EXIT EQUITY LLC

Exit Planning 101

Understand the Levers that Improve the Value of Your Business

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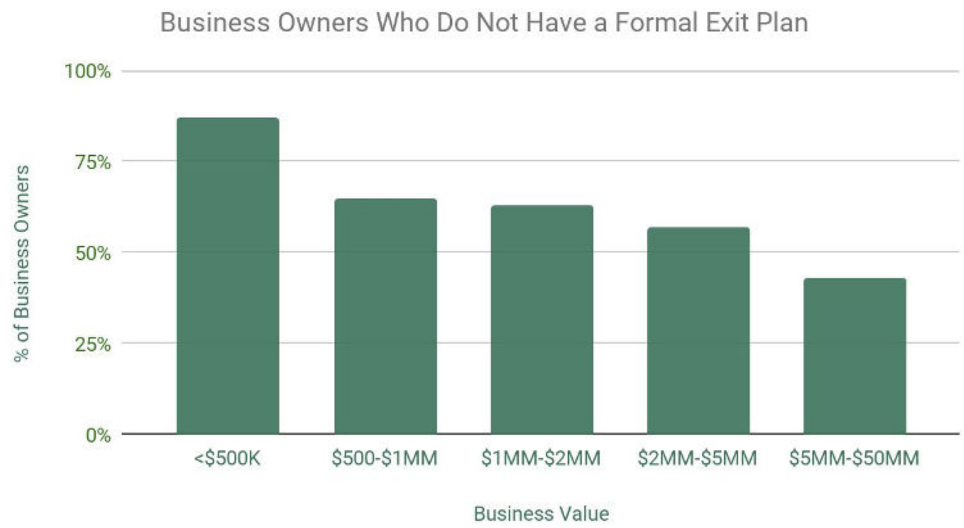
Why Exit Plan?

This white paper is intended to educate a business owner's key advisors - primarily CPAs and Wealth Management professionals– on the main considerations in Exit planning: maintaining strong cashflow, minimizing business risk, and optimizing a company for growth. These factors will influence how an owner is able to align his/her personal financial goals with the sale of their business.

Exit planning is a critical and time-consuming activity but makes an enormous impact on a business owner's ability to create flexibility and leverage when the sale of the business starts in earnest. Business owners and their advisory team -accounting, legal, wealth management, intermediary. - must be able to understand the value drivers so that they can implement improvement actions to an owner's most valuable asset – their business!

In a recent survey by the International Business Brokerage Association, respondents indicated that little to no exit planning was carried out by small and mid-size business owners:



When a company does go up for sale and a buyer enters into negotiation, due diligence can reveal business scars, warts, and blemishes that have been hidden out of sight. These risks allow a buyer to negotiate the sales price downward, impacting a business owner's cash at close and ability to transition to a new business venture or into retirement.

Transaction Planning Timeline

It Pays to Plan

In an ideal world, business owners begin the exit planning process 3 to 5 years from their desired sale date and work with key advisors to build out a plan that aligns to the owner's goals. Understanding the exit process will help allocate resources to the most pressing issues that influence valuation and best support a successful transaction.

Before jumping into the top three consideration areas - cashflow, business risk, and growth potential, let's first understand the transaction process to get a business bought or sold.

BUYING	PREPARATION	SELLING
Identify key industries that are a good fit based on your background Begin assessing available capital needed for the size business you'd like to acquire Begin making decisions re: jobs, financial situation and strategic long-term planning	5 YRS	Set your exit plan objectives. Get an initial valuation. Create timeline and plan that align valuation to exit goals. **Exit Equity can provide expert guidance at this crucial planning stage**
Research potential businesses and learn about industry segments	3-4 YRS	Get financials in order Staff business so that it can operate with minimal owner involvement Streamline expenses
Explore financing options, start your deal sourcing plan (e.g. meet broker, sign up for distribution lists, compile lists for independent outreach)	1 YR	**Engage Intermediary:** Have valuation refreshed, check performance against initial value. Understand 'net to you' and if on track for personal financial planning goals. Decide whether to 'hold and grow' or 'sell and go' **Contact Exit Equity to guide the process at this stage**
Create decision criteria for evaluation of targets. Create initial target list	8-9 MOS	Intermediary creates business prospectus and marketing materials, begin sourcing and qualifying buyers
Evaluate target(s). Review financials, ask questions, submit Indication of Interest (OIs) and/or Letters of Intent (LOIs) Refine, negotiate LOI with target seller	4-6 MOS	Obtain letter of Intent (LOI) from multiple buyers. Refine, negotiate LOIs. Select best fit LOI and buyer. Sign LOI
Initiate due diligence process with list of requested items. Initiate the lending/ funding process. Clarify and refine LOI	2-4 MOS	Address due diligence questions Continue running your business to not impact transaction (e.g. maintain revenue and expense levels) Clarify and refine LOI
Continue to review due diligence items. Begin creating the Purchase and Sale Agreement based on the Letter of Intent (with attorney)	1-2 MOS	Continue to address due diligence items. Negotiate purchase and sale agreement
Review, refine and negotiate Purchase and Sale contracts (with attorney). Finalize financing sources. Meet key employee(s), review customer list. Start planning for Day 1 and beyond	0-1 MOS	Complete final terms and contingencies within the Purchase and Sale agreement. Introduce key employee(s) and disclose customer list. Create backup copies of important financials, emails, etc
Sign and close all legal contracts, including Purchase and Sale Agreement and addendums. Buyer sends funds to Escrow. Funds are wired to Seller	CLOSING	
	POST SALE	**Celebrate!** Make announcement to the team. Begin ownership transition process. Do adjustments and reconciliations. Enjoy your next chapter!

