

Main Street Businesses: Smart Strategies for Exit Planning



Griffiths, Dreher & Evans, P.S.
Wealth Management CPAs

Table of Contents

Getting Started.....p. 1

Exit Plan Options:

The Matrixp. 1

Main Street vs.
Middle Marketp. 1

What's Your
Business Worth?p. 2

Investment Value vs.
Fair Market Valuep. 2

Avoiding Surprisesp. 2

How much money
do you need?p. 3

Who do you want to
sell your business to?p. 4

When do you want
to sell your business?p. 5

Joining the 2% Clubp. 6

Focused on Your Needs:
A Well-Defined Process for Helping
You Reach Your Goalsp. 7

Meet Griffiths, Dreher
& Evansp. 9

By Tom Griffiths, CPA, CFP, ABV

Executive Summary

Main Street businesses are those with less than \$3 million in annual sales and less than 20 employees. While Main Street businesses are the backbone of the U.S. economy, the U.S. Small Business Administration reports that 4 out of 5 of these businesses liquidate when the owner decides to retire rather than ending in a profitable sale to a new owner. If you're a Main Street business owner, key challenges you may face when creating an effective exit plan may include:

- Becoming financially secure enough to be able to leave your business
- Profiling your ideal buyer and developing a plan to sell or transfer to them
- Understanding how and when you will get paid and the risks involved

Values for your business can vary widely depending on the type of buyer and the type of transaction involved. That's why it's important to explore a range of possible outcomes, while taking a flexible approach to identifying the best type of buyer and transaction terms for your needs. This white paper will explore the potential outcomes of successful exit planning for Main Street business owners. Using a matrix, this paper will illustrate the range of results we most commonly see when working with Main Street business owners.

While creating an effective exit plan from your business can be complex, the good news is that you don't have to tackle it alone. Working with an experienced advisor can help you increase the investment value of your enterprise. Most importantly, finding an advisor who understands your wealth preservation and personal income needs in retirement, as well as the unique challenges and opportunities associated with the future sale of your business, can help you create a more comprehensive plan.



Getting Started

If you are like most business owners, your business is your biggest investment and you are counting on being able to cash out some day when you are ready to retire or move on. As such, the most significant financial planning issue for you as a business owner is planning for the eventual exit from your business. The sale or transfer of a business can be a big financial event—one that frequently becomes a part of your legacy. Much like saving for retirement, the earlier you start your exit plan the better chance of creating the best outcome. As a Main Street business owner, how do you plan for the eventual exit from your business?

Exit Planning Options: The Matrix

In order to properly navigate the exit planning maze to your successful exit, it's important to understand your available options. There are essentially three ways to leave your business—you can sell to a third-party, sell to an insider or transfer to a family member. In addition, there are two distinct sizes of businesses—Main Street businesses and Middle Market businesses. These variations create six different zones for business owners. (See matrix below.) Your expectations for the value of your business, the strategies employed to develop your buyer and the timing and amounts you will be paid for your sale will all vary depending on the exit zone you fall into. Keep in mind that the investment value of your business and outcome from an exit plan can be significantly different based on your zone.

Exit Plan Matrix

	Sale to 3rd party	Sale to Insider	Transfer to Family
Middle Market	Zone 1	Zone 2	Zone 3
Main Street	Zone 4	Zone 5	Zone 6

Main Street vs. Middle Market

Main Street Businesses account for a very significant number of all businesses in the U.S. So what's the difference between Main Street and Middle Market? Main Street businesses are those with less than \$3 million in sales and less than 20 employees. Middle Market companies have more than \$10 million in sales and more than 50 employees. In between, are businesses I call "Main Street Upper" with 3-10 million of sales and 20-50 employees.

- Middle Market companies will generally have an exit plan in zones 1, 2 or 3 of the matrix
- Main Street companies in zones 4, 5 or 6 of the matrix
- Main Street Upper businesses might be in any of the 6 zones of the matrix

Differences in exit planning: Main Street vs. Middle Market

	Main Street	Middle Market
Advisors Involved	1 - 3 Professionals	3+ Professionals
Estate Planning	Simple	Complex
Business Valuation	Calculation of Value	Opinion of Value
Insurance Planning	Simple	Complex
Management Team	Little or No Value	Large Value
Likely Buyer	Individual	3rd Party Strategic
Most Value to Seller	Sale to Insider	Controlled Auction Bid
Transaction Advisor	Broker	Investment Banker
Exit Planners	Nearly Zero	Many
Exit Plan Cost	\$2,000 - \$6,000	\$25,000 (EPI, BEI)

¹ Source: Financial Service Needs of Established Business Owners: *The Size and Demographics of a Wealthy Underserved Market.*



What's Your Business Worth?

