AMERICA'S SBDC KANSAS

Kansas SBDC

Succession/Exit Planning

&

Valuation Services

Succession and Exit Planning

What is Exit Planning?

An exit plan asks and answers all the business, personal, financial, legal and tax questions involved in transitioning a privately owned business.

It includes contingencies for illness, burnout, divorce, death.

Its purpose is to maximize the value of the business at the time of exit, minimize taxes, and ensure the owner is able to accomplish all his or her personal and financial goals in the process.

-Richard Jackim
Cofounder of the Exit Planning Institute

A “Successful” Exit Strategy has Three Legs

- ❑ Maximizes the value of the business
- ❑ Ensures you are personally and financially prepared
- ❑ Ensures you have planned for the third act of your life

- Peter Christman
Cofounder of the Exit Planning Institute

Continuous Process

Initial Steps

Establish Goals
- Value Objective
- Exit Options
- Timeline

Assess Readiness
- Owner Readiness Survey
- Attractiveness Survey

Quarterly Cycle

Informal Valuation/ Assessment

Plan Alignment
- Personal
- Financial
- Business

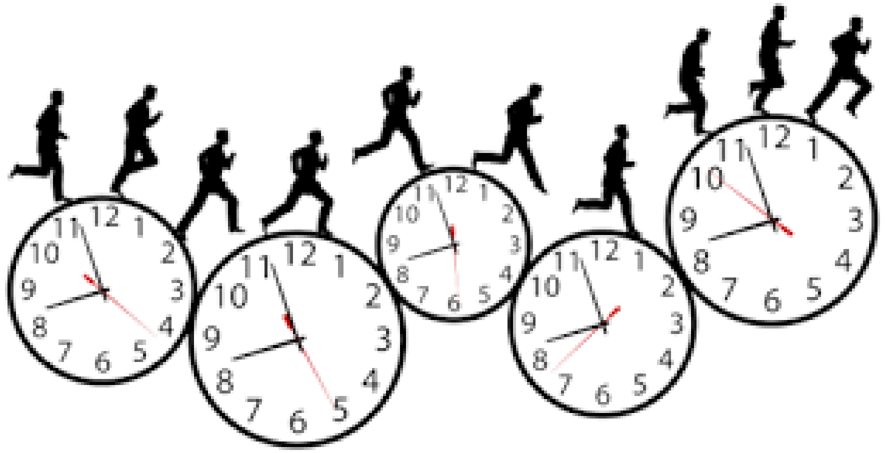
Identify Gaps

Action Plan

Transition Options

Internal	External
Family Transition	Sale to Third Party
Management Buyout	Re-Capitalization
Sale to Existing Partner(s)	IPO
Sale to Employees (ESOP)	Orderly Liquidation (or not so orderly?)

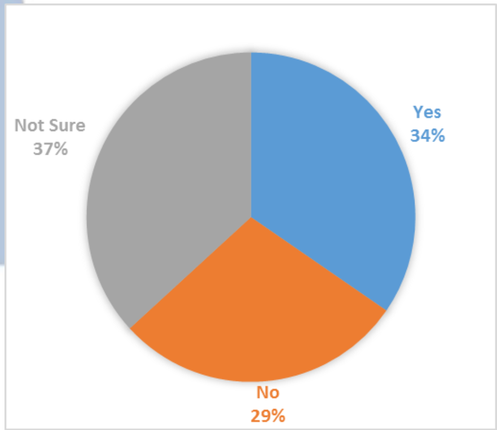
How Long Does It Take?



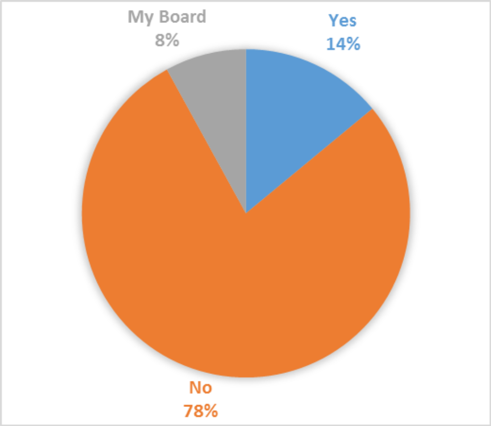
Step	Min. Period
1. Prepare exit plan	6 months – 1 year
2. Build value and complete tax planning	1 year or more
3. Complete a transaction	1 year
4. Post-Transition process	1 year or more
Total Time	3 to 5 years