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Top 3 Value Drivers

There are several value drivers that impact the potential sales price of a business. Prioritization and importance of each is dependent on the specific industry and business itself:

CASH FLOW	RISK	GROWTH
Financial Performance	Customer Base	Strategic Vision
Add Backs	Business Dependency on Owner	Industry — Niche, Timing, Potential
Clean Financials	Motivation to Sell	Products — Unique, Margins, Tech
Market Environment	Ability to “Present” the Business	Market Strategy/Branding
Leverage/liabilities		Economics of Scale

Keeping things simple, the top three value drivers we advise clients to attack are cash flow, business risk, and growth trajectory. We will dive into each category in the next three sections.

Value Driver 1
Cashflow

Clean Accounting and Financials are Key

Demonstrating profitability each year is critical to attracting potential buyers. Clean financials are a requirement for any interested party to measure and evaluate what a quality business is worth. To do this, financial records must be accurate, consistent, and timely. There are multiple types of valuation methodologies and each type relies on accrual-based financials.

To perform a valuation, valuation specialists will need to review both tax returns and financial statements to perform a calculation of value. Five-years' worth of Clean, detailed income statements and balance sheets will be the baseline to determine an initial value. Business owners can improve the valuation by identifying "add backs," which are expenses in the financial statements that are considered discretionary spending by an owner, or a one-time expense that will never happen again. These expenses can be added back to the bottom line of the business for the purpose of improving profitability, the company valuation, and ultimately the selling price.

Examples of "add backs" include:

- Owner's personal car, gas for personal use
- Salary to family members not working directly in the business
- Travel and entertainment expenses not related to the business
- Owner salaries/bonus in excess of fair market compensation
- One-time accounting or legal expense that is not related to the ongoing business

On top of clean accounting practices, asset ownership should be clear of any debt disputes and liens must be easily identified and/or transferable. The sales price of a company can be improved if property is included, so clean title is key.

Tip: Many CPA firms do not have an in-house valuation specialist that has experience valuing a business specifically for the purpose of being sold on the current open-market, so be certain to work with a business broker or intermediary who performs valuations on a regular basis.

Value Driver 2
Business Risk

Minimize and Eliminate Risks

Owners should take the time prior to the company sale to minimize business risks. Past success is indicative of future results, so eliminating any dormant business threats will help strengthen the business valuation. These risks typically fall into three categories: people, process, and product.

A business that is set up for a seamless transition from the current owner to the buyer will obtain a higher valuation. This means that the business can run itself with key managers and employees that are currently in place. If a business is only successful because the owner works days, nights and weekends, employee turnover is high, and staff shortages exist, potential buyers will negotiate the sale price downward. The business owner’s goal should be to work himself/herself out of the day to day business. We advise that they should be working on the business, not in the business.

Repeatable sales and operational processes can help ensure a new owner's success. Strong documentation proving business processes are followed will reduce continuity risk when ownership transitions, as well as reduce the time ownership may be required to stay on board.

Finally, a business owner must be able to articulate and demonstrate their competitive advantage. The company’s secret sauce could be a combination of multiple factors, such as cost efficiency, differentiated product/service, distribution network, or key alliances and partnerships. Leading up to the company sale, an owner should strengthen and sharpen advantages over its key competitors.

