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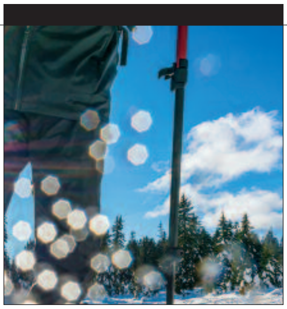

Value Acceleration: The Gas Pedal for the Value of a Business

Clients often intend to fund their retirement through sale of a business; Value Acceleration is intended to increase the value attained through that sale and help ensure a sale occurs.

SETH WEBBER, CASEY KARLSEN, KATY WHITEHEAD, AND CAMERON SCOTT

Consider the following statistics regarding private businesses and liquidating that asset:

- 63% of private businesses are owned by baby boomers.[1]
- Approximately 10,000 baby boomers are reaching retirement age each day.[2]
- 78% of business owners expect to fund 80% or more of their retirement through the sale of their business. [3]
- Only 20% to 30% of the businesses that go to market actually sell. [4]

While many people are retiring each year and counting on the value of their business as part of their retirement plan, a considerable number are unable to actually generate any liquidity beyond normal compensation. They may even have a very valuable business but are not able to convert that value into cash. What a terrible situation! Like a sailor stranded on a desert island—surrounded by water but dying of thirst.

Attaining liquidity from one's business and increasing business value are two topics that go hand in hand. Factors that increase business value often also increase the ease of selling the business, and vice versa.

Businesses are often valued by using an income metric such as EBITDA (earnings before interest, taxes, depreciation, and amortization) and a valuation pricing multiple. The most effective way to increase business value is for the business owners to focus on improving the multiple by reducing business risk. The following are five examples of effective ways to reduce business risk and improve the multiple:

1. Reduce reliance on the owner of the business.
2. Incentivize key employees to sign long-term employment contracts.
3. Diversify the customer base.
4. Create sustainable and recurring revenue.
5. Maintain audited financial statements.

By planning ahead and implementing the above steps, business owners may be in a much better position for retirement. These five strategies are just a few of the ways through which business owners can increase the value and liquidity of their business. The Value Acceleration framework created by the Exit Planning Institute, as presented below, gives business owners a complete set of tools to make their businesses more valuable and transferrable.

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Value Acceleration overview

According to a study by PricewaterhouseCoopers, 12 months after selling, three out of four business owners surveyed "profoundly regretted" their decision.[5] This statistic highlights the importance of the Value Acceleration process, which focuses on increasing value by aligning business, personal, and financial goals. This process prepares business owners for transition, increasing the likelihood of a successful transfer.

The Value Acceleration process has three stages: Discover, Prepare, and Decide. The *Discover* stage is where business owners take inventory of their situation, focusing on risk reduction and alignment of their business, personal, and financial goals. The information gleaned in this stage is then compiled into a prioritized action plan utilized in future stages.

In the *Prepare* stage, business owners follow through on business improvement and personal/financial planning action items identified in the Discover stage. Examples of action items may include the following:

- Addressing weakness identified in the Discover stage, in the business or in personal financial planning.
- Protecting value through planning documents and making sure appropriate insurance is in place.
- Analyzing and prioritizing projects to improve the value of the business, as identified in Discover stage.

EXHIBIT 1

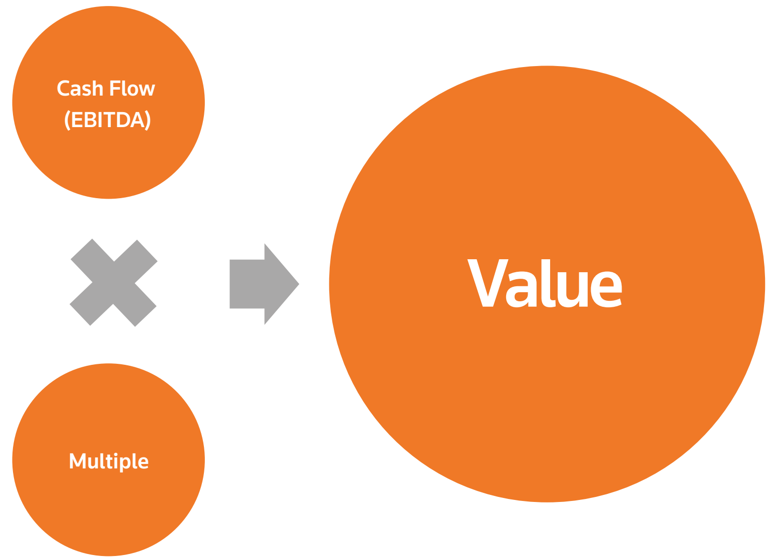
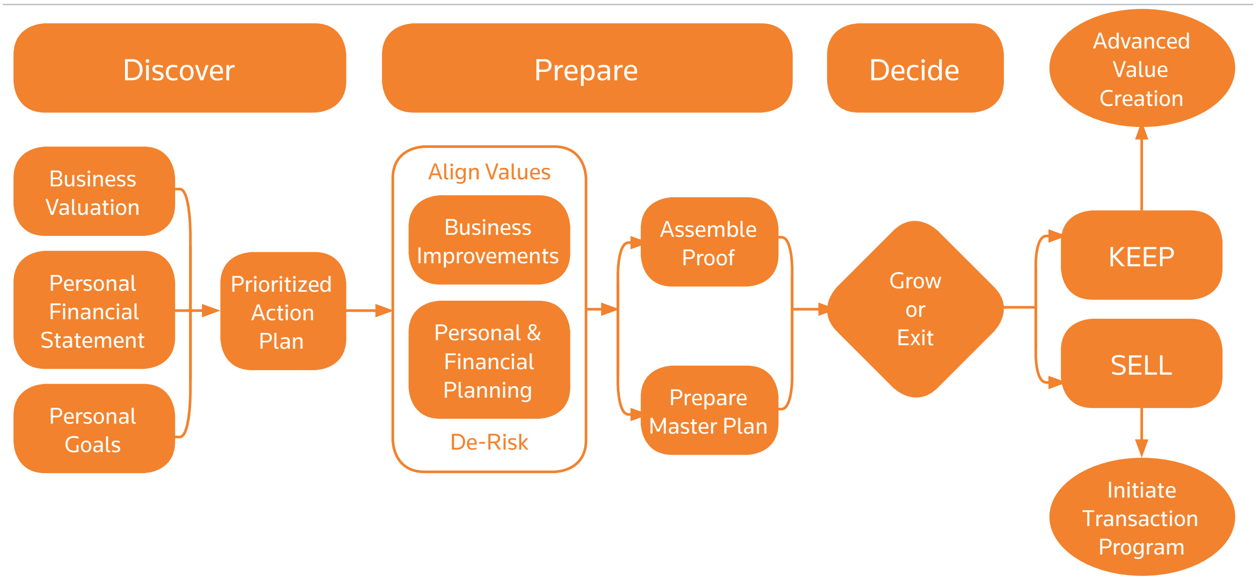