The value of your business depends on the anticipated buyer. In exit planning there is always more than one potential buyer, so your business will always have more than one value at the same time. Keep in mind that most published information regarding business valuation for exit planning assumes an exit plan for Zone 1—Middle Market sales to a third party. Zone 1 is where a business could achieve the highest possible value in a sale. However, many Main Street businesses won't qualify because of minimum size requirements. If you are a Main Street business, it's important to have realistic expectations for the value of your business and consider a flexible range of values, rather than a single, fixed value.

Sample Valuations

Business Values in Exit Planning

	Sale to 3rd party	Sale to Insider	Transfer to Family
Middle Market	6 - 10 times earnings	5 times earnings	IRS Rules for Hypothetical Buyer
Main Street	3 times earnings	5 times earnings	IRS Rules for Hypothetical Buyer

As business owner, remember that there are significant differences between Main Street and Middle Market Exit Planning. For example, a Middle Market company might get the most value from a sale to third party. As a Main Street business owner, you will likely get the most value from a sale to insider. In addition, the net proceeds you receive can be significantly affected not only by sale value but by the taxes on the sale or the estate taxes on a transfer. With proper planning and assistance from the right advisor, you can maximize the net proceeds, minimize the taxes, successfully transfer or sell to the successor of your choice and exit your business on the date you want to.

Investment Value vs. Fair Market Value

When hiring an analyst or advisor to help estimate the value of your business, be sure you understand the exact type of valuation the professional you're engaging specializes in before signing a contract. What most Main Street business owners need to know when planning an exit strategy is the "investment value" of their business. Investment value represents a range of reasonable values that you could potentially expect when selling your businesses to a well-qualified buyer. Investment value reports take into consideration multiple factors in each exit zone, including the size of your business, the different types of buyers present in the marketplace and current market value trends. Because there is more than one potential buyer for your business, a thorough investment value report should generate more than one potential value for your business.

Many business valuation analysts tend to produce an IRS "fair market value" report, which is very different from investment value. The IRS fair market value seeks to identify a single market value for a company, and then heavily discounts it for lack of marketability to a value to be used for estate and gift taxes based on the assumption that the business must sell very quickly and therefore at a big discount. Fair value is sometimes required in cases of divorce, but typically isn't the best tool for a planned sale.

Avoiding Surprises

Exiting your business requires a business owner to answer three key questions:

- How much money do you need?
- Who do you want to sell to?
- When do you want to leave your business?

The answers to these questions are not as obvious as they seem and frequently have some big surprises in store for the business owner. Turn the page for some real-life examples to help illustrate how these questions come into play.



How Much Money Do You Need?

Bob was 65 and ready to retire. For over 30 years he had been running a small specialty machine shop. He enjoyed his business immensely over the years and had great pride in what he had accomplished. However, he found himself increasingly thinking that it was time to do the traveling with his wife they had always talked about. Over the years, a couple of his main customers had commented that when he was ready, they would be

interested in buying his business. Like most business owners, Bob had re-invested heavily in his business over the years and the business represented most of his wealth. He figured that since his business was so solid and had provided him with such a good lifestyle that it would fetch a price that would allow him to continue this lifestyle in retirement.

Surprise #1: Your business is only worth about 3-5 years of its earnings

Since Bob had been living on most of what his business made, he hadn't accumulated any wealth outside his business and had almost nothing else to support his retirement. Bob won't retire. He will continue to work his business because the sale of his business would require giving up the income that supports his lifestyle and it just won't seem worth it. If you are like Bob and have most of your wealth tied up in your business, you will likely continue in your business until you are no longer able to work, and then leave it while making significant reductions to your standard of living. According to the Exit Planning Institute, 50% of business owners leave their business due to one of 4 D's—death, disability, divorce or distress. Accumulating wealth during your business years and leaving your business on purpose to retire is far more enjoyable than becoming a member of the 4D club.

Exit Planning Step #1: Make a plan to accumulate wealth outside your business

Ideally, you should plan to accumulate at least 2/3 of your wealth outside your business during your business years. As part of this progression, a logical sequence is:

- First, establish the business.
- Second, purchase real estate for the business to operate in.
- Third, begin investing in stocks and bonds.