Value Driver 3
Growth Trajectory

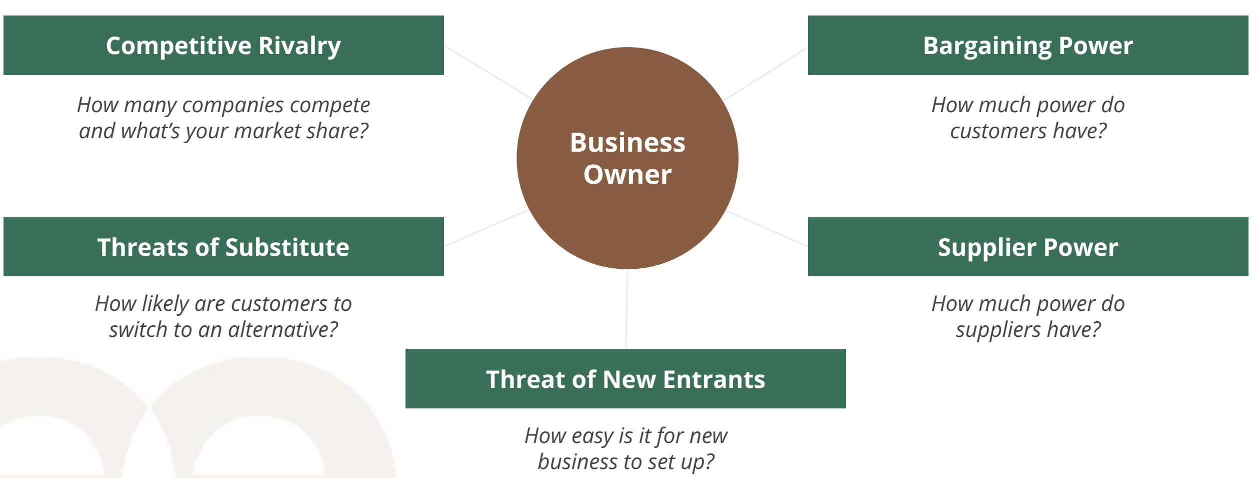
Finding the Right Buyer to Take the Reins

When a potential buyer approaches a target company for sale, their background and career experiences greatly impact how they view growth potential. All Buyers have a vision for what a company can become under new ownership, and this likely differs from how the company founders view the company's trajectory. Current ownership should be prepared to help buyers understand how the business can grow in the future and what levers unlock growth. If a buyer can clearly see how they can scale a target business, this directly relates to how much they are willing to spend to acquire the business. Buyers only will pay for growth potential that they can reasonably obtain once ownership transitions.

To hit a new gear for company growth, buyers will look at areas that can bring in additional revenue or optimize costs. This could include:

- **Customer and supplier diversification**: concentration, contract and payment terms, foreign vs. domestic, horizontal vs. vertical integration, etc.)
- **Products**: niche vs. commodity, value added services, loss leader and margin profiles in segments, etc.)
- **Operations**: capital expenditure to scale up and out, digital transformation in sales, marketing, training, and operations, human resource development and retainment, etc.)

A great framework to reference when looking to understand a company's growth potential is Michael Porter's seminal power – Porter's Five Forces. Buyer's will likely have a specialty in one of the five forces and a business thesis on how they will achieve growth success when they take over the reins.



To position a company for sale and receive as many offers as possible, we should consider the three buyer personas for small/mid-sized businesses: financial, strategic, and synergistic. Each buyer persona will have different motivations, growth goals, and investment criteria (and for this exercise, we are using broad generalizations).

A financial buyer purchases a business based on right sizing revenue, EBITDA, buy-side financing, and owner's take home earning potential. This type of buyer may have interest in growing and flipping the business, but that takes second priority to generating an income for the owner and their family. Often times, the buyer is a single person or couple with experience in the industry who now wants to no longer be an employee and become an owner.

A strategic buyer purchases a business to complement their existing business or portfolio, or add-on to their platform. This can be based on geographic territory, integrating a more vertical supply chain with a buy vs. build approach, or limiting competitive pressure in the same product/service category. These buyers may offer less than a financial buyer, as they likely have experience within industry and have systems, process, and operations already in place. Competitors fall within the strategic buyer category, so a seller should be careful not to disclose any trade secrets during the buyer vetting process, limiting disclosure of proprietary data until the very end of the transaction.

A synergistic buyer will have the largest appetite for a premium purchase price and best flexibility to pay cash to close an acquisition. This buyer looks at an acquisition as an inorganic growth method to increase revenue and profits through access to new products, distribution networks, supplier base, and intellectual property. This is where the secret sauce previously mentioned in the mitigating risk section can drive a stronger asking price.

