CHAPTER 1

An Introduction to Business Exit Planning

I am prepared for the worst, but hope for the best.

—Benjamin Disraeli (1804–1881)
British statesman

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In some languages and cultures, the concept of success is very much associated with exiting. For example, the Spanish word *éxito* means 'success'. The word comes from the Latin verb *exeo*, meaning 'to exit'. Similarly, in Italian, *riuscire* means 'to succeed', whereas the word *uscire* means 'to exit'. There is much logic to this. To enter a war, for example (think of Vietnam, Iraq, and Afghanistan), is the easy part. To exit is much trickier—and you cannot call it a success until you have exited. An investment is similar; making the investment (e.g. buying shares) is the easy part, but you won't know whether you have been successful (i.e. made a profit) until you have sold it. Your company is no different. With the benefit of hindsight, a successful exit from your business is a precondition to your ownership of that business being considered a success. As American financier and investor Henry Kravis stated, "Don't congratulate us when we buy a company. Any fool can buy a company. Congratulate us when we sell it and when we've done something with it and created real value."

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In this chapter, I will introduce the numerous business exit options that a business owner might explore, and attempt a definition of Business Exit

Planning. I will then provide some statistical evidence further underlining the need for business owners to engage in Business Exit Planning, and finish the chapter with a discussion on the need to understand your own motives with respect to Business Exit Planning and to set clear objectives in any Business Exit Planning exercise.

WAYS TO EXIT YOUR BUSINESS

Most people associate a **Business Exit** with selling their businesses to third parties, and this is, perhaps, the most common form. But there are many other ways to exit your business:

- *Intergenerational Transfer:* Transfer of ownership to one or more of your children or other relatives.
- *Management Buyout (MBO):* Transfer of ownership to one or more members of your management team.
- *Initial Public Offering (IPO):* Also known as going public, this involves selling shares of your company on a stock exchange. These may be your shares (e.g. funding your exit) or you may have your company issue new shares (e.g. treasury shares), the proceeds of which would flow into your company's bank account, or a combination of the two.
- *Merger:* This involves merging your company with another company to create a new, combined entity. Under the terms of the merger, there may be provisions in the agreement to purchase a portion of your shares at closing, or perhaps all your shares over time.
- *Hiring management:* This option involves hiring professional management to run the business, with the owners withdrawing from day-to-day management of the company. (This is an exit from an operational point of view, but not from an ownership or financial point of view.)
- *Refinancing:* You may be able to extract considerable cash from your business if you find a bank or other financial institution to lend money to your company. (While this may facilitate a partial or considerable exit from a financial viewpoint, it does not achieve any form of exit from an operational point of view.)
- *Employee Share Ownership Plan (ESOP):* This involves selling shares to the employees of your company.
- *Liquidation:* Some businesses are worth more if broken up and liquidated than operated or sold as a going concern.

WHAT IS BUSINESS EXIT PLANNING?

Business Exit Planning is the process of explicitly defining exit-related objectives for the owner(s) of a business, followed by the design of a comprehensive strategy and road map that takes into account all personal, business, financial, legal, and taxation aspects of achieving those objectives, usually in the context of planning the leadership succession and continuity of the business. Objectives may include maximizing (or setting a goal for) proceeds, minimizing risk, closing the sale quickly, or selecting an investor that will ensure that the business prospers (whether because of depth of knowledge or depth of pocket). The strategy will usually include the mode of exit envisaged (IPO, MBO, sale, etc.), a marketing strategy, and a timetable. The strategy should also take into account contingencies such as illness or death.

The Business Exit Planning process typically involves tax planning, as one of your objectives as a business owner will be to maximize *after-tax* proceeds. It may additionally involve estate planning, if your objective is to pass at least part of the proceeds to the next generation.

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It should be understood that some of these objectives may be contradictory. For example, maximizing the speed of a transfer will probably be to the detriment of maximizing proceeds. Hence, it is important for you not only to know your objectives, but also to prioritize them, so as to be in a position to make tradeoffs. Professional judgments may also be involved in making these tradeoffs (e.g. is it worth accelerating the sale process by two months if it is likely to reduce **Transaction** revenues by 30 percent or more?).

As with most things in life, if you do not set your objectives and map out a strategy for achieving them, actually achieving those (undefined!) objectives will be a pure accident. Engaging in Business Exit Planning should increase your chances of a successful business exit. It will help you to:

- maximize the proceeds of the exit;
- minimize taxes, hence maximizing the after-tax proceeds of the exit;
- ensure an orderly transition for the leadership of your company, to a party likely to take the business to the next level;

- define your post-exit activities;
- invest the proceeds of your exit wisely; and
- reduce the level of stress and risk in the Business Exit process.

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As mentioned in the Preface, some exit strategies allow you to exit in terms of your personal involvement with the business; some allow you to exit in the financial sense; some allow you to exit in both senses. I urge you to consider all options to the extent they are appropriate. Weigh all of your options before committing to a course of action. The appropriate exit strategy will depend on your objectives.