Once you have achieved a balance of a third of your wealth in your business, a third in real estate and a third in stocks and bonds, you will be in a good position to exit your business when you want. According to the book *Get Rich, Stay Rich, Pass It On: The Wealth-Accumulation Secrets of America's Richest Families* by Catherine McBreen and George Walper, America's wealthy households achieve an allocation of wealth similar to this.

Who Do You Want To Sell Your Business To?

Susan was 55 and the owner of a successful wholesale supply company. She had two key employees that were instrumental building and running her business. Susan was fairly conservative financially and had always lived on less than her business made. She had accumulated 50% of her wealth outside of her business. With the sale of her business, she expected that she could be financially independent. Over the years she had hinted to these two key employees that when she was ready to leave, she would sell the company to them. Susan knew that if she sold to an outside third party, that the new buyer would likely make significant changes and employees might lose their jobs. She was proud of the business she had started and wanted her legacy to continue. She cared deeply about the employees and the families of the people who had helped her become a success and felt she owed it to them to sell to these two key employees.



Surprise #2: Your buyers have no money and poor credit

Susan had failed to fully develop her buyers. Her two key employees were willing to buy the company, and they had the management skills to run it, but they had no money to buy the business and their credit was not good enough to obtain financing. Susan could not become financially independent without getting at least a portion of the money up front from the sale. She was deeply disappointed and is faced with some difficult decisions. She will either have to postpone her plans and work several years longer while helping her key employees develop better credit and obtain the means for a down payment. Or, she will have to sell to a third party putting at risk her employees' jobs and the legacy she created.

Exit Planning Step #2: Make a plan to develop your buyer

Ask yourself this question: "What characteristics does the ideal buyer for my business have?" You must investigate this early in the process so that you can target and develop the best buyer for your business. Owners commonly don't think about developing their buyer—they think of this as the buyer's responsibility. But the buyers in this situation don't see it coming any more than the selling owner does. When the buyer is not ready, it becomes the seller's problem. Developing your buyer can mean a lot of different things depending on who you plan to sell to. In addition working with buyers on creditworthiness and down payment accumulation, exit planning has a variety of mechanisms to help you develop your buyer such as phased sales of non-voting stock, stock bonuses, deferred compensation programs, estate planning gifting techniques and others. Most take time, so start early.

When Do You Want To Leave Your Business?

Paul was a 56 year old owner of a small manufacturing company. He had been in business for over 25 years and had always lived on less than his business made, allowing him to accumulate wealth outside his business. His two adult children worked in the business and for years he had developed them as buyers by grooming them to take over. The day came and Paul decided it was time to leave. After 25 years in business he was excited about the freedom he would enjoy and the thought of not having to worry about the business anymore. He didn't need top dollar from the sale of the business to become financially independent and wanted to sell to his children for less than full value. The children were ready to buy, had good credit and a decent down payments. He had done everything right, but Paul was disappointed to find out that the bank wouldn't finance his children for the purchase of the business without his personal guarantees on the notes taken to pay him. How could he stop worrying about the business and enjoy his freedom if he was going to repay the notes if the business failed after he left?



Surprise #3: You will probably have trailing financial risk

You probably won't feel like you have left your business until you have been paid and any personal guarantees are gone. For the most part, selling a business to insiders generally involves attaching to post sale payment streams from the business. Whether it is a seller financed note, personal guarantee of the buyer's loan, an unfunded deferred compensation, or something else, you will bear a risk of loss after the sale for a period of time and it will make you feel as if you have not yet left your business. So you can see how answering the question "when do you want to leave your business?" can be tricky to answer.

Exit Planning Step #3: Make a plan to deal with post sale financial risk

According to *How to Run Your Business So You Can Leave It in Style* by John Brown of Business Enterprise Institute, insider buyers with 100% cash at close are rare, especially if you are getting good value for your company. You will most likely have post-sale financial risk. One way to manage the question of "When do I want to leave?" is to sell your business 2-3 years before you want to leave, and stick around to babysit your risks until you get paid. Banks will often release personal guarantees at 2-3 years into the note or when it is paid down to a certain point, provided they agree to these terms to begin with. Most owners don't realize that they can retain control of the company after the sale by selling most of the company stock as non-voting stock and keeping the voting stock until they are paid, this even works in an S-Corporation. There are many exit planning mechanisms to help manage post-sale financial risk. The best way to eliminate post sale financial risk is to get the clock started ticking.

Joining the 2% Club

As a business owner, you know from firsthand experience that being an entrepreneur involves taking risks. If you've been in business for more than 10 years and are currently well positioned to leave your business when you want to, you belong to a very small club of successful business owners. In fact, we call this group of business owners the "2% Club" because only 2% of all business owners make it this far.

