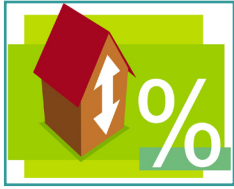




FEATURE



Business Owners: A Rush for the Exits?

[By David Kauppi, Managing Director, MidMarket Capital]

Most technology companies have contingency plans in place in the event that their headquarters are devastated by a fire, flood, or other natural disaster. Relatively few, however, have in place a strategy for another kind of management calamity, the unexpected retirement of a founder, owner, or group of senior managers.

Our population is aging. The statistics are clear: over the next two decades, 78 million baby boomers will turn 65, the traditional retirement age. In 2005, workers over 55 represented 16% of the work force; by 2020, that will rise to almost 25%. At some older facilities, such as NASA's Langley Research Center, 55% of the work force is already eligible for retirement.

For corporate management, the aging work force presents several issues. One long-term but hard-to-measure problem is knowledge management. As experienced workers retire, a vast quantity of know-how, solutions, and creative experience is heading out the door.

Another problem, which can emerge as a sudden, acute issue, is inadequate succession planning. This process is also known as "exit planning," since for many business owners it is a planned process of selling the business to an outside organization. In such cases, the owner is not planning for succession by a family member or business associate, but rather a sale and complete exit.

A 2005 PriceWaterhouseCoopers survey of CEOs of America's fastest-growing private companies found that 65% plan on retiring and/or selling out their ownership position within the next ten years. However, only 46% said they have done "some" or "a great deal" of succession planning. The rest said they had done little or no planning.

Why don't more business owners and senior executives have an exit strategy? One reason may be simply a lack of time; many are overloaded managing for today and short of

time for long-term planning. Another reason may be psychological. Many business owners feel conflicted about exit planning; they have nurtured their business over the years, and it has come to be a key part of their identity. It may be difficult to face up to the thought of stepping down.

Although the need for exit planning may be difficult to face, the need for a well planned strategy is greater than ever. As we face the oncoming wave of baby boomer retirement, the choices become more problematic.

Experts project a doubling in the number of businesses that will hit the market looking for a buyer by 2009. According to the Federal Reserve, in 2001, 50,000 businesses changed hands. That number rose to 350,000 in 2005 and is projected to increase to 750,000 by 2009.

As the overall population ages and sellers outnumber buyers, the laws of supply and demand point to an erosion in valuations for business sellers. At this point, the trend looks to be gradual. However, as we have seen recently in the prices of certain stocks and debt obligations, a "rush to the exits" can precipitate a sudden, calamitous drop in prices.

An additional, unsettling factor for business owners contemplating retirement are potential changes to the tax code. Democratic party leaders, including the major presidential contenders, have put forward proposals to change the current tax structure. Business owners and other "wealthy" citizens should pay close attention. Most of the proposals would increase

personal income tax rates and other forms of taxation.

For example, the current 15% tax rate on capital gains, previously scheduled to expire in 2008, has been extended through 2010 as a result of the Tax Reconciliation Act signed into law by President Bush in 2006. However, in 2011, this lower rate will revert to the rates in effect before 2003, which were generally 20%. It could potentially go higher, if the federal budget deficit worsens and Congress adopts a "tax the wealthy" philosophy.

In addition, the federal estate tax threshold will rise to \$3.5 million in 2009 and is theoretically scheduled to be abolished altogether in 2010. However, most of the Democratic proposals call for continuing, or even increasing, this tax. For business owners planning to cash out in the future, this is a very real consideration.

Given this uncertain future, what are the options for a business owner who is anticipating selling his business in five years?

One answer is to move up your sale time frame, but not necessarily your exit time frame. For example, one way such a move might be structured would be to sell the business in the next 18 to 24 months with an agreement to continue working full-time for an additional year to transition customer relationships and manage intellectual property. This would be followed by a limited consulting engagement for an additional two years.



FEATURE

This solution requires the business owner to view the business sale and his or her retirement as separate, contingent events. While this scenario may be difficult to envision at first, it can be very advantageous. Too many owners wait too long and end up selling because of a negative event like a health issue, loss of a major account, a shift in the competitive landscape, or family demands.

Naturally, all of these negative reasons for selling will likely put the owner in an unfavorable negotiating position. As a general rule, the faster an owner wants to disassociate himself from his business, the more the buyer will want to discount the purchase price. A stated desire to leave quickly will almost certainly be seen as a red flag by potential buyers.

As an experienced M&A specialist or veteran business broker knows, the more a business depends upon a single person or family for its success, the greater the risk to the buyer. The greater the percentage of projected earnings that is dependent on future new sales, the lower the percentage of transaction value that the seller will receive as cash at closing. The greater the concentration of company sales to a small number of customers, the lower the price and the greater the earn-out component of the transaction value.

Most privately held or family-controlled businesses have at least one of these value detractors present. However, a smart business sale strategy can mitigate the negative impact on selling price. By

exiting before the necessity of exiting, the company's sales trajectory will more than likely be on the increase than on the decline.

Buyers pay a premium for growth, and discount for flat or falling sales. Unless a company's entire revenue stream is contractually committed over the next several years, most buyers will introduce an earn-out as a component of the total transaction value. This is a risk avoidance strategy that ties the total acquisition price to the future performance of the business post-acquisition. It is also designed to keep the business seller engaged in the near-term performance of the business.

The reality is that the "normal" or typical response from business sellers is to seek the entire sale price in cash at close. However, experience has shown that if the definitive purchase agreement is properly memorialized, earn-outs can be a big plus for a seller. One strategy is to tie the earn-out to future revenues of the acquired property. That is relatively easy to audit if necessary. Earn-outs based on future EBITDA or division profitability are more problematic because of the greater possibility for interpretation by the buyer.

As we have seen, one major factor that can determine company valuation is the seller's timing. A second major factor — one also controlled by the seller — is the number of bidders. Amazingly, a very high percentage of companies are sold without any competitive bids, in many cases to a competitor.

Very few people would sell their home to an unsolicited buyer without consulting a real

estate agent, yet many business owners sell their companies without seeking outside advice. Business brokers and other licensed financial professionals experienced in business sales are in the best position to find qualified buyers.

Planning for retirement is, in a real sense, coming to grips with our own mortality, which is difficult for any individual, even successful business owners. To make a business sales decision on an impulse or at the last-minute can have very severe negative consequences, both for the business and the individual.

As management expert Peter Drucker noted, "What you have to do and the way you have to do it is incredibly simple. Whether you are willing to do it is another matter."



About the Author

Dave Kauppi is the publisher of the *Exit Strategist Newsletter* and president of MidMarket Capital, Inc., an M&A advisory firm and business broker. Kauppi is a certified business intermediary (CBI) and a member of IBBA (International Business Brokers Association). For more information, visit www.midmarkcap.com/exit.

EmploymentCrossing is the largest collection of active jobs in the world.

We continuously monitor the hiring needs of more than 250,000 employers, including virtually every corporation and organization in the United States. We do not charge employers to post their jobs and we aggressively contact and investigate thousands of employers each day to learn of new positions. No one works harder than EmploymentCrossing.

Let EmploymentCrossing go to work for you.