EVIDENCE ON WHY BUSINESS EXIT PLANNING IS NECESSARY

If the example of my father's company has not convinced you of the need for Business Exit Planning, allow me to muster some statistics to support the proposition that it is necessary. A 1996 study of 749 heirs of U.S. family businesses revealed the following:[1]

- In nearly half (47.7 percent) of the cases, the transition and ultimate collapse of the business was precipitated by the founder's death.
- Only in relatively few instances (16.4 percent) did the business failure follow an orderly transition between the owner and the next generation; in situations where the owner was forced to retire, the figure dropped to 6.1 percent.
- Most heirs, regardless of the industry, believed the business failures were the result of inadequate estate/financial planning, poor preparation for the transfer, or a lack of assets to cover the estate taxes. Other reasons given were conflicts with non-active family members and insufficient capital with which to effectively run the business.
- While most owners (76 percent) had estate plans, in the opinions of the heirs, most were severely flawed and did not provide sufficient resources for the business transitions or estate tax obligations.

In the United States, it has been estimated that only 28 percent of private businesses have engaged in any exit planning.[2] According to a 2008 Canadian survey, only one in 20 businesses have a written succession plan.[3] In other parts of the world, this figure is likely to be lower. It is not surprising, then, that owners are typically dissatisfied with the results of their Business Exits. In a survey of 300 former business owners, once again in the United States, 75 percent felt that the sale did not accomplish their personal or financial objectives.[4] According to a UK survey, only 7 percent of businesses offered for sale attract a buyer—partly because they are marketed badly and partly because there is no value in the business.[5] So there is definitely enormous scope for improvement with respect to succession and transfer of business ownership, which underscores the importance of Business Exit Planning.

UNDERSTAND YOUR MOTIVES

Business Exit Planning can be viewed as the blueprint or strategy for the actual Transaction or exit, just as you commission a blueprint before beginning to build a house. It is most effective if your point of departure occurs when you have an understanding of your own motivations and aspirations. In other words, you must know thyself.

> Understand your real motivations for owning your business and why you are considering selling it.

When I say know thyself, I am suggesting that you look inside yourself to understand your real motivations for owning your business and why you are considering selling it. For some owners, owning a business is about drawing an income rather than building equity value in their businesses. For others, it's about supporting a lifestyle with cars, travel, or other perks. Some don't even realize the full extent of wealth generation potential in building equity value. Building equity value is a necessary motivation if you are to build real value in your business, irrespective of whether you are planning to exit. Knowing your real motivations will help you choose the appropriate form, timing, and strategy for exit.

There are a number of possible motivations for exit:

- *Retirement:* You may feel the need to move on to a different phase of your life, enjoy it more, spend more time with your family, relax, and

so on. One of my clients, who was outraged whenever anyone mentioned the idea of his retiring or selling, went to the Red Sea on vacation. The vacation was so marvelous that he came back transformed, having realized that there was more to life than running his business. He is now contemplating an eventual exit.

- *Diminished passion or energy:* It is unlikely that your business will be successful unless you have the energy and passion to make it a success. If you lack either, it is probably better to exit sooner rather than later. If you are suffering from burnout, try an extended holiday. A surprising number of business owners are simply bored by the monotony of running a business, and feel they need to escape in order to pursue self-actualization or bring more balance to their lives.
- *Your current or expected state of health:* If you are in your 50s, 60s or 70s, what kind of condition is your body in? What are your health risks? If you have less energy now than you had, say, three to five years ago, there is a good chance that you will have even less, three to five years from now. Will that leave you with sufficient vigor and energy to run your business? Have you been diagnosed with a condition that is likely to deteriorate over time?
- *Lack of capital:* Every business needs capital to grow. If you started a business in a very capital-intensive industry, there is a high probability that you may run into limits to growth and may require funding (see Box 1.1). There are many high-tech companies that develop an exciting product and then lack capital to take it to global markets. For such companies, a sale may produce far more shareholder wealth than an underfunded expansion, and the product will likely receive a much better launch.
- *Dispute resolution:* A Business Exit is sometimes triggered by various forms of dispute; for example, a divorce may force the sale of a business, or you may be at odds with your co-shareholder. Sometimes the sale of a business is just the cleanest, easiest way to solve the dispute. There may be a lack of liquidity to satisfy the other party or parties unless the business is sold.
- *Increase in risk:* When the regulations or legislation governing an industry change, the regulatory risk of your business may increase. For example, there may be less flexibility on raising prices, more difficulty in passing through costs, or a higher risk of penalties. An increase in competitive forces may also increase risk levels. For whatever reason, your business might just be getting too risky, or as you advance in years, your appetite for risk may diminish.
- *Portfolio diversification:* Some wealth planners suggest that no one should have more than 20 percent of their net worth tied up in any

BOX 1.1 ENERGY SERVICES COMPANY

The owner of an energy services company (ESCO) had developed an extremely interesting business model, whereby it replaced the archaic heating equipment of old public buildings (hospitals, prisons, municipal buildings, etc.) with brand new, energy-efficient heating equipment. This cost on average between €250,000 and €1 million per installation.