Consider the following:

- 40% of new businesses fail the first year
- 80% of businesses fail within 5 years
- 96% of business fail within the first 10 years

Of the remaining 4% of business owners still in business after 10 years, only half of those business owners (about 2%) successfully leave their business when they want to. This means they are able to leave on their own terms and receive the net proceeds they're looking for.

While these statistics may seem discouraging for even the most optimistic entrepreneurs, there is a silver lining. If you are reading this white paper, chances are good that you're already on the right track for achieving your financial goals.

At Griffiths, Dreher & Evans, we can provide you with a practical framework for joining the 2% Club. Some of the strategies presented here you may already be familiar with, while others may require some time, education and planning to implement properly. Working with many successful business owners over the years, we've learned that one of the essential requirements of joining the 2% Club is managing risk, which requires diversifying your investments away from your business. Consider this: owning a single stock is a riskier proposition than owning a mutual fund that invests in 100 stocks. Similarly, owning only your business presents more risk than owning a diversified portfolio of financial assets, which may include your business, physical real estate and securities, such as stocks, bonds and mutual funds.



The CPA Wealth Manager Approach

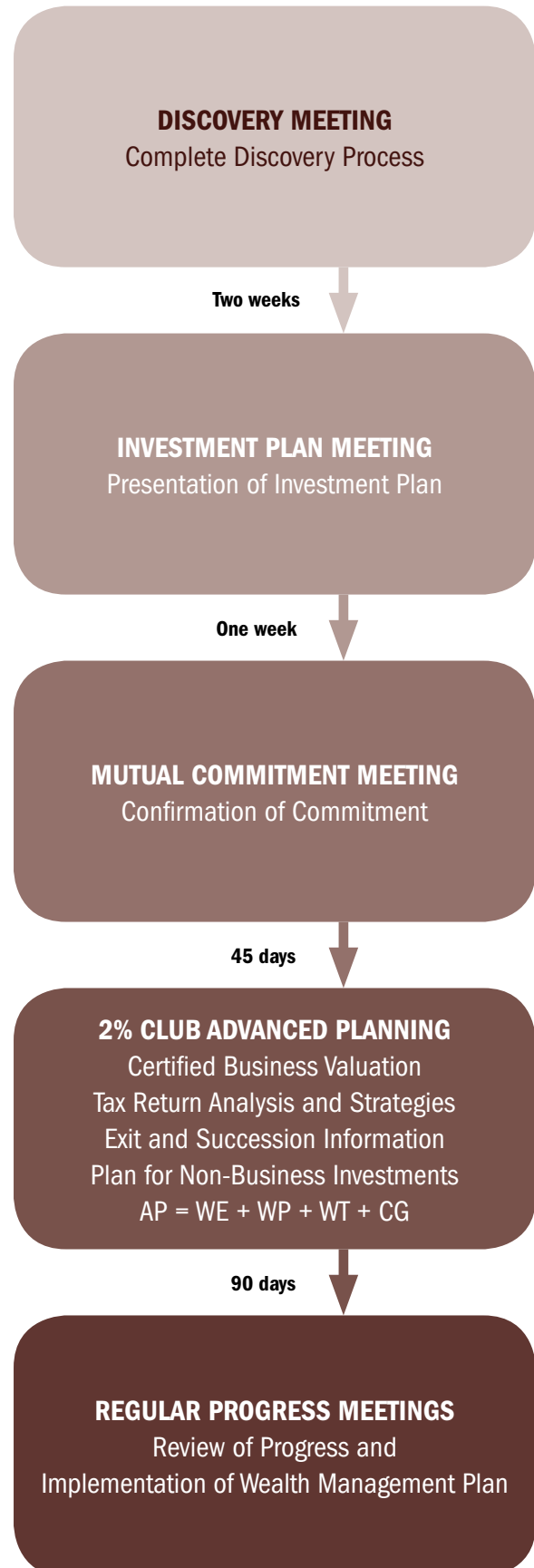
Focused on Your Needs: A Well-Defined Process for Helping You Reach Your Goals

A credible CPA Wealth Manager should have a well-defined process for helping you reach your financial goals. At Griffiths, Dreher & Evans, here are the steps we take to better understand your needs and help you join the 2% Club.

