The Business Owner’s Dilemma in Exiting

WHITE PAPER

Table of Contents

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 in 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 that 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 the Audit Committee, and past Chair of the Audit Committee for the Education Credit Union in Kitchener, Ontario, from 2013 to 2017. He is currently 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. 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 provided 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.

The Business Owner's Dilemma in Exiting

Background Data Points – Setting the Stage

Studies show that about 70% of small business owners intend to exit their business within the next 5 to 10 years. In many cases, up to 80% of a business owners personal net worth is tied up in their company. Most business will not sell, especially for the price an owner expects.

According to BVResources.com (Q3 2018) the average Selling Price/EBITDA ratio seems to center around 3.5 over a 5-year period (Q1 2013 to Q2-2018). If an owner were to sell a company with EBITDA of about $150,000/year, that would equate to a business sale price of $525,000. Investing these funds at 6% annual return would contribute at least $2,625/month to an owner's retirement income after exit.

A stable well-run business experiencing strong growth and returns should be able to receive 7-times EBITDA (*stock markets achieve 10 to 20 times EBITDA; for example the S&P 500 has typically averaged from 11 to 14 over the last few years*) which translates into just over 1-million dollars in business valuation.) The extra $525K could double the monthly owner's retirement fund to $5,250/month after exit.

Much of the current research indicates that most business exits, and transitions will either not materialize or achieve much less than desired results.

There are reasons this failure rate is so high:

1) **Lack of planning**
2) **Lack of investing in their business**
3) **Troublesome financial statements**

Lack of planning is perhaps the highest reason for failed business exits and transitions. Like selling a house, staging is an important element to increasing the availability of interested buyers. Unlike selling a house, it takes years to build a business that is attractive to many buyers. A buyer will want to ensure that once the owner leaves, the business will not fall apart due to loss of customers or key employees, squeezed margins, failed equipment, or deteriorating customer satisfaction.

Often as business owners begin to think about retiring, their attitude in investing in the business begins to change. Often, they are reluctant to replace equipment or invest in new products or services. The process of withdrawing cash out of the business starves the business of needed working capital and results in a process of withdrawing value out of the business.

Finally, lackluster financial results turn away buyers very quickly. Buyers are looking to purchase a businesses future cash flows and declining sales and/or margins represent red flags. Buyers will want to see a history of sales and profit growth based on 3- to 5-years of financial results. One year's worth of improvement does not make a trend.

CFIB, BDC (Business Development Bank of Canada), Forbes, and Business Finders Canada all recommend that business owners start exit planning as early as possible. One could say that you should run you business as if you were going to sell it every day.

A excerpt from Deloitte & Touche signifies that, "71% of small and mid-sized enterprise owners plan to exit their businesses within the next ten years, strongly highlighting the growing importance of enhancing business value. However, the challenge is that few organizations genuinely understand what actions they must take to achieve this goal….".

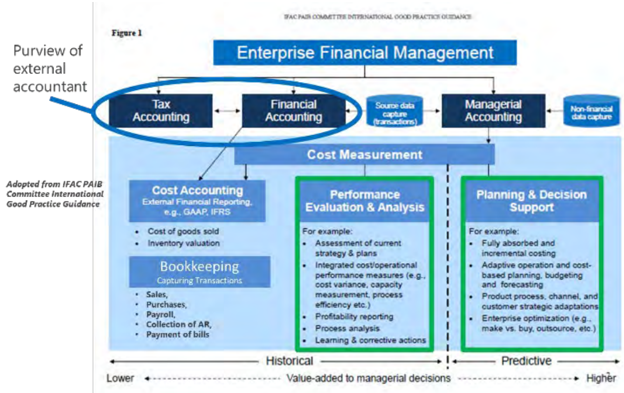
Given that no two business are alike, the trick becomes in determining what business owners must do to improve their business value. Professionals exist to help with owners' investible assets, help on managing the business asset is now required.

Dynamic Forces of Personal and Business Wellness

Business owners have access to private wealth management professionals to help them plan for their retirement. These professionals are well trained to understand your risk profile and navigate your investible assets to maximize future value in your retirement years.

Business owners also have access to accountants who can provide them with accounting and tax advice for their business but often this is somewhat limited to financial statement compilations and tax filings on an annual basis. We often hear from clients that although their accountants explain the changing financial results, they are often left wondering what precipitated these unexpected outcomes, or more importantly, what to do about them.

Although most financial statements are prepared to industry standards, the problem with financial statements are that they are outcomes based on past sales results, purchases, and business decisions made – yet the uniqueness of the business and the underlying policies and process used to run the business are not captured. As a result, the fact that working capital and profitability may have declined, the linkages to what policies, process, and procedures contributed to the unexpected results are not made.



To close this gap, what is required are knowledge and experience in accounting and finance, and operations, sales, marketing, and development. This is important because these skills will allow a business to unravel potential accounting problems that could impact their ability to take on a more appealing business strategy.

