Show consistent EBITDA growth. Your net profits should be consistent for a period of time, ideally at least three years. You want to avoid any wild revenue swings if at all possible. Remember that consistent growth in net profit will translate into reduced risk for a prospective buyer.

3. Execute well-defined client contracts. Just as you want to show stable revenues with consistent growth, you also want to show that your source of revenue is stable as well. If at all possible, lock in long-term contracts that represent recurring revenue. Also be sure that the contracts are structured to make them easily transferrable. Your contracts represent your revenue stream and you want to be sure that their value can be easily transferred to a potential buyer.

4. Lock in your key employees. Just as your contracts assure a solid revenue stream, you need to consider key employees as part of your corporate assets. You want to protect your “human capital.” Remember that without strategic managers and employees who are invested in making your business succeed, you don’t have a business.

You can lock in your key employees with good contracts that guarantee returns for company loyalty. For example, you can include a stock accumulation clause that gives employees stock that vests over time; the longer they are with the company, the more stock they earn. You also stretch bonus distributions over time as an incentive to retain employees.

And be sure that your employment contracts include a non-solicitation clause so employees don’t look at the sale of the company as a chance to raid the client list and either start their own company or take business to the competition. You might also consider including a non-competition clause as well.

5. Implement systems that assure reliable performance. Too many small businesses find themselves relying on people instead of processes. When you consider who your key employees are, you want to think about those individuals who offer strategic value to your operation, either because of their unique ability to work with clients, to market the firm, to close sales, or perform some other business-critical function. An employee isn’t considered “key” simply because they hold the keys to the filing cabinet.

Assess the tasks that your employees are doing and see if they can be done more efficiently by implementing systems. Remember our example of the entrepreneur with a stranglehold on his invoices. By creating a system to handle billing, you have created something transferrable.

Ask yourself the all-important question “Is your business at risk because of one single employee?” If the answer is “yes,” consider how you can minimize that risk by replacing that employee’s job with an automated, repeatable system.

6. Eliminate dependency on the business owner. If your business can’t function without you, then it has no value to a prospective buyer. For example, if you are the sole source of new business or sales, or if you are the only contact that the clients trust, then you make yourself indispensable and your business worthless to others.

In working with small businesses we have seen too many instances where dependency on the

business owner has led to disaster. In one case, when the owner died suddenly, his widow realized that the business he had spent years building was practically worthless because all of its value went with him. In another instance, we saw another small company crumble because operations were disrupted while the owner dealt with a divorce.

The best way to test the independent operation of your company is take an extended vacation. Leave the office for a while and see if they can get along without you. If they can't, determine where the bottlenecks are and take steps to make sure operations aren't solely dependent on you.

7. Demonstrate solid sales and marketing. In many small businesses, the owner is the biggest sales producer. You need to make sales and marketing a successful, standalone operation that can function on its own. Here, again, creating autonomous systems can help. Implement a lead-generation and sales process that doesn't depend on you. Either hire sales and marketing staff or even outsource your sales support. The objective is to create a solid sales machine with a stable, predictable new business pipeline that will demonstrate to a prospective buyer that your business will generate income into the future.

8. Implement risk management. You need to minimize risk and protect your company's assets and intellectual property (IP) in such a way that you can make it transferrable. Make sure you have solid employee and consulting agreements in place. If your business is dependent on IP, make sure it is protected by trademarks and patents, and be sure that your IP is protected so it can't be acquired by your employees or contractors.

9. Determine who is your buyer. Identify your best buyout possibilities and consider where you are going to get the biggest value. Is yours a strategic or an investment sale?
Consider approaching potential investors who may want to eventually take over your business. Also use your business networks to talk to others about selling your business. Strategic relationships could ultimately lead to a sale.

10. Plan your exit strategy. Take the viewpoint of a prospective buyer and determine what could stand in the way of a potential sale. Particularly look at the legal ramifications of how your company and its assets are structured, and how that could impact a sale. For example, when you sell your company the buyer most likely won't want to deal with an asset sale because of the tax implications. If you have an S corporation or an LLC, then it's easier to separate the assets. If you have a C corporation it's more challenging. How you structure your company and its assets can have a big impact on the value of the sale.

As part of the process, you want to make sure that you consult trusted advisors to help you along the way. Gather experts who can help you improve your company's value and protect your assets. Some of the specialists you should consult include a valuation specialist, a business coach, financial advisor, and a transaction intermediary. And be sure you have a reliable business attorney, CPA, insurance agent and estate planning attorney as part of your consulting team.

When most small business owners decide to sell their business, they plan from three to six months in advance. That's not enough time if you need to make a course correction or demonstrate a consistent performance track record that will appeal to a prospective buyer. Ideally, you should be planning your exit strategy from the day you open your doors. You should always be looking at ways to improve operational efficiency and implement processes and systems that yield consistent results. If you haven't been planning your exit strategy, start now and be prepared to give yourself a few years to provide the runway you need to prove the value or your company.