The Discovery Meeting

At the first meeting, we use a systematic, detailed interview process to define your true financial needs, goals and current position. This process will provide us with the information we need to create a Total Client Profile. This is a key tool for communicating your financial picture to a network of specialists we will turn to for help in creating customized wealth management strategies. During the meeting, expect us to work with you to:

- Uncover your values, wants and needs
- Collect information to assess the suitability of working together
- Garner the details necessary to create a wealth management plan



The Investment Plan Meeting

In this meeting, we will present you with a detailed investment plan that describes your needs and risk tolerances and provides benchmarks for tracking progress toward your goals. This plan will serve as the road map that can help enhance the probability of achieving everything that is important in your financial life. Investment plans will likely include these six important areas of discussion:

- Your long-term needs, objectives and values
- A definition of the level of risk that you're willing to accept
- The expected time horizon for your investments
- Your target rate of return
- Our recommended asset allocation strategy for your portfolio
- Our investment philosophy and methodology

The Mutual Commitment Meeting

At this meeting, if you have been pleased with the discussions so far, you will likely become a client. You can ask any questions or voice any concerns about the investment plan. You and the CPA Wealth Manager can then make a mutual decision about whether you should proceed. If you choose to work together, the advisor will ask you to execute all documents needed to begin to implement the investment plan.

2% Club Advanced Planning Meeting

Next our team of CPAs with expertise in business valuation, taxation, exit planning and investments goes to work on your wealth management planning. We complete a business valuation, in-depth tax analysis, exit strategy, and a plan for non-business investments. We meet and apply our expertise to evaluate all aspects of your financial situation and devise appropriate solutions. When needed, we bring in professionals, from our team of outside experts to assist with legal, banking, insurance or other specialized solutions.

Once a plan has been developed, you will receive your Certified Business Valuation, results of our Tax Return & Tax Strategy Analysis and information you should be aware of regarding any applicable exit planning. We'll also give you our recommendations for developing additional investments outside of your business. Our goals are to help you enhance, protect and eventually transfer your wealth to your beneficiaries.

Regular Progress Meetings

These meetings will likely be held on a regular basis to address issues relating to anything in your Wealth Management Plan as appropriate. You will be able to ask questions at each meeting, and your advisor will review and explain your portfolio's performance relative to your long-term goals.





Meet Griffiths, Dreher & Evans

At Griffiths, Dreher & Evans, we specialize in helping Main Street business owners build long-term financial security. Our services include accounting, tax planning and preparation, business valuation and wealth management solutions. As CPA Wealth Managers, we can help you:

- Grow and protect your wealth
- Reduce and manage your taxes
- Take care of your family and employees
- Enjoy more choices for how you spend your future

Building a path to your future

As a Main Street business owner, it's important to make decisions that build wealth in the context of your financial past, present and future. The accounting services we provide help you look at your past and present, taking a clear inventory of your assets and liabilities. Our wealth management services help you look toward the future and forge a clear path for getting to where you want to go. We can help you create a plan to manage taxes, build wealth and minimize risk. Our ultimate objective is to help you enjoy the full financial and emotional value of your life's work.

Protecting and growing the value of your business

We understand that business valuation services play an important role in your financial plan. That's why we provide initial and ongoing certified business valuations to our clients as part of our comprehensive approach to wealth management. We recommend an annual valuation so you can be better prepared for the future and more favorably positioned to

achieve all of your financial goals. Based on your annual valuations, we also offer practical guidance and advice for increasing the visible value of your business.

Creating long-term financial security

Helping you develop investments outside your business puts you on the right track for achieving a broad range of financial goals, while minimizing the risks associated with business ownership. We want you to join the 2% Club—those business owners who stay in business for more than 10 years and ultimately leave the business financially strong and on their own terms. Our proven approach to wealth management creates long-term financial security for Main Street business owners like you.

As a successful business owner, you're probably already on the right track for meeting many of your financial goals. However, there are always opportunities for improving your financial strength and creating a more well-defined path for the future. We encourage you to talk to one of our accounting and investment professionals today about your unique vision of what you want to accomplish in life. We also encourage you to ask us for a list of referrals. The best way to get to know Griffiths, Dreher & Evans is to talk to some of our existing clients. Our goals are to answer all of your questions and learn more about how we can put our considerable resources to work for you. It's not about the money—it's about helping you achieve your life goals and living the life you've always imagined for yourself.

About the author: Tom Griffiths is a Certified Public Accountant (CPA), Certified Financial Planner (CFP), is Accredited in Business Valuation (ABV) and is a Certified Exit Planning Advisor (CEPA). He is also the founder of Griffiths, Dreher & Evans, P.S., a Spokane-based certified public accounting & wealth management firm specializing in meeting the needs of today's Main Street business owners. To learn more, contact Tom at 509.326.4054.
