



Exit Strategies for Small Business Owners

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This article is intended for beginner valuation professionals, and small business owners who may be considering an exit within the next 3-10 years.

Although there are many variations, there are really only a few realistic exit strategies for most business owners. Most strategies only make sense for certain classes of business, so for any given business, even fewer options are viable. Here we review these basic options, which types of businesses they work for, and outline the pros and cons of each.

Anecdotes

The owner of a residential construction firm (with over 100 contractors) had a heart attack at least partly because he was so stressed by the daily hassles of running his business. He survived, but decided to simply **give** his business away to a friend because he couldn't handle the stress. Given the fact that his business was well established and generally profitable, by giving the business to his friend, the owner probably missed an opportunity to sell the company for several million dollars.

Lesson: A lack of planning is often the same as planning to fail.

Another business owner built his real estate consulting company to about \$60 million annual revenues over 20 years. At the peak he had over 200 aggressive brokers and sales people generating revenue, and he paid himself most of the company's profits each year. Along the way he came close to going broke several times, because there simply wasn't enough cash to keep the business going. He also alienated large numbers of dedicated employees who had worked very hard to grow the company and were constantly frustrated by the apparent lack of planning. About 7 years before he sold the company he began preparing the company for a sale. He cleaned up the company (hired a management team, formed an advisory board, documented internal procedures, upgraded the company's computer systems, etc.). He also brought in a variety of consultants and reviewed every aspect of the company --- IT, accounting and finance, marketing and sales, etc. He ended up selling the company for over \$100 million.

Lesson: Planning usually pays off.



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A public company formed a third party fulfillment business in the late 1990s. The parent company planned to spin off the subsidiary through a sale, or possibly an IPO. For a few years the subsidiary boomed, riding the wave of Internet sales fulfillment. However, two things went wrong almost simultaneously: the outsourced fulfillment market changed for the worse, and the parent company became embroiled in an acrimonious and hostile shareholders' revolt. The subsidiary's Chief Operating Officer (COO) realized they had missed the window for an IPO, but thought there was still an opportunity to prepare the company for a sale, or fold the subsidiary back into the parent company and ride out the downturn. He made a presentation to an interested suitor who was willing to offer several million dollars for the company. Unfortunately, the parent company's management team thought they could do better and decided not to pursue the offer. The parent company then let the subsidiary's management team go, and eventually sold the company for under \$1 million. Although they did sell the company, they got a much lower price than the earlier offer.

Lesson: Timing is important and obstinacy is not the same as planning.

Exit Strategies

Shut It Down

Every week I read about a small business closing its doors because the "new lease is too expensive", "the owner had a stroke", the owner "just got tired", or because "business was slow". Hundreds of businesses go out this way every day --- often a small shop, a restaurant, a small construction company, a shoestore, or a doctor's office. Usually there is an asset sale of some kind, and sometimes the business name is purchased by someone else for pennies on the dollar and restarted with different owners.

If a business has been around for a long time, chances are there is a substantial amount of "goodwill". In other words, the business name (or "brand") is valuable. If a business simply shuts down, this goodwill is usually lost. Even if someone offers to buy the name later, because the business has shut down, the value has dropped, and the selling price is lower than what it would have been if the business was still operating.

While "shutting down" is almost always an option, it is rarely the best exit strategy. As long as the company's brand has any value, the company has a loyal or sizeable customer base, or the company has a stable core of employees, the business owner would be significantly better off selling the company.



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Drain It

Another option is to just take as much cash as you can out of the business each year, while keeping enough in the business so it can continue operating profitably. This strategy makes sense where the business generates a lot of cash flow and requires little hand-holding by the owner. Examples might include certain manufacturing businesses, restaurants, nightclubs, real estate brokerages, consulting firms, and others.

While the “drain it” option may not yield the highest possible return on investment, it does have its advantages. It requires very little planning, and it can be very profitable.

However, there are a few potential disadvantages: a) If you take the money out in salary, your tax bite could be considerable. Consult with your accountant or a financial planner. b) If you are the majority owner, but not the sole owner, you could be violating operating agreements by taking out too much money, with or without paying the other owners. c) And if you take out too much money at the wrong time (for instance, just before an economic downturn) you could quickly kill the business, and still face a huge tax liability.

Sell It

A sale is always an option: the question is how much can you get for your company?. The key is to find suitable buyers who assign a high value to your company. Generally, the more potential buyers, the better, since then you can establish a market price.

