The Issue

A Publication of CFOs2GO

Volume 9, Issue 1 **Jan 2019**

Exit Strategies for SME's

Always be thinking ahead!

By Chris Chillingworth
Partner, CFOs2Go

Thomas Mele
Principal, Mele Group

As each New Year opens, accompanied by the self-evaluation of how I/we did in the prior year, what I/we did right, and the things I /we could have done better, accompanied by the optimism that New Year springs from the belief that we can ALL start over / improve on our base, we offer this consideration, as an area to include in your New Year planning.

As financial and operational consultants, we often discuss ways in which to make our clients more profitable, more opportunistic, and more efficient in an ongoing business environment which assumes perpetuity. But another, oft-overlooked component, is to help our clients transition out of their company on their terms, without undue influence or pressures dictated by circumstance such as, death, disability, unmarketability of the enterprise or succession planning failure. Two recent CFOs2Go clients have hired us for the express purpose of planning for a transition in 3 – 5 years out.

Why focus on exits? Because if you decided or were forced to sell your business today, it is unlikely you would get the best value. Even if you don't believe you would sell your business today, it makes sense to always be thinking ahead. The sale or transition out of a business is a complicated undertaking. Planning for your exit allows you to:

- Take advantage of market timing
- Provide sufficient time to find the ***right*** buyer (strategic, financial, family transition, etc.)
- Reduce the timing in which the business is in "escrow"
- Reduce the risk that a negative finding during Buyer due diligence will be discovered, negatively impacting valuation.
- Clean-up litigations, inefficient operations, right-size the business, and otherwise…
- Maximize the value of the organization.

Businesses are complicated. Businesses are not like selling a car or a house. First, businesses have many stakeholders, all of whom, one way or the other, play an integral part of the success of a business entity:

- Investors / Owners / Partners
    - Some of whom may have preferential interests
- Board of Directors
- Employees
- Customers
- Vendors
- Lenders

Second, businesses are composed of many different types of assets, which may be valued differently:

- Physical Assets (Inventories, Property, Plant, Equipment)
- Contractual Assets (Accounts Receivable, Notes Receivable)
- Intangible Assets (Intellectual Property, Workforce-in-Place, Customer Lists, Goodwill)
- Known Liabilities
- Contingent or Unknown Liabilities
- Future Contractual Commitments
- Intangible Obligations (Stock Options, Warrants, etc.)
- Tax considerations
- Future Cash Flows

The Transaction Process itself is complicated:

- "Shopping" the Seller by an Investment Banker takes time. Many companies would prefer that the knowledge they are "for sale" be kept confidential. The longer the "shopping" process takes and the more companies that are confidentially contacted by the Investment Banker, the greater the risk that unintended disclosure will result.
- Buyer due diligence takes time. The buyer often employs a team of highly competent legal, financial, operational, business development, marketing, human resource and merger & acquisition employees, outside attorneys, as well as valuation and M&A consultants. These teams comb through the

company's contracts and records, interview key employees, and often wind up knowing more about the company than the company did itself.

- Because of the passage of time, and the very volatile nature of business is general, there are risks in the several months that pass between the signing of the Letter of Intent and the closing of the transaction. Much time is spent negotiating what happens if "x" happens. The Buyer wants to close months later with the same company they bargained for.
- There are working capital considerations. Also, all M&A contracts contain provisions that the working capital (current assets minus current liabilities) will be the same at close as the time the transaction was entered into. A purchase price adjustment occurs if the working capital differs, as it invariably does.
- Since a major component of every business is its employees, there are usually attempts to "lock up" key employees through financial incentives given to those employees if they stay for a certain period beyond the close of the transaction.
- Often, the disclosure that a deal, once entered into, does not close has a devastating impact of the Seller's business and associated valuation. Yet the Buyer wants to preserve certain "walk rights", or the right to walk away from the transaction if certain conditions are met. Without getting into details, these rights negotiated in advance between Buyer and Seller are called, "Material Adverse Conditions, or "MACs."
- Seller and Buyer virtually always make representations and warranties to each other. Should these "reps" and warranties be breached, there are generally financial damages, which in the case of the breach of a Seller's rep or warranty, can survive the closing of the transaction in a private company sale. This allows the Buyer to sue for damages and recover from the owners of the private company sold after the sale has been consummated. (Reps and warranties of public companies "die at the close" as it is impracticable to recover damages from perhaps thousands of public shareholders.)

CONSIDERATIONS

What can I do now to influence my company's value in the future?

High Impact Operational Areas That May Need Your Attention Prior to Your Exit Transaction

Did you know that only 10% of the businesses listed for sale in the US ever sell?
(source: www.bizbuysell.com)

Whether you chose to sell your business or one of the other transaction types, there are three critical areas that will need your attention, to ensure your business can thrive without you and you receive maximum value from the transaction. You will need to focus on:

1. Building a capable leadership team and organizational strength
2. Developing a market strategy and sales plan that shows a clear, believable path to profitable growth
3. Ensuring your operational infrastructure is scalable, documented and continuously improving

Each of these areas will be reviewed in detail during the transaction due diligence process, so it is best to get started working in these areas now since it can take 3-5 years to address these areas fully. Let's discuss briefly what are some practical steps you can begin to take today.

