Determining Your Business Health as Part of Your Succession Planning

WHITEPAPER

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RK Fischer & Associates Overview

RK Fischer & Associates is a business consulting and coaching firm that helps business owners increase value in their business by improving their operational and bottom-line financial performance which enables them to achieve profitable growth. All of the services we provide are focused on meeting those goals for every stage of a business.

We offer and deliver our services in multiple formats to meet the needs of our clients and how they choose to learn through a combination of facilitation, coaching, consulting, coaching with consulting, and training. Our services assist you, so you can focus on working more "on your business." Though we are located within Southwestern Ontario, we can provide many of our services to businesses remotely across Canada.

As business advisors, our primary focus is on owner-operated businesses who are under 150 employees. Our two partners have significant managerial and executive experience in complex businesses, such as manufacturing, hi-technology (Fintech, SaaS), business services, as well as financial services. We have worked with clients in a variety of industries from retail, construction, transportation, manufacturing, professional services, healthcare, recreation, and food & beverage, to name a few. We work directly with the business owner to understand their specific business goals and challenges, so we can implement the right solutions ensuring you have continued long-term success.

We have associations and affiliations with other professionals such as lawyers, financial accountants, business brokers, business valuators, lenders, and other service providers who help us in providing you with one-stop-shopping for your business requirements.

Our goal is to bring clarity and focus to your business.

Visit us at www.rkfischer.com, to find out more about all of our offerings and how we may help you with your business, or contact us at info@rkfischer.com.

Our Partners

RUDY FISCHER

Rudy Fischer is a management accountant with a CPA, CMA designation who works closely with our clients to help them improve the financial health of their business. Management accountants focus on your financials going forward and create value for your business by combining strategic planning, performance management (financial & non-financial), and expertise in providing owners with the intelligence they need to grow their business. He will work closely with your financial accountant in understanding the financial history of your business, which is their focus.

Rudy has over 25 years' experience in the hi-technology sector in finance, manufacturing, engineering, product management and marketing disciplines. He has held executive management positions with Everlink Payment Services, Rogers Communications, Sprint Canada, Nortel Networks, Newbridge Networks and Mitel, where he was responsible for various business units.

Rudy has expertise in planning, managing, and marketing products through all stages of the product life-cycle, including setting strategic direction along with the building and directing of the teams who will accomplish the necessary goals. Rudy has launched and been responsible for taking many new products to market including small business voice systems, wireless solutions, data centres, enhanced voice services, fixed-mobile convergence, card payment solutions, and financial transaction acquiring solutions.

Rudy was a Board Member, Member of Audit Committee, and past Chair of the Audit Committee for the Education Credit Union in Kitchener, Ontario from 2013 to 2017. He currently is a Board Member of Southwest Regional Credit Union. He holds a designation of an Accredited Canadian Credit Union Director (ACCUD).

He volunteered before moving from the GTA for the BACD in Durham Region where he acted as a mentor for their clients and provided training as needed. He is a mentor for Futurepreneur.

KAREN FISCHER

Karen started RK Fischer & Associates in January of 2010 after 25 years of success in marketing, sales, channel development and general management with the hi-tech, business services and manufacturing sectors. She held management or executive management roles for companies such as Cognos, Entrust, Mitel, Siemens, and Pitney Bowes. In the last six years of her career before starting RK Fischer & Associates with her business partner, she held start-up Executive roles that included help with plans for financing and acquisition. Based on this experience, Karen felt the small & medium business market was underserved by the consulting industry. She found most firms focus on larger businesses and if they do acquire a smaller client they try to implement large business methodologies in the small business, which is not a fit for most businesses under $25M in revenues.

Karen is passionate about having the chance to help business owners whether that is through growth, increased profitability, or obtaining financing. She is happy to share her expertise and experience that she gained from her prior career with business owners to help them and their businesses flourish. Since the time she started RK Fischer & Associates, she has built strong partnerships in the GTA with other professionals that offer complementary services.

Karen is a past Member of the Board of Directors for the Business Advisory Centre of Durham Region where she held the position of Secretary/Treasurer. This is the small business centre that serves the region of Durham.

She served on the Membership, Marketing and Event Committees for the Ajax-Pickering Board of Trade and was responsible for the development of their Professional Development Series. She filled in for a semester at Durham College for a professor on leave and developed and delivered a Digital Marketing course to the Entrepreneurship Program. She also volunteered as a mentor for BACD and provides training as required.