Most business brokers recommend you start planning for a sale at least 3-5 years in advance. This may sound overly cautious, but in many cases even 5 years is not long enough. As a business owner it is very easy to become overly attached to your business and lose sight of what the business really looks like to an outsider. What makes your company valuable to you may not have any impact on a potential buyer.

Friendly Buy-Out

This is when a business owner transfers ownership to family members, friends, or employees. It is still a sale, but the terms and nature of the transaction are usually very different. The fact that the buyers are close to you makes this both easier and harder to complete. Easier because you have a much better knowledge about the buyer; harder because you tend to be less objective about the buyer, and are more likely to let your



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guard down in negotiations and planning. Be sure to engage an experienced professional so you protect yourself before, during and after the sale. And, as with all other options, start planning early.

IPO

Although IPOs get most of the press, they are actually very rare. There were 853 IPOs in 1996, near the peak of the 1990's economic frenzy. In a more typical year the number is more like 200, or even less. There are over 5,000,000 non-farm employer firms in the United States, so in a typical year, less than 0.01% of all firms undergo an IPO in any given year.

The IPO process itself is both costly and labor intensive, and usually requires an upfront investment of over a hundred thousand dollars. Public companies have to produce detailed reports on their financials, staffing, marketing, operations, management, etc. These reporting requirements typically cost hundreds of thousands, or even millions, of dollars each year. The Sarbanes Oxley Act, passed shortly after the Enron scandal, costs even the smallest of firms several hundred thousand dollars in consulting fees. Finally, many companies are just not valued highly on the stock market. For instance, very few consulting firms go public. Because a consulting firm's assets are tied so closely to its staff, if the staff leaves, the assets walk out the door.

Of course there are a very small number of firms for which an IPO makes sense, and may even be necessary. However, for the other 99.99% of us, an IPO is just not a viable exit strategy.

Preparing for the Exit

Most exit strategies benefit from preparation and planning. Consider the case of a closely held family restaurant. Suppose the owner is the head chef and his wife is the manager. The restaurant has been in business for 30 years, has a loyal clientele, and is very profitable. If the owner and his wife leave, the recipes and cooking style go with him, and the customer service and operational efficiencies go with her. There isn't much left in the business except the name. However, if the owner and his wife begin planning for a sale years before, they can make the restaurant much more valuable to a potential buyer. For instance, the chef can train one or two assistant chefs, and teach them his secret recipes and cooking techniques. The wife, who manages the restaurant, can hire one or two assistants and train them. She can develop procedure manuals (or at least define what the procedures should be). She can also introduce her protégées to regular



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clients so they know who they are. After a few years, a buyer could easily take over the business and keep it going as long as he is able to keep the now well-trained staff on board. By following the above steps, the owner and his wife have significantly increased the value of their business.

Larger businesses have much more at stake. The best approach is to postpone the sale for a few years, and gradually put some key elements in place to maximize the value of the company. Basically anything that increases transparency, efficiency, revenue or profitability, or decreases risk or costs, should be considered. These include

- ◆ Build a real management team. Start at the top (for example a CFO, a COO and an HR Director), and fill out lower level positions as needed. Define roles and responsibilities for each position, and hire top-notch people. A solid management team adds value in several ways: a) better decision making since each member of the management team builds on specialized knowledge in their area of expertise, b) separation of powers -- if there is one bad apple, you can replace it. This is simply not possible otherwise. c) redundancy --- if one manager leaves on short notice, often another manager has enough knowledge to act as an interim replacement.
- ◆ Set up and document business processes and systems. This includes an employee manual, an automated accounting system, a CRM system, a marketing and sales process, etc. Such systems reinforce and support the management team. They also provide transparency, and give further evidence that the whole business is not just smoke and mirrors.
- ◆ Clean up the company's books. This starts with a professional accounting audit, but ends with actually implementing the auditor's recommendations. Examples include better documentation of expenses, invoices, backorders, payroll deductions, benefits, cash management, etc.
- ◆ Conduct an inventory of all physical assets. Update this inventory at least once a quarter. This typically includes furniture, books, hardware, specialized equipment, manufacturing or office supplies, and software. There are numerous good software programs available to track and manage physical inventory at larger businesses; for a small business you can simply use an Excel spreadsheet. Many companies over-estimate or under-estimate the value of their physical assets. If you under-estimate, you are leaving money on the table when it comes time to exit the business; if you over-estimate you create suspicion in the buyer's eyes and endanger the exit strategy negotiations.



