7 Steps to Leaving Your Business

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Leaving your business is a challange. Using our seven step process will help you leave your business with style.

Introduction

You've worked hard to build a business. If you're like most people, you want to make sure that when it's time to leave your business, you want to do so with the maximum amount of value you can. I've found that there are seven specific steps that need to be taken to improve your chances or being able to leave your business in style.

> *John Aardvark was 48 years old. He had established a successful business, but had not managed to save anything for retirement. Every dollar he made, he reinvested in the business. Although, he didn't think he spent a great deal of money, every year, he was happy with the life-style he had put together for his family. But, because John was looking at fifty, he started to think about someday leaving his business and having enough for him to enjoy the rest of his life.*

John has a problem which he probably inherently understands, but has not been specifically stated. That is how he is going to leave his business and still maintain the life-style that he has put together for himself. The good news for John is that he is still young enough to make and implement plans that will get him to his goals.

Step One, What do you need?

The very first step that John needs to take is to find out what he needs to become financially independent. This is what we call our life-style inventory. The way John will figure out his life-style needs is to sit down with this checkbook and figure out specifically what his present life-style costs every year.

The steps that John needs to take are as follows:

- Go through his checkbook and categorize all expenditures over the last year. This is much easier if you use Quicken or Microsoft Money.
- Look at all of the personal assets that he owns and wants to continue to own.
- List all personal assets that he would like to own in the future that he does not own right now.
- Put down a rate of improvement in his day to day life-style.
- Analyze what the annual dollar value is of the benefits that are provided by the company that does not show up in John's personal checkbook.
- Understand how much he'll have to pay in taxes in retirement to maintain the life-style he wants to have.

Once this information is assembled, we then can come up with a number where we can say that John has achieved financial independence. The issue that John will have to come to grips with is that he most likely won't be financially independent while he owns his company. In fact, depending on the way the business is sold, John may never be completely financially independent.

Step Two, What's it worth?

> *John went to his CPA and asked him what he needs to do to leave his business. His CPA told him that one thing he needs to know is what his business is worth. Since his CPA was capable and had his CVA (Certified Valuation Analysts) designation, he was able to provide John with a valuation of what his business would be worth using standard valuation methods.*

There are many drivers that will provide an ultimate value for your business. However, ultimately your business is worth what someone else is willing to pay for it. The trick is understanding what is fair value for both you and the potential new owner. No matter who is the successor owner of your business, they will need to be able to pay for it for the deal to be a good one.

I find that an overlooked area is the cost of taxes on both sides of the transaction. Most advisors will help you understand what you have to pay in taxes. However, it's also important for you to understand what they buyer will have to pay in taxes. The more you can help the buyer limit their taxes, the more the buyer can afford to pay you for your business.

For example, if you are selling your business for $1,000,000, under normal circumstances the buyer would have to make $1,800,000 for them to give you the $1,000,000 for your business. This is because most of the time buyers will purchase a business with after tax dollars. This means they first have to earn enough money to pay the taxes and then give you what you want for your business. Our buyer in our above example would have to pay the government $800,000 in taxes before you get your $1,000,000 which brings the cost of the purchase to $1,800,000.

If you are able to make the transaction mostly ordinary income, you will be able to save your buyer a huge amount of taxes. If we could make the business price by $1,000,000 using deferred compensation, we would then have an after tax cost for the buyer of $650,000. This discounted price is because we don't have to earn taxes to pay this money, in fact, we get a tax deduction so our after tax cost is about 35% of the cost of the usual ways businesses are bought.

Understanding this principle can help you easily improve your after tax take from the sale of your business by at least twenty five percent. However, for this to work, you must have a team that understands the techniques and importance of changing your business sale from a capital transaction to one that is primarily ordinary income.

Step Three, Increasing the value drivers of your business

> *John is in a cash business and has always run his business to limit the amount of taxes that he pays. He has done everything he can to have the business pay for personal business expenses as long as it's been legal. John was very disappointed in the valuation his accountant gave him. At his accountant's suggestion, John engaged a consultant to help devise strategies that John could use to improve the value of his business for a potential buyer down the road.*

When you think about leaving your business, it's important to understand what the value drivers are for your business. In many operations I work with, I find that businesses are taking actions that actually decrease the value of their business. They might not be using cash effectively, servicing clients at a loss, selling to the wrong Customers or not taking advantage of the hidden value in their business.