Upon moving to Southwestern Ontario, Karen has become a Board Member for the Sarnia Lambton Chamber of Commerce and she volunteers for the Chamber on the Business After 5 Committee.

Determining Your Business Health Today as Part of Your Succession Planning

Baby Boomers are those in Canada who were born between 1946 and 1965 and are now ~50 to 65 years of age. According to the 2011 Census, baby boomers represent approximately 29% of the Canadian Population. When you consider the age group that is considered working age (19-65), baby boomers represent 44% of the working population. Over the next 15-20 years the baby boomers will begin their journey into retirement. The year 2011 signaled the year that the first baby boomer was set to retire. Though the recent economic down turn will have delayed many plans, this cannot stop the inevitable which will end up translating into a higher workforce exit rate in few more years as the economy recovers.

Not only are baby boomers retiring from employer based enterprises, many small business are owned by baby boomers. These owner based businesses often form an important part of the owner's personal retirement/financial plan. In 2004, 47% of the SME owners were 50 and older, in 2007 that number grew to 58%. Applying this to some interesting statistics taken from the Stats Canada and Industry Canada's website where:

- There are approximately 1 million small businesses in Canada with 100 or fewer employees.
- There are approximately 1.1 million employer businesses in total
- 75% of all businesses employ fewer than five employees.
- 98% of business in Canada have fewer than 100 employees

We could assume that ~ 387 thousand (1.1M x 75% {>5} x 47% {50+}) small businesses will encounter some form of transition over the next 15 years.

In a report "The State of Entrepreneurship in Canada – Feb 2010", it states the probability of small businesses surviving the current year is ~85% to 88%. Based upon that number and some simple calculations less than 1 in 5 small businesses will survive the next 15 years (Report indicated ~51% survival rate for 5 years). Assuming an 88% annualized survival rate and depending upon when you plan to exit your business, the chance that you will have a business to provide for retirement is simplified as follows:

Years to retirement	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15
Probability (Survival)	88%	77%	68%	60%	53%	46%	41%	36%	32%	28%	25%	22%	19%	17%	15%

That means, out of the 387 thousand small businesses fewer than 5 employees, only 58 thousand businesses are expect to survive over the next 15 years. If you are business owner who is between 50 to 65 years old and are looking to your small business to provide you for your retirement, these statistics could keep you up at night.

As part of their life events planning, many business owners are hoping that their current business will provide for them with the income they need in retirement. This income could be in the form of income / dividends or the outright sales of the business itself. Regardless of the choice, eventually the business will pass into new hands and under different control.

Compounding the business issues, thanks to the retiring baby boomers, there is about to become a wave of business exits. If supply and demand has its way, this will serve to put downward pressure on business value assuming there are a finite number of business purchasers who have access to limited funds. Knowing the best value (as defined as the biggest bang for the buck) will win out, now is the best time to start working on your business to 1) increase value, 2) increase longevity, 3) increase sales and 4) establish operational excellence.

Business Valuation

There are a number of methods that can be utilized to value a business. Regardless of the methodology chosen, ultimately a common theme begins to emerge which is profitability and the quality of that profitability. We often hear about valuations based upon:

Pricing multiples:

Value = Times revenues (say 1x) or Times earnings (say 5x)

Capitalizing Income:

Value = Income / (Required rate of Return)

Net present value of Free Cash Flow (FCF)

FCF = Gross Cash Flow – Owners pay

Value = NPV(ΣFCF at a prescribed discount rate)

Liquidation

Value = Σ Assets at market buy price – Σ all monies owing to creditors

Eternal optimist (Emotional)

I like it … I think I can … sky's the limit!

Everyone wants to find the eternal optimist. These folks are rare and what distinguishes them from most buyers is that they have an intuitive sense about the hidden value in a company, or a vision of how the future will play out with your company. As seller of your business you are all eternal optimists; the problem is that sellers cannot seem to find the right buyer who can see and value the business in the same manner that they do.

It may come as a shock to small business owners to find out that their businesses are not worth as much or as marketable as they anticipated. Although you may be optimistic about your business and its prospects, the purchaser is not. They may see things that detract from the value they hoped to gain with the business purchase.