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- ◆ Form an advisory board. This is different from a Board of Directors, since the advisory board members have no formal fiduciary responsibilities and therefore assume no legal liabilities. They are **advisors**, not **directors**. Bring in smart people that you trust, who understand your business, and who will ask tough questions and help you find the answers. There are many variations, but all effective advisory boards have the following in common: independent advisors who think for themselves, understand the business, work well with each other, and who are willing and able to spend at least a few hours a month on the business. Avoid the temptation to form a showboat board where the advisors are famous but have no time or interest in helping your business. Also limit the number of golf buddies, relatives, and friends on the board.
- ◆ Hire an outside firm to conduct an audit. Note that I am not talking about a financial audit. A business (or operations) audit covers marketing, sales, customers, partners, internal operations, management structure, compensation, and more. The audit is usually quick (just a few weeks) and identifies and prioritizes outstanding issues in every area of your business. The auditor should be objective, so don't try to save pennies by having internal staff do it. Ideally, if you plan to sell the company in 5 years, you should do an operations audit now, with follow-up audits every 12-18 months thereafter. The follow-up audits can be focused on the areas that need most attention (for instance, marketing, sales, or Information Technology). Audit price range from \$3 K to \$20 K, depending on the size of the company and the extent of the audit.
- ◆ Designate a competent leader and create teams to address any problems uncovered in the audits. Make sure each team understands that they are responsible for solving these problems, and set up a reasonable reporting framework (update you once each quarter, for instance). Hold the leader and his teams accountable for results. Even if you hire an outside firm to guide you through the process, you will still need an internal resource to coordinate things within your company.
- ◆ Hire a competent firm to conduct a valuation for your firm. Repeat this every few years as you approach your target sales date. A valuation serves several purposes: a) it provides an unbiased estimate of your company's value by a third party. If you hope to sell the company for \$25 million, but the valuation comes in at only \$6.5 million, you know something is wrong. b) it typically identifies at least a few areas of concern: perhaps the issue is too slow a turnaround on inventory, or too much spending on executive compensation, or limited growth among more nimble competitors. Professional valuations range from as little as \$5,000 all the



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way up to \$50,000. The lower end should be fine for smaller businesses (say less than \$5 million).

- ◆ Review all insurance policies and make sure the company is adequately insured for all major risks. The easiest way to do this is to bring in one or two insurance agents from competing companies. Most insurance agents will develop a comprehensive proposal at no charge. Once you decide on an insurance package, be sure to have your corporate attorney review the policy to make sure you are actually covered for the risks you deem most important.
- ◆ Develop and test a disaster recovery plan. This is especially important for businesses with major computer infrastructures (dozens or hundreds of servers) and time-sensitive, mission critical applications. Many firms specialize in disaster recovery planning. A good plan usually requires months of preparation and testing before it is considered complete.
- ◆ Review all employee, partner, and vendor contracts and policies to make sure the company is in compliance with all applicable city, state and federal laws, and minimize chances of frivolous lawsuits or other legal actions. Many small business owners have their real estate attorney handle all of their legal issues --- this is a huge mistake. You need a competent business attorney who understands and works with businesses like yours.
- ◆ There is a chance that key employees will leave the company if they hear rumors of an impending sale. A “stay agreement” specifies the terms and conditions under which an employee may leave. It can impose penalties for leaving before a certain date or event, such as loss of stock options, etc. Talk to your attorney and HR Director and have appropriate stay agreements drawn up and signed by key employees.
- ◆ Start networking with business buyers, other business owners, business brokers, and others. A good place to start is a local entrepreneurship group, Chamber of Commerce, or a local chapter of a business broker association. MBBI (the Midwest Business Brokers and Intermediaries), for instance, has monthly meetings where business buyers and sellers can get together to learn more about buying and selling a business --- typically for the cost of a lunch. Other useful groups are The Entrepreneurship Institute (www.tei.net), the Turnaround Management Association (www.tma.org), and the Association for Corporate Growth (www.acg.org).



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- ◆ Finally, although it **usually** takes years of preparation to sell a business, sometimes the right opportunity comes along much sooner. Be sure to watch market trends and keep your ego in check. Many entrepreneurs have missed opportunities because they were convinced they could do better later, only to watch their window of opportunity close over time. If a great offer comes along before you have everything in place, take it --- or at least give it serious consideration. This is especially true for fast-moving, trendy businesses, where being “first to market” can create huge valuations (which usually decrease rapidly once the trend fades). Examples include companies like Facebook, YouTube, and MySpace.