Exit Planning Statistics

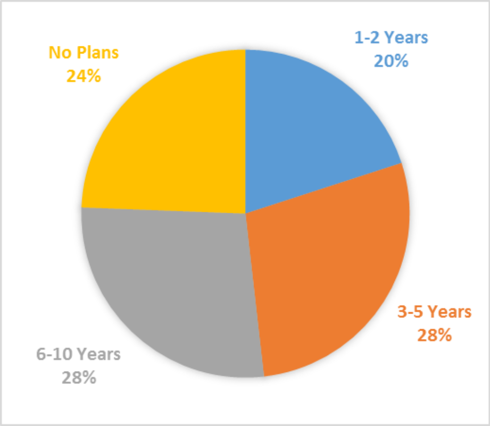
Results of an Exit Planning Institute Survey of Business Owners



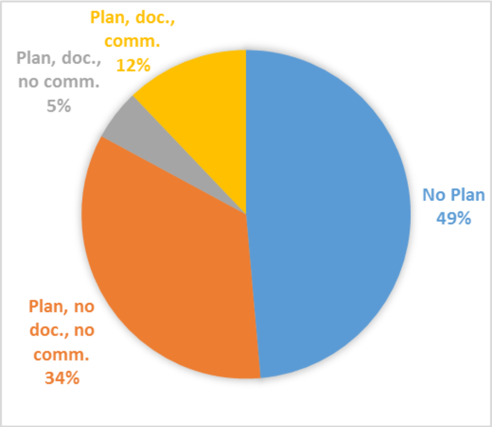
Do You Know Your Transition Options?



Do You Have a Formal Transition Team?



When Do You Plan to Transition?



What is Your Timeline?

SBDC Advisor Activities

- **Advise on Exit Planning Process**
  - Exit Planning process and considerations
  - Option 1: Advise on a DIY basis -or-
  - Option 2: Lead exit planning team and produce reports (program income)
- **Business Valuations**
  - Advise on process, range of multipliers, factors affecting value
  - Formal business valuations (if certified)
  - Financial baseline, analysis of multiplier ranges, rules of thumb and estimated multipliers
- **Value Acceleration Process**
  - Advise on resources and options
  - Assist with action plan
  - Advise on specific value acceleration subjects or actions
- **Transition**
  - Advise on process
  - Assist with due diligence planning and review of results

CEPA *Exit Planning* Certified Advisors

Karl Klein - Topeka

Tom Byler - Pittsburg

Lisa Brumbaugh - Emporia

Jack Harwell – Overland Park

Getting the Most Out of Your Business

Valuation Services

Three keys to successful transition

1. Know how much money you need to retire in the manner you wish. *Will probably require working with financial planning professional. (Not one of us…somebody with specific training!)*