When you study the mainstream business valuation methods a new term begins to emerge that is not explicit in the above valuation list; and that is: **RISK. Required Return Rates** are always adjusted based upon risk. Assuming a risk free discount rate of 4% over a 5 year period you could receive 4.5 times of the annual free cash flow your business generates. Introducing risk can reduce the value of your company from the 4.5 times to, say, 3 times by increasing the required rate of return the investor expects from your business. Because of risk within your company, the new owner may require a 20% return on their money. Reducing the risk corresponds to increased multiples or NPV values.

The most significant tool to increase business value available to the business owner is show revenue and margin growth for a number of years. There are many other things you can do to reduce risk with your company.

Risky Issues

Productivity, innovation, access to resources and adaptability to changing market conditions are a few of the items that if done well will reflect positively on the survival of the businesses. These are issues that cannot be addressed within a year but will need years of planning, implementation and track record to master. Just as most people (over years) plan with a financial advisor for their RRSP portfolio, business owners need to plan their business exit and maximize return on their business as well. Other areas of due diligence includes:

- **People** – are the people who are left behind capable, willing and motivated to contribute to the ongoing success of the company? Is the business sustainable without the business owner as part of the business?
- **Finance** – although the cash flow may be sustainable, are the relationships with your bank, creditors, suppliers, partners and customers healthy and based upon mutual respect and benefit?
- **Partnerships and Control** – are there any agreements that limit the options a new owner could consider with your company?
- **Marketing** (the plan – do you know what you're after) – are you in sustaining mode with your company or are you trying to build momentum that a new owner can take advantage of?
- **Sales** (revenue, margin, growth) – As stated above (and worth repeating); the most significant tool to increase business value available to the business owner is show revenue and margin growth for a number of years. Also be prepared to address: What is the quality of your sales? Is 70% of your business contingent upon one customer? Is the customer base diversified sufficiently to mitigate against the single loss of customer? Is revenue on an upward trend? Are margins in line or better than industry average?
- **Operations** (capacity, coverage, cost effective, quality) – what happens when a large order comes in, can you deliver in time and with quality? At what sales or product volume will you require the next level of investment? When, as owner, you leave, will others know what and how to do their jobs? What level of documentation do you have within your company? How do you measure operational success? What obsolete equipment do you have on hand? Will the new owner need to replace most of the equipment?
- **Customer Service** (happy return customers) – what percentage of your customer base would be willing to recommend you? What percentage of

your base does recommend you? Just as important – what percentage would not recommend you? Why?

- **Intellectual Capital** – Do you have any competitive advantage with your service and/or product that keeps you differentiated from your competitors?

Assessing risk against each of the items above will result in a risk adjustment factor. The factors will be assigned on the basis of 1) Failure likely, 2) Crisis, 3) Issues need tight management, 4) At will of market, 5) Secure or 6) Money in the bank. You will want to score a 6 in each of the 8 categories above. Achieving 48/48 (8 categories x score of 6) will probably result in a higher earnings multiple or NPV value whereas scoring 8/48 will probably result in you not being able to give your business away.

The bottom line is you have to have a well-run company that will survive on its own without direct involvement from you.

Reducing Risk and Improving Business Value

If you are a business owner who is planning to retire in the next decade, planning for succession should be a priority for you. You have worked hard to make your business a success, so it makes sense to extract the most value you can out of that business.

The activities required to achieve the above objectives cannot be accomplished one year before you decide to sell. You need years to plan, implement, adjust, implement etc. Trying to accomplish all of this within a year will rob you of value you can extract out of your business. Besides, it could take you about 12-24 months to sell your business. Not only do you need to establish a premium price for your business at the beginning of the sales cycle, you will need to maintain or improve that value as purchasers evaluate and conduct their due diligence on your company. Considering the 12-24 month sales cycle coupled with the business improvement process required, you should begin to review these items at least 5 years in advance and then start the planning and implementation for the business transformation.

Although it is nice to say that you need to get a 48/48, what does that mean? How does that number translate to improved value? More important, is the cost of moving the yard-stick from a 40 to a 42 higher than the expected increase in price? To answer this not only do you need to know your numbers, but you need to go beyond your financial numbers to your operational numbers as well. How does a 5% increase in product or service yield translate into Free Cash Flow? How does a process improvement in customer service improve revenue or reduce costs? Are the expenditures in these improvements resulting in the business value increases I expect?

Steps to Planning Now

1. Assess where you are today in all areas of your business to see how you are performing with a trusted small business advisor.

2. Benchmark where you fit in performance in relationship to others in your industry.

3. Look at the changes you need to make over the next few years to either sustain your current valuation or to achieve a higher future valuation.