Leadership team and organizational strength.

Did you know that 71% of companies do not feel their leaders are able to lead their organization into the future?
(source: www.infoprolearning.com)

To ensure continuity and long-term success you will need a core group of leaders that have the maturity and depth of knowledge to be able to lead and continuously improve their respective operations. You can go look for them now or train them up from within your current team—both options are hard and take time. Finding and holding on to good leaders will require their compensation to be tied to the overall long-term success of the business and you will have to be able to delegate to them operational control of their function and empower them to make decisions.

Market strategy and sales plan to profitable growth.

Did you know that only 56% of companies with fewer than 50 employees have a documented marketing plan?
(Marketo, 2014)

The first critical step here is to get you, the owner, out of the sales process. If you are the rainmaker, managing all the top client relationships and discovering all the new business—the operation will not thrive without you. Your marketing, customer acquisition and sales processes need to be made independent of you and automated wherever possible.

The next step is to clean up your product portfolio; some revenue is better than others, you want to turn your focus on products and services that generate the highest gross margins and are in areas that have potential for growth. Any resources spent in the next 3-5 years on offerings that do not meet that criteria are not productive and will drag down the value of your company. Go through your offerings and get rid of everything that is a distraction and unprofitable, so that you can direct your resources to offerings and markets that have growth potential.

Finally, for a business to be attractive to a buyer there has to be growth potential, this is where you can let your creativity run wild. What can you do with the assets and core competencies within your company? Where can it go in the future? You do not have to do it or make it happen; you just need a believable, compelling story.

Operational infrastructure that is scalable, systematized and continuously improving.

Did you know that companies lose up to 30% in revenue
every year due to inefficiencies?
(source: IDC, www.entrepreneur.com/article/286084)

Document, literally write down, take pictures, draw diagrams of how things are done in every functional area of your business. You do not have to do this yourself, have your leaders and their teams do it. This documentation adds tremendous value to your company when a person assumes ownership or operational control. Your way of doing business is one of the assets they are purchasing and it protects them if a critical team player unexpectedly leaves.

You also want to encourage your team to innovate. If you have been successful in getting a core group of leaders, you want to empower them and the teams they lead to be continually looking for ways to improve their specific area of expertise—make it a game.

After you have addressed these three critical areas it will take at least 2 years of operation with your people and systems in place to ensure they are working as planned and are sustainable. Then you will be better positioned to receive maximum value when you execute your exit strategy of choice. That is why we are encouraging you today to Always be Thinking Ahead!

TYPES OF EXITS

With that as a prelude, we discuss some of the pros and cons of various exit transactions in the Appendix that follows. While the pros and cons are meant to illustrate the major features of each exit transaction, they may not be fully comprehensive of any transaction contemplated on your part. Please consult your local legal and financial advisors.

Summary

Even if you believe your ultimate business exit is years away, it's never too early to evaluate how you're going to get there, and what you want the desired outcome to be. CFOs2Go and Mele Group combine to provide unprecedented support in evaluating your options and strategies to achieve your long-term goals. Why not avail yourself of a free consultation with CFOs2Go Partner Chris Chillingworth or Mele Group Principal Thomas Mele? Chris can be reached at (408) 309-1343 and cchillingworth@cfos2go.com, and Thomas at (925) 413-4712 and ThomasMele@melegroup.net.

Chris Chillingworth is a partner with CFOs2Go Partners specializing in the high tech manufacturing, software, and service industries. He has over 30 years' experience in financial leadership including multiple roles as a CFO in both the public and private sector.

He leads our financial systems, technical accounting, high tech, and corporate governance practice groups. Chris is a member of our Mergers and Acquisitions Practice Group.

https://www.2gocompanies.com/cfos2go-practice-groups/mergers-acquisitions-practice-group/

Thomas Mele is owner and principal at Mele Group.

As businesses grow, they reach plateaus and get stuck. Thomas partners with his clients to develop a vision and strategy for growth, then helps them get their operations into a rhythm of execution so they can achieve breakthrough growth and realize their revenue and profit objectives.

Thomas has a Ph.D. in Electrical Engineering and 25 years of experience in the Semiconductor Industry at two Fortune 500 companies in many diverse and challenging executive-level roles. Mele Group was founded in 2014 and has its headquarters in Pleasanton, California.

https://www.melegroup.net

CFOs 2GO Partners is a hand-picked team of leading practicing CFO consultants who customize and provide financial management solutions for client companies. The company was founded and is still managed by a former CFO. Each of the consultants have, in addition to themselves and the other consultants, access to specialty financial management executive search and placement services to assist in quickly fulfilling on client company requests both in the U.S. and abroad.

www.CFOs2GO.com
(925) 299-4450

Appendix

Buy / Sell Agreement

A Buy / Sell Agreement is common where the parties are known to each other (Partnerships, Family business, Owner / Key Employee(s), etc.) and establishes the terms and conditions and, generally, the means by which the business will be transferred from Seller to Buyer in advance.