For compliance, reporting to stakeholders, and for tax purposes, financial statements are an important tool to running a successful business. Many private businesses utilize an external accountant to assist them with these tasks. Many private businesses utilize an external accountant only once per year for these purposes and are often surprised by the results. Instead of being surprised at year-end by your accountant, a more forward-looking financial planning is required for the business. Businesses require access to skills and experience which can provide the information companies need to make business decisions that will result in growth and increased success.

Preparing and Maximizing Business Value

“There is simply no better way to become wealthy than starting and successfully exiting a business.” (*Tepper, Mark. Walk Away Wealthy: The Entrepreneur’s Exit-Planning Playbook*)

With approximately 80% of a business owners personal net worth tied up in their business it is important to maximize the value of the business. According to BVResources.com (Q3 2018) the average Selling Price/EBITDA seems to center around 3.5 over a 5-year period (Q1 2013 to Q2-2018). If an owner was to sell a company with EBITDA of about $150,000/year, that would equate to a business sale price of $525,000.

Given, according to a BDC study, that most business “are not making the best moves to realize the highest possible (value)”, the potential for a well run business should be able to easily achieve 6 or 7 times EBITDA (*stock markets achieve 10 to 20 times EBITDA*) which translates into over 1-million dollars in business valuation. The extra $475K can contribute significantly towards a business owners retirement fund.

Valuation of a business takes into consideration, factors that are both beyond the control of the owner and directly controllable by the owner. Risk-assessment of the business drives the value of the multiplier used to arrive at the ‘business price’. The multipliers are determined by a combination of bank rates, the stock market, industry type, size, and company specific items. Each component represents specific risk elements and these build on each other to arrive at a 'multiplier'; the higher the risk, the lower the multiplier, and risk is determined by the buyer, not the seller.

Current bank rates, the performance of the stock market, and issues within an industry type are not controllable by a business owner. To a degree, the size of the business might not be under the control of the business, however; specific company items are totally under the control of a business owner. There are eight value drivers of business value that an owner has direct control over:

1.	**Financial**	History of financial performance and accounting system
2.	**Growth**	Likelihood of profitable growth and at what rate
3.	**Independence**	How reliant business is on specific employee, customer, or supplier
4.	**Financial Structure**	How well the business generates cash
5.	**Revenue Quality**	Contracts, recurring, repeatability, one time, or random
6.	**Monopoly**	How well differentiated is the business and on what basis
7.	**Customer Sat**	Will customers re-purchase or recommend your business
8.	**Owner Risk**	How dependant is the business on the owner's presence

It has been shown that these eight drivers can influence the ultimate price a business can earn; it can take a 3.5x and improve it to 6x or 7x. Improve performance through these drivers takes time and perseverance.

When addressing building up wealth in the business, one needs to be prepared to accept that "what makes your business profitable from one year to the next may be at odds with what makes it valuable" *(Tepper, Mark).* Investments in the business this year may reduce current net income but could improve business value in the long run. The willingness to invest leads to the most important determinant in building business value; to what category the business owner belongs.

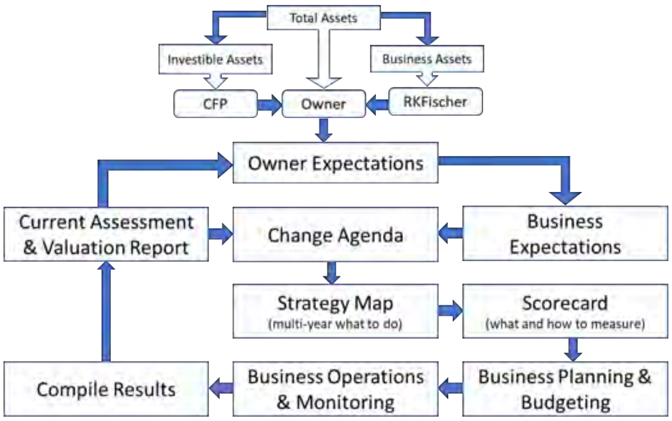
Lifestyle: the business exists to fund owner's lifestyle, or

Going Concern: businesses are long-term assets that function to build long-term value.

Lifestyle business owners tend to pull out all available cash with little regard to improving or considering investment opportunities. The business is often starved of the cash required to build long-term return for the owner. The owner chooses to continuously pull value of the company resulting in much lower valuations when they plan to exit later. These owners tend to think that a dollar invested is a dollar foregone. This group is highly unlikely to invest in activities to improve valuations.

Going Concern owners have a business mindset that employs processes to analyze investment opportunities for the expressed purpose of building long-term shareholder value. These owners tend to think that a dollar invested will be returned multiple times.

This is the group that we have most the most success with business dealings and outcomes.