In most business acquisitions, be it an outside or inside sale, the amount of money you will receive will be based on the ability of the business to produce cash for the new owners. So, for you to maximize the value of your business, you must make sure you are doing all of the things necessary to make the business have as high a cash flow as possible. Understand there is a difference between profit and cash flow. You will pay taxes on profits, but you don't always pay taxes on increased cash flow. This is especially true in a capital intensive business.

Most of the time, the next owner of your business will be a tax motivated owner. By this we mean, they also will want to not concentrate on showing huge profits, but will want to have maximum cash in their pocket after taxes. It's up to you to structure your business so the new owner can use pre-tax dollars to purchase your business. You also want to make sure that the Customers you service truly show a profit and you have measurement systems in place to know who your best Customers are and why.

Some things you can do to improve the value of your business are:

- Install a deferred compensation program for yourself so the new owners can purchase your business interest using pre-tax dollars.

- Quantify who your best Customers are and then put marketing programs in place to attract more of these types of Customers.

- Use leverage intelligently by borrowing money when you can get a positive return off using other people's cash.

- Know what the key measurements are in your company and then make sure everyone in the company pays attentions to those key statistics.

- Pay attention to the three legged stool of wealth creation. The three legs are increasing the after tax value of your company, using qualified retirement plans to diversify your wealth and own the real estate you operate your company from.

- Have programs in place for paying your people for doing the right things that make your business more valuable.

Step Four, Who's going to buy it?

John's children were in high school and he thought that one of them might want to go into business with him. However, he didn't want to wait fifteen years before he got out of business. John was pretty sure that if his children didn't want the business, then he would like to see one or two of his key people take the company over.

As you are going through the first steps of deciding who the new owners will be, it's important to look at the first three steps to see if what you want to do with your business makes sense. For example, if you don't like the future of the business, you most likely will not want to do an inside sale. This is because in most instances inside sales will require that you to hold paper which will require you staying involved in a business that might not have a great future.

If you believe that the business is basically a good one and you would like to see it continue not only for your benefit, but for the benefit of your family or present employees, then an inside sale might be just the way to go.

I believe there are only four ways to leave your business:

1. A sale to an outsider.
2. A sale to your managers.
3. A sale to family members.
4. Liquidation.

Although there are similarities, each of these options will have different strategies that are important in helping you achieve maximum value from your business. Also, if you are forced to liquidate, then you will have left all of the good will in your business on the table. I believe that for you to maximize the on going value of the business, only the first three options are truly available for you when it comes time to leave your business.

As you go through the decision process on whom the successor owners of your business will be, it's important to know the new owners would want to own your business and what will get them excited about taking it over. In all instances, you must be able to communicate to the new owners, the value of your operation, both the obvious ones as well as the hidden values. This would come from recasting the numbers of your business realistically with what the new owners would receive in annual cash flow.

You will want to make sure that you remember to include a capital reinvestment number in your cash flow projections. Every time you leave out a major expense in showing the cash flow of your business, you run the risk of losing credibility with your potential buyer. If you are selling to a third party, you must plan that they will be sophisticated in evaluating your business. If making an inside sale, you don't want to oversell the potential cash flow because you will most likely have to play the role of bank for the new owners and you will want to make sure you get paid.

Recasting your numbers showing what the new owners will get can be a great tool in helping you maximize the value of your business. You will have to teach the new owners what they will be able to get out of the business on an after tax basis. Done properly, this can dramatically improve the value of your business.

Step Five, Your Key People

> *John had five key people in his company. He knew that if his children took the business over, he was going to need all five people to stay. He also knew that if he sold to one of the managers, the other four people would be needed. Finally, if he sold to an outsider, then all five of the managers would be important for a period of time till the new owner decided how they would run the business.*

One of the key value drivers of your business is the quality of your management team. All the successor owners should be very interested in your management team and how they will interact with each other after you're gone. In each of the scenarios with successor ownership your management team will either be a value driver or a value reducer for your business.

In all cases you will want to make sure that your management team stays for a period of time during the transition from your ownership to your successor owners. One of the easiest ways to doing this is to institute a stay bonus program for your key managers. This is especially true for managers who will not be new owners of the company.