ESCO designed, installed, and maintained the equipment during a long-term contract (typically 10 to 15 years). The energy savings were more than enough to provide the company with a handsome return on capital, as well as to reduce the energy costs of the public authority. The business was very profitable.

So why did the owner sell? Growth of this type of company is extremely capital intensive. He had reached his capital limit. The banks had indicated that they would be unwilling to keep up with the growth of the company without an equity injection, so either massive amounts of fresh equity would be required, or a much stronger covenant would be needed to guarantee the loan.

In a nutshell, ESCO was worth a great deal more to an investor with deep pockets, who could take advantage of all the opportunities available to the company. The company was sold to a global corporation that was able to not only better finance the growth opportunities, but also to utilize further opportunities to leverage the particular expertise of ESCO globally.

single investment. While we can argue about the correct percentage, many business owners (my father included) exceed any kind of prudent share of net worth tied up in their businesses. Generally, portfolio and risk diversification becomes even more important with age, as retirement approaches.

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Investors will want to know your reasons or motivations for selling your business, and are likely to ask the question directly. You should have an appropriate answer prepared. Retirement, for example, is considered an

excellent reason by most investors. But if you wait too long to sell your business, and develop medical problems that prevent you from working full-time with energy and passion, most investors will sense it. Postpone beyond a certain point, and it inevitably becomes a distress sale. As was the case with my father, if the owner faces an urgent exit, or might not be available to assist with an orderly transition, the valuation is likely to be negatively impacted, or investor interest may fail to materialize altogether.

As a business owner, you should constantly be assessing the cost/benefit analysis of retaining ownership of your company versus selling it. There are potential benefits to retaining the business if it is possible to grow the value of the company in the near future. But there are also risks: a recession may diminish the value of your business; competition may intensify; some of your key staff may leave; your own health may unexpectedly deteriorate; or someone may commence litigation against your company.

THE SPECIAL CASE OF RETIREMENT

For a business owner, retirement can be like going from full speed to full stop literally overnight. Some business owners get cold feet when they are selling their businesses and withdraw from or even sabotage a Transaction because they cannot come to terms with the concept of retirement. Some business owners, consciously or subconsciously, harbor deep-seated fears about retirement, as if it were an admission of giving up, of having one foot in the grave. And yet there are also countless examples of owners who retire early, develop new meaning for living, re-invent themselves, and continue to lead extremely active and productive lives. As the saying goes: perception is reality. The old notion that retirement is essentially inactivity or a vacation is no longer applicable. Many retirees are very active at least into their 70s, consulting, enjoying a second source of income, contributing their time to charity, etc.

Problems may arise in cases where owners have pursued their businesses with such singular focus that they have neglected other interests, and so have trouble contemplating any transition. If you are one of these owners, the 'know thyself' principle is all the more important: you need to develop activities that can be pursued outside of work. Children or grandchildren? Consulting? A few Board positions? Social activities? Travel? Or like Bill Gates, you can spend the first phase of your life making money, and the next phase of your life giving it away. There are many activities and opportunities you can pursue once you've sold your business.

Experts talk about the 'addiction' of owners to their businesses. Apparently business owners fear that after retirement their "bodies will not

be fed the necessary dose of chemicals required from the business addiction."[6] It sounds very much like athletes addicted to their sport: intense physical activity may release morphine-type stimulants known as endorphins. There is much to be potentially addicted to when running a business: power, lifestyle, expense accounts, travel, and the perks of owning a company, not to mention the stimulation from negotiations, meetings, and teamwork. You should understand the possibility of such an addiction for a couple of reasons. First, because it might interfere with rational thinking (e.g. a business owner might be ageing and infirm, and refuse to contemplate exit because of his/her addiction); and second, because there are a surprising number of business owners who get as far as negotiating a **Sale and Purchase Agreement** (SPA) and then, suddenly realizing that they are incapable of shaking their addiction, back out of the deal.

Planning future activities can help prevent or minimize that feeling of going from full speed to full stop. Write that book. Seek out a few board positions. Plan that around-the-world trip. Reactivate some of your old hobbies. Start a new one. Take up golf. Start playing a musical instrument. Attend Rotary meetings. Whatever it takes. Find something that will motivate you, something that you will enjoy. You have multiple facets to your personality, and life beyond your business is your chance to explore these. Plan ahead.

> Relatively few business owners miss their businesses once they've sold them.

Surprisingly, relatively few business owners miss their businesses once they've sold them. A 2006 UK survey showed that only 8 percent of former owners of family-owned businesses missed their businesses and only 18 percent would ever consider getting back into the business.[7]

Whereas a century ago, average life expectancy barely exceeded retirement age (for those fortunate enough to reach retirement), today, the average individual in most developed economies may expect to have one or more decades of retirement. With advances in medicine, the time we spend in retirement is likely to increase even further. So, the importance of planning for retirement cannot be underestimated.

If you are like most business owners, you probably see the sale of your business funding your retirement. A 2004 Australian survey, for example, noted that 50 percent of business owners expected the sale of their businesses to fund their retirement.[8]