Understanding the motivations of the ideal buyer should influence the necessary changes a business owner can undertake to make the business more attractive. This could include diversifying customer base, building supply chain resilience domestic and abroad, or creating a more robust management team. While it is a sound strategy to "fish in multiple ponds" when it comes to selling a business, a business owner should strategize on who the most likely buyer might be and weigh against what buyer is likely to provide the highest asking price, best terms, and fit.

In general, private equity only takes interest in buying small/mid-sized businesses at the $1M EBITDA (unless it's an 'add-on'). The reason behind this rule of thumb minimum is that companies producing less than $1M EBITDA cannot, in general, seamlessly function without ownership taking on many different roles and tasks, so transitioning to a new ownership and management team can be extremely challenging. For companies producing less than $1M EBITDA, buyers are likely to come from wealthy individuals looking for a career change, competitors, or adjacent businesses with a strong balance sheet looking to expand.

Business owners have their own bias on company valuation and what set of buyers will come to the table once they go to market. We strongly advise our CFA and CPA partners to remove this bias, work with a neutral 3rd party to make an independent assessment on valuation and expected traction from buyers.

What if the Value is not Enough?

Plan B Options

The valuation price is not the critical number when it comes to exit planning, but it is the starting point–at the end of the day what truly matters is how much an owner nets from the transaction.. Business owners should account for the valuation range, debts to be paid at closing, percentage split to other owners, and tax implications of the take home number. If the take home number is not sufficient to transition to a different career or into retirement, then it might be better to "hold and grow" the business for a few more years instead of selling.

If the "take home" net number does not meet an owner's financial planning goals, there are multiple avenues to improve pay out over time. Owner's can consider creative seller financing options, selling only the business without including the real estate, selling a portion of the company and rolling over equity into the new company, performance based earn outs, and advanced tax deferment strategies to name just a few alternative paths.

Completing a valuation, finding buyers, negotiating deal terms, and finalizing tax strategies can be overwhelming. Exit Equity deals with these issues daily, so let us be a resource to educate, execute, and hit a home run when it comes time to sell a business. Each business, transaction, and owner's financial/personal situation is different, so we are always ready to get creative with our partners to help our clients reach their goals, even if that means holding back on a sale in order to shore up risks and improve the overall health of a business.

Building an Expert Advisory Team

When it comes to converting company value into retirement funds, Benjamin Franklin is correct when he said “If you fail to plan, you are planning to fail.” Exit Equity understands that selling a business is a moving target and we work with clients on their timeline to reach their tailored goals. It can be a quixotic journey if you do not put structure to the sale, so let us help alleviate the headaches, minimize the risks, and remove the unknown variables in the planning and transaction process.

It is critical that business owners start Exit Planning early and build a team of non-biased advisors that can help improve a company’s valuation. Cash flow is king, business risks are threats to realizing the high end of the valuation range, and growth potential is specific to each unique buyer.

If you, or your clients, want to level up your exit planning expertise, Exit Equity is ready to be your trusted partner. We augment partner CPA and Wealth Advisor capabilities with our client services:

- Clarity on 'Net to You' from a company sale through Broker’s Opinion of Value and Certified Business Valuations
- Drill down on rule of thumb multiples for any specific industry and key valuation drivers where buyers will attempt to discount the offer price
- Sell-side capital gains/real estate tax deferment analysis, strategies, and execution
- Leverage creation when approached by a single buyer through bespoke Buyer search and qualification
- Best in Class marketing and business prospectus material creation
- Buyer blind competitive bidding, contract advisory and negotiation
- Deal structuring, legal and accounting coordination
- Due diligence management and closing coordination
- Recapitalization, owner buy-out, new investment assistance (when applicable)

Exit Equity LLC is a leading merger and acquisition practice located in the Pacific Northwest. Specializing in sell-side advisory services, the majority of our clients are owners of privately-held companies with enterprise values up to $25M. Our team operates with experience, integrity and a hard-work ethic. Clients use Exit Equity to facilitate M&A due to our end-to-end service:

Net-To-You
What's in Your Pocket
Is Most Important

Valuation Range
Value Proposition then Decision Point

Optimal Value
We Market Without Price

Unique Process
Blind Competitive Billing

Reasonable Fees
No Large Upfront Fees

Assess and Manage
We Prepare and Manage the Due Diligence Process

Financing
Pre-Qualify by Institutions

Control Expenses
Coordinate Due Diligence, Legal, Accounting

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