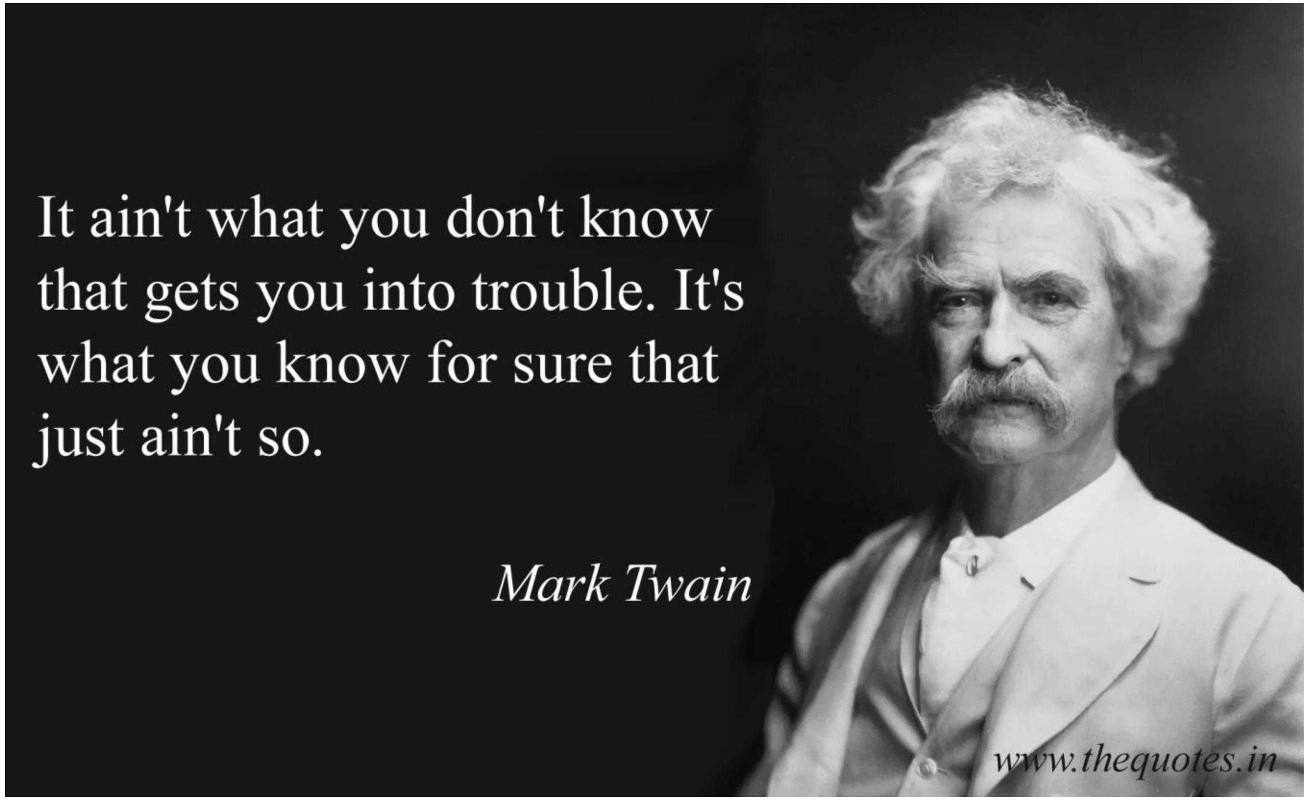
2. Know what your business is worth. *We'll be talking quite a bit about that!*

3. Understand your "third act". *This may seem optional, but in my experience, it's critical. What are you doing to do???*

Some common notions of value

- 2 to 3 times Seller's Discretionary Earnings plus inventory
- 5 times EBITDA
- "My sweat equity"
- Some function of revenues (1x revenues, 0.5x revenues, etc…)
- **Often, folks who are familiar with one approach simply discard other approaches. They apply their favored tool even when it's not the best one. (When all you have is a hammer, everything looks like a nail)**

(nods head slowly)



True or False?

- A business is worth the present value of the future cash flows of the business.

- A business is worth what one person will sell it for and another person will buy it for…as long as the buyer can come up with the money.

- I quit my job making $40,000 per year. This was 25 years ago. So I figure the business is worth $40,000 times 25 years, or $1 million, because of the sweat equity I have contributed.

ONE universal truth

•V = B/R

- If you remember ONE thing from today, this is the thing to remember.
- **Value equals a benefit stream (B) divided by some appropriate capitalization rate or “risk” rate(R).**
- KEY: you have to MATCH the benefit stream to the appropriate (R)!!!
- A multiple is the INVERSE of a cap rate:
  - 2x = 50% cap rate
  - 2.5x = 40% cap rate
  - 3x = 33.3% cap rate
  - 4x = 25% cap rate
  - 5x = 20% cap rate
- I will not move past this slide until everybody understands!