In the world of management accounting, there is a saying "what gets measured, gets done". The trick to improving business value is by first, employing a process to assess current business risk and establishing a benchmark valuation (*measure 1*). Next, working with the owner, we establish the businesses long-term financial goals, "*the targets*". (These goals are often derived by the owner working with their private wealth management professional; this defines what the owner needs to get from the business.) Using business owner expectations and comparing/contrasting them with the current position, we develop a change agenda for the business. The change agenda is used to develop goals, objectives, measures, and tracking mechanisms that provide periodic status and progress reports towards achieving the owner's ultimate goals. The process is closed loop in that the periodic assessments are utilized the new benchmarks in developing further goals and objectives.

APPENDIX – Notes from Studies & Articles

CFIB – Nov 28, 2018

72% of small business owners intend to exit their business. With many baby boomers planning to retire in the coming years, business succession is a major concern.

The vast majority of business owners (81 per cent) intend to sell or transfer their business to retire, although only a fraction of them have started planning for their departure. In fact;

- 51 per cent have no plan at all,
- 8 per cent of respondents have a formal written plan, and
- 41 per cent have an informal plan.
- 48 per cent of business owners plan to sell to third parties,
- others prefer to pass their business on to one or more family members,
  - whether through a sale (25 per cent), or
  - a transfer (21 per cent) such as an inheritance

Finding a suitable successor or buyer is the main hurdle to succession cited by survey respondents (56 per cent). With this in mind, CFIB recommends that small business owners start planning for their succession early on and prepare for the unexpected by working out several potential exit strategies.

BDC (Business Development Bank of Canada)

Study: The Coming Wave of Business Transitions in Canada (Sept 2017)

- shows that many Canadian small and mid-sized business owners who plan to exit their business are not making the best moves to realize the highest possible return
- 41% of entrepreneurs plan to leave their business without acquiring another one
- among the 41% who expect to leave their existing firm without buying another business, five out of six say they plan to retire
- How do today's entrepreneurs plan to go about exiting their business?
  - 22% wind down business and sell assets (least profitable)
  - 52% Sale/transfer of control outside the family
    - Third part sale (most profitable)
    - Management buyout (somewhat profitable)
  - 26% Family succession (mixed results)
- Nearly two in five business owners who expect to sell to outside buyers within the next five years appear to have done little or nothing to spruce up their financial reporting. Most have also neglected to take action to maximize profits in anticipation of a sale. A healthy cash flow is especially important in the years leading

up to the transfer of ownership because it goes a long way towards maximizing the value of the firm
- Entrepreneurs looking to exit without acquiring another firm (representing 41% of respondents, as indicated previously in this report) appear to have little interest in expanding the existing business. Close to a third in this category express a strong aversion to growth
- As with selling a house, some advance "staging" can make a big difference.
  - Such a cautious approach to business growth often has an unfortunate result, in that the company fails to reach its full potential value.
  - This is worrisome considering that most entrepreneurs have no other asset more valuable than their business.
  - Letting the business go, as opposed to taking the action needed to enhance its value, can thus cast a long shadow over an entrepreneur's retirement prospects.

Forbes – Feb 5, 2017

Study Shows Why Many Business Owners Can't Sell When They Want To (US based)

- many owners probably won't be able to sell their businesses when they're ready, because they're not taking critical steps toward a transition or toward getting the full value of the enterprise, according to Christopher Snider, president and CEO of the Exit Planning Institute (EPI).
- EPI show that many owners have little to no exit planning in place, even though many of them have 80 to 90 percent of their financial assets based in the business itself
- unfortunately, many owners also appear to be waiting until late in the game to begin planning for the eventual sale or liquidation of the business
- eight statistics from the survey:
  - 53 percent said they had given little to no attention to their transition plan
  - 88 percent had no written plan to transition from the current owner
  - 80 percent had never sought advice about a transition
  - 70 percent don't know what after-tax income they need to support their lifestyle
  - Only 58 percent of those surveyed have an estate plan
  - Two-thirds agreed that "Getting full value for my business to fund retirement or other business interests" was their top goal in the transition of the business, yet less than 40 percent … knew the value of their business
  - Less than 48 percent of businesses with multiple partners have a buy-sell agreement in place

- 25 percent were comfortable that their managerial team would be successful if the owner wasn't involved after the transition

Business Finders Canada (web site)

- About 80% of the businesses on the market will not sell. It is primarily due to owners not realizing the need to plan for the sale of their business
- "71% of small and mid-sized enterprise owners plan to exit their businesses within the next ten years, strongly highlighting the growing importance of enhancing business value. However, the challenge is that few organizations genuinely understand what actions they must take to achieve this goal…." – Deloitte & Touche
- 40% of these owner's plan to leave their businesses within the next five years, and over 70% within the next ten years
- About 80% of the businesses on the market will not sell.
- Less than 18% of owners have a written exit plan for leaving their business

The number of businesses sold in Canada is expected to double each year for the next ten years. (Community Futures)