- Pros
  - Price is fixed or determinable in advance
  - Terms and conditions are known in advance
  - Provisions generally cover death, disability, retirement or termination of a partner / owner
  - Continuity of the business is reasonably assured

- Cons
  - Purchase price may become unrealistic over time
  - Potential buyer (insider) may not have financial capacity at the time the Buy-Sell is triggered
  - Each party's contribution to the business may change over time, resulting in inequities if not planned for.
  - Buy-Sell impedes a partner from selling his interest to a 3rd party.

Succession Plan (Inheritance)

Similar to a Buy / Sell Agreement, this arrangement is common where the parties are known to each other and establishes the terms and conditions in advance and, generally, the means by which the business will be transferred from Owner(s) to Heir(s).

- Pros
  - Continuity of the Company and the brand are assured
  - Owner chooses his successor
  - Transition takes place over time with appropriate training of upcoming management
  - Value transferred to the heirs in an orderly fashion unimpaired
  - Supply income to the owner after retirement
  - Planning can minimize taxes and supply liquidity through insurance
- Cons
  - Heirs may not be as devoted to the business or share the same vision of the future as their founders
  - Heirs may not have the requisite skills or personality to maintain customer and vendor relationships
  - Employees may become disenfranchised
  - Family disputes may arise between heirs with differing interests
  - Liquidity to the owner may be limited by working capital required to maintain the company operations and growth

ESOPs: Employee Stock Ownership Plan

Company makes tax deductible contributions to a Trust that acquires and allocates shares to employees over time

- Pros
  - Succession strategy with certainty of outcome.
  - Stakeholders achieve liquidity while maintain operating control
  - Plan is exempt from diversification requirements
  - Plan is exempt from unrelated business income tax on S-Corps
  - Only tax qualified plan that can borrow monies to acquire securities

- Cons
  - Company's financial condition is strong enough to support a shareholder liquidity event while maintaining sufficient operating capital
  - Employees have voting rights and now have a say in how the company is operated.
  - Employees must be given "put" or share repurchase rights
  - Company must have strong earnings and taxable income
  - Cashflow dedicated to the ESOP may strangle future liquidity
  - Probably should not be considered with companies with fluctuating earnings.

Leveraged Buy-out (LBO)

Company borrows the funds necessary to retire the interests of some or all of the Owners

- Pros
  - Buyers benefit from leverage and lower initial capital investment
  - Company uses its own cash flow to service the acquisition
  - LBO's often produce operating efficiencies and restructuring possibilities designed to increase profitability and operating cashflow
- Cons
  - Company must have a strong cash flow as the proceeds used to buy the company are borrowed
  - If costs of capital, leverage is too high, or company is poorly performing, company may be broken up or face bankruptcy to retire the debt
  - The same restructuring possibilities may lead to employee layoffs, low morale, key employee departures

M&A: Financial Buyer (Private Equity)

Buyer is interested in the growth and the cash flow potential of the business as an investment

- Pros
  - Key management generally stays intact
  - Large amounts of capital can be injected to invest in the business
  - PE firms take an active interest in the business with a goal of maximizing value and cashflow
  - If disagreement on value, earn-out potential
- Cons
  - Potential dilution or loss of equity stake
  - Potential loss of management control
  - Business objectives may differ
  - Valuation disagreements
  - Exit strategy disagreements

M&A: Strategic Buyer

Strategic Buyers are looking for growth through acquisition of complimentary verticals, strategic business segments, customers, or competitors where viable synergies may exist.

- Pros
  - Strategic buyers looking for companies with viable synergies may be willing to pay more.
  - Strategic buyers generally bring experienced management to the company
  - Strategic buyers may be willing to inject additional capital into the business to obtain their objectives.
  - Often the synergies and capital injections result in improved efficiencies and profitability.
  - Strategic buyers generally know the business or industry and are able to close the transaction faster than financial buvers

- Cons
  - Owners generally do not remain involved and are replaced with Buyer's management
  - May not offer Owner liquidity they desire, if not an all-cash deal
  - Ultimate financial gain to owner may be more or less based on future operations, if not an all-cash deal
  - Existing employees may face disruption, layoffs, change in culture, or location.
  - Managers may be replaced or become subordinates

IPO: Going Public

Shares of the Company are sold in the public marketplace and are subject to regulation and scrutiny of the Securities and Exchange Commission (SEC).

- Pros
  - Obtain equity and improve financial condition
  - Provides liquidity to founders
  - Shares become freely marketable
  - Publicly traded shares usually more valuable than privately held shares
  - Valuation is irrefutable
  - Shares can be used as currency to affect future transactions
  - Options can be granted to employees
- Cons
  - Management's freedom to act now governed by a Board
  - Management tends to exhibit short-term behavior in response to shareholders
  - Costs of going public, and continuous reporting once public are enormous
  - Significant management attention devoted to shareholders
  - Public companies governed by SEC regulations
  - Marketability of management's shares may be constrained by insider trading regulations.
  - Management control of company may be lost to dissident shareholders