Boomers with Businesses...and no exit strategy

If you have a client who is a baby boomer business owner and who does not yet have an exit strategy, he/she is in trouble and you have an opportunity to help.

An exit strategy is an owner's plan for cashing out of the business he/she worked so hard to develop. All too often the owner is too busy managing the business to develop and implement an exit strategy.

So what will the marketplace look like in 2012, when the boomers start to sell their business and retire? The data indicates it will be a buyers market, with an excess supply of businesses and a limited demand. Why? Because 80% of the companies in the U.S. are privately held and there are 87 million baby boomers who will reach retirement age in 10 years. That's a lot of business owners wanting to retire. The market will be flooded and buyers will be able to pick and choose.

What will make a business attractive to the limited pool of potential buyers? The same two things that make it attractive today.

1. The buyer must want it; it must be desirable in terms of profit, cash flow, management team and workforce.
2. The buyer must be able to afford it; capital to finance the deal must be available. (Even in today's rather evenly balanced market, lack of capital is the cause of a high number of failed transactions.)

Experience shows that most of these boomer business owners do not have an exit strategy in place. The unspoken expectation of an owner without an exit strategy is that the business has value and the value will be realized at the time of sale. Early in my career, a friend who was building a construction business told me "The nice thing about owning a business is not the paycheck but the fact that you are building wealth for your retirement."

Yes, that is true, but only if you can sell it. Often there is a disappointing disparity between what the owner thinks the company is worth (sweat equity value,) what the market says it is worth (market value,) and what the assets are worth (book value.) The time of sale is the worst possible time to seek the value in the business.

In order to avoid disappointment when it comes time to sell the company, smart business owners develop an exit strategy that includes tactics for tapping the value of the company over time, and making themselves obsolete, i.e. building an organization that will perform well without them.

Such a strategy requires time to mature and come to fruition. Experience indicates somewhere on the order of 8 to10 years. That means boomer business owners need to implement an exit strategy today!

A manufacturing client in the Midwest, with revenues in excess of $5 million, asked for assistance in developing an exit strategy with a target date of 2015. The first generation owner had a son and daughter, both in the business. The owner was aware of the statistics that showed one-in-three private companies succeed through the second generation and one-in-ten succeed through the third generation. He did not want to jeopardize his retirement based on an earnout agreement and hired us to assist him in developing an exit strategy favorable to all family members.

Candid discussions with the owner, the owner's financial planner and a survey of potential buyers provided us with the information we used to develop the plan. The strategy consisted of three elements:

1. Ensure the company has assets that will continue to perform after transfer of ownership.
2. Develop a potential source of financing without engaging in a stock deal, earnout agreement or extended payments.
3. Capture sweat equity value on an annual basis rather than relying on it to be there on the date of sale.

How We Did It

In examining how to separate the owner from the business we concluded there are a limited number of ways ownership can be transferred; The owner can sell it, transfer it to the next generation, turn it into an ESOP, or take it public.

ESOPs work but are complex and expensive and taking it public was not an option. The owner wanted tactics that would provide the flexibility to either sell outright or transfer to the children. This flexibility required a strong and focused management team and a loyal and dedicated workforce.

To develop a strong and focused management team we customized a non-qualified deferred *incentive* compensation plan for them. We used a design called LeaderShare®, specifically designed for closely held companies. Working with the owner and financial advisor, we developed a 10 year revenue and profit plan. This became the company vision for profitable growth. A deferred wealth building mechanism was established that rewarded the participants for performance toward the plan. The annual targets were adjustable to cope with the unforeseen changes but the ten year objective was considered realistic by all involved. It was the first time the management team had considered what the company might look like in the long term and everyone found it an exciting experience.

This tactic acted to retain and focus the leadership team. In keeping with the owner's desire for flexibility, it provided the option of financing a management buyout. The option to overlay another LeaderShare® plan in years six through fifteen provided a strong retention mechanism for the management team should ownership transfer to the children. (The owner and children also participated in the plan, thus providing them with access to the value of the company as it accrued.)

Funding
The plan established a predictability of future earning and the financial planner used this information to develop tactics for funding the deferred payout. He addressed the risk management element with 10 year term insurance on the owner and each plan participant. He developed an investment program that emphasized strong performance in the portfolio while maintaining low turnover. Because the portfolio was owned by the business, capital gains would be taxed at 20%, dividends at 8% and any interest payments would receive a low tax rate.

All that remained was to establish a process that would develop a loyal and dedicated workforce. With funding, a leadership team and a dedicated workforce, the value and desirability of the company would be assured. Even if a buyer could not be found, the owner would have the flexibility of disengaging from the day-to-day business while continuing to receive a revenue stream.

To develop a loyal and dedicated workforce we customized a cash incentive pay plan for them. We used a design called ScoreCard™, because of it’s ability to measure financial and operational performance on the front line level.