Capitalization rate (risk rate):

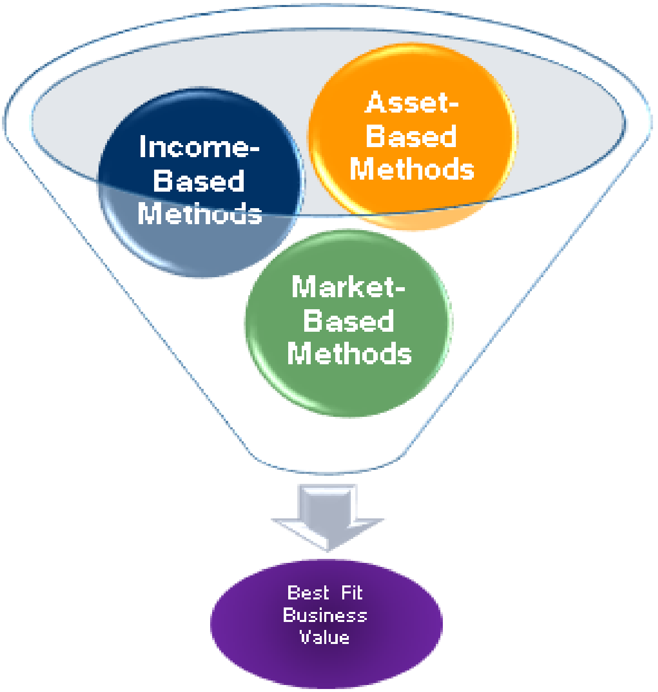
- Savings account. FDIC insured (ultra low risk, ultra low return) What? 1%?
- Risk free rate: US Treasuries. Maybe 2.5% (low risk, low return)
- Typical S&P 500 stock might have a P/E ratio of 15x earnings. Cap rate is inverse, so 100/15 = 6.67% (still pretty low risk)
- Mid market deal…business does $25mm in revenue. Layers of management, owner involvement is minimal, easily replaceable, plenty of key management staying on board. 10-12x or 8-10%
- Lower end of market--$5mm in revenues, key employees staying, owner has prepared to transition roles. Financial buyer could hire to replace owner. 4x to 5x EBITDA or 20-25% cap rate.
- Owner-operated business, owner highly involved, might have some key employees, but new owner will run the business. 2x SDE to 3x SDE or 33-50% cap rate.

Valuation approaches

- **<u>Asset approach</u>**: How much are the assets worth? *Not a great way to decide, unless the assets are worth MORE than the value of the future cash flows.*

- **<u>Income approach</u>**: Figure out the benefit. *Use the appropriate cap rate, which is determined by a variety of historical, contextual facts.*

- **<u>Market approach</u>**: Figure out the benefit. *Use the appropriate multiple (inverse of cap rate!), which is determined by comparable transactions.*



Common benefit streams

Seller's Discretionary Earnings

Net income plus owner salary/benefits, plus discretionary expenses, plus non-cash expenses (depreciation, amortization) plus interest.

- Mostly appropriate for owner-operated, non-scalable, non-disruptive Main Street businesses. NOTE: This is a higher cap rate, but also a higher benefit stream than EVERYTHING below. Why? Because it includes ALL owner salary/benefits.
- Matched (R): SDE multiple from BizComps, IBA database, etc… (it's an algebraic inverse, so 2.5x = 40%, 3x = 33.3%, etc…)
- Typical use: asset sale pricing of "Main street" businesses, specialty retail, small owner-operated firms of all types. Next owner might be "buying a job" so to speak.
- Often Market Method

Common benefit streams

Cash flows to invested capital

- Net income
- plus non-cash expenses (depreciation, amortization),
- plus interest (net of tax)
- Owner salary/benefits normalized to market rate, so ONLY the amount in excess gets added
- MINUS future capex requirements
- Minus working capital adjustments

- Matched (R): WACC (weighted average cost of capital)
- Typical use: Asset sale transaction, especially anything not owner-operated or with additional non-owner management.
- INCOME METHOD

Common benefit streams

Cash flows to equity

- Net income
- plus non-cash expenses (depreciation, amortization)
- Owner salary/benefits normalized to market rate, so ONLY the amount in excess gets added.
- MINUS future capital expenditure requirements.
- Minus working capital adjustments
- Interest is NOT added back.