A stay bonus is a compensation program that allows all your key people to participate economically in the transfer of the business. Usually stay bonuses will have deferred payment schedules that are tied to triggering events such as the sale of the company. If the managers stay and perform at certain levels then they would be eligible for cash payouts that would reward them for years of past service as well as getting the company through a transitional period.

Having a stay program in place will certainly be a value driver if you decide to sell to a third party. An outside buyer does not want you, but they certainly want your key people. Having an economic incentive for key people to stay will allow you to get more money for your business, both from an outside and inside buyer.

Step Six, Protecting your Asset

As John was thinking about leaving his business, he wondered what he could do to make sure that while he was running the business he was safe from law suits. He also wanted to make sure that after he sold the business he would get the money that was owed to him. He was especially worried about the situation where he might have to hold paper for any of the potential purchases that could buy his company.

In today's litigious society, it's probable that you will be sued if you own a business. Since your business is usually your largest asset, you will want to make sure that if sued, you can protect this asset from creditors or people who would like to win the legal lottery and ruin your quest for financial independence.

For this reason, I strongly suggest that you consider setting up multiple entities that will shield your assets should you be sued. If you are in a business where liability can pierce your corporate veil and get to you personally, then you will want to speak with an asset protection specialist that understands what you can do to protect yourself from those who would take what you've worked your life for.

John also will want to make sure that he continues to have ultimate control over his business until he is paid for his business when it comes time for him to leave. The easiest way for this to be done is for John to have the company stock put in a voting trust that he controls until the new owners have paid him what they promised.

John wants to sell his business to his children or managers, so this will be relatively easy to accomplish as one of the conditions of sale. However, if John sells his business to a third party, then they will not allow a voting trust to be established. In that case, John must have security interests that will easily allow him to access cash that is owed him.

If John has structured his business for maximum tax efficiency at the time of sale, he can probably induce the buyer, be it an outside or inside buyer to give him the maximum amount of cash upfront they can come up with. Since we are going to structure our sale where the buyer gets a tax deduction for all cash they give us, there is an incentive for our buyers to pay us upfront so they get tax deduction in the year of the purchase.

Our primary goal in asset protection is to make sure we first get the cash for our business and then protect the cash we receive from those who would like to take it away.

Step Seven, Investing the Proceeds

John is now 62 years old and he is about to pass the business on to his children. The total sales price is $3,000,000 of which he is going to receive $1,200,000 up front. John will also be getting $150,000 per year for the next twelve years so he won't need to use any of the upfront money to live on. This is the first time in his life that he has had to invest this amount of money and frankly, he's scared as to what could happen to money he's receiving for his business. He knows this money must last the rest of his life.

The sale of a business is often the first time an entrepreneur actually has real money to invest. John was great at running his food service company, but he was not an experienced investor. Luckily, John had good advice for his investments and learned early that the goal of investing money from the sale of his business was not maximizing his returns, but making sure there was enough to live on.

The first step that John did when thinking about selling his business was figuring out what he needed. This exercise helped John to find out that he lived below his means. If he managed his money prudently, he may have plenty of money to live out his life. John's investment advisor continued to work with him to understand that prudent meant enough and not getting a maximum return.

John realized that it was important for him to get a fair return on his investment, but it was more important that his capital base did not disappear in a severe market correction. For this reason, he insisted that his investment managers had strong and solid programs to limit his losses during a market down turn.

I believe that as you start to accumulate significant amounts of investable assets that you must concentrate on capital preservation more than capital growth. In other words, there should be stop loss points predetermined in all investments you make. In addition, if possible you want to use hedging strategies that allow you to have protection when markets decline but participate at a significant level when markets are moving up.

When you sell your business, you have converted an engine that produces cash every year that you control to an investment that in many respects will be out of your control as to its performance. So, it's important to have a strategy in place that will help you live your life if the market goes up or down.

Conclusion

Because John went through his exit planning in an orderly manner, he was able to put together strategies that helped him get what he wanted both while he was running his business as well as when he decided it was time to leave. He understood the importance of using the seven steps as the basis for his planning.

Most importantly, John put together an advisory team that specialized in helping him realize the maximum value from his business while limiting taxes not only for himself, but for the successor owners of the business. He learned early on, that controlling taxes on both sides of the transition was probably the most important key in improving the value he could receive from his business when it was time to leave.

So, I hope that you, like John, put together a team that will help you make the proper plans so that when it comes time to leave your business, you can do so in style.

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