- Matched R: build-up method cap rate or CAPM
- Typical use: calculating an EQUITY value, not an ASSET SALE value, so intergenerational transfers, sometimes employee transfers,

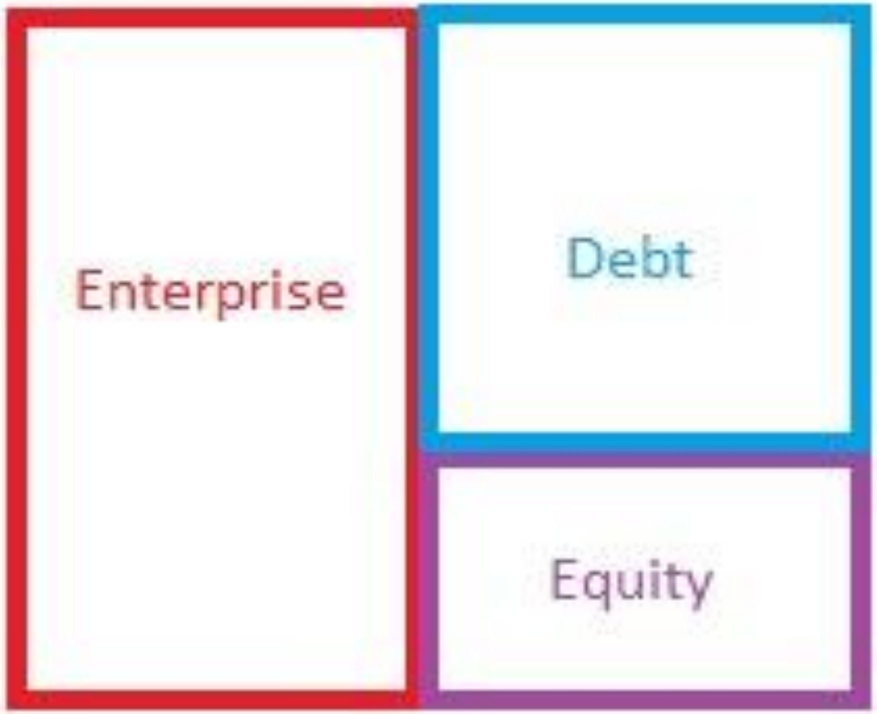
Other valuation methods

- Adjusted net assets
- Excess Earnings/Treasury method (hybrid)
- Guideline public (market)
- Discounted cash flow (income)
- Too many to list, really. Just know they exist.

Things that frighten me a little bit

- BRG. I actually think it's a useful tool, but it's a lot MORE useful if these concepts make sense. If you are going to use the BRG, you might look up the results for a janitorial service. It might list it as 2-3x SDE. But if you're working with a HubZone certified janitorial service with tons of commercial and/or gov't contracts, $10 million in revenues, and layers of management, that might not apply.
- Anecdotal rule-of-thumb guesswork. "I hear that insurance brokerages usually sell for 2x revenues. I want to sell mine for that. I mean, basically, it's money in the bank."
- Any analysis that ONLY includes one methodology.
- Any analysis that presents a range of values that is unhelpful. "Hey, I want to sell my house. What's it worth? Somewhere between $200K and $500K." Is that REALLY helpful? No! So why would that be helpful for a business owner?

Enterprise value or value of equity?



Value acceleration

- How do you maximize the value of your business? What happens if you need more than the value of your business?
- Should you maximize value, anyway? What if you're selling to a family member?
- Value acceleration is, at the base, GOOD BUSINESS PLANNING!
- Do you know what your house is worth?
- You might consider that…

More value acceleration

- What if your worthless neighbor runs your shipping/receiving department? You have to spend 5 hours/week following in footsteps. You pay him $100K when you could hire it for $60K.
- Makes your business more valuable to free up the cash flow.
- Makes your business more comfortable to live in, too.
- Assess (key value drivers)
- De-risk
- Accelerate
- Do another iteration (or two or three)
- The more time you have, the more you can do! Start early!

VPA Valuation Certified Advisors

Will Katz - Lawrence

Lisa Brumbaugh - Emporia

Soon to Include:

Karl Klein - Topeka

Questions?

Other things going on with the Kansas SBDC…

New/Returning Physical Centers:

- KCK
- Salina
- Dodge City

New Virtual Centers:

- Kansas SBDC National Tech Commercialization Accreditation - 1st Q 2018
- Encountering Innovation (DoD tech commercialization events) - 2017
- Cyber Security Center (assessment/training/advising/referrals) 1st Q 2018
- Succession/Exit Planning – Planned for late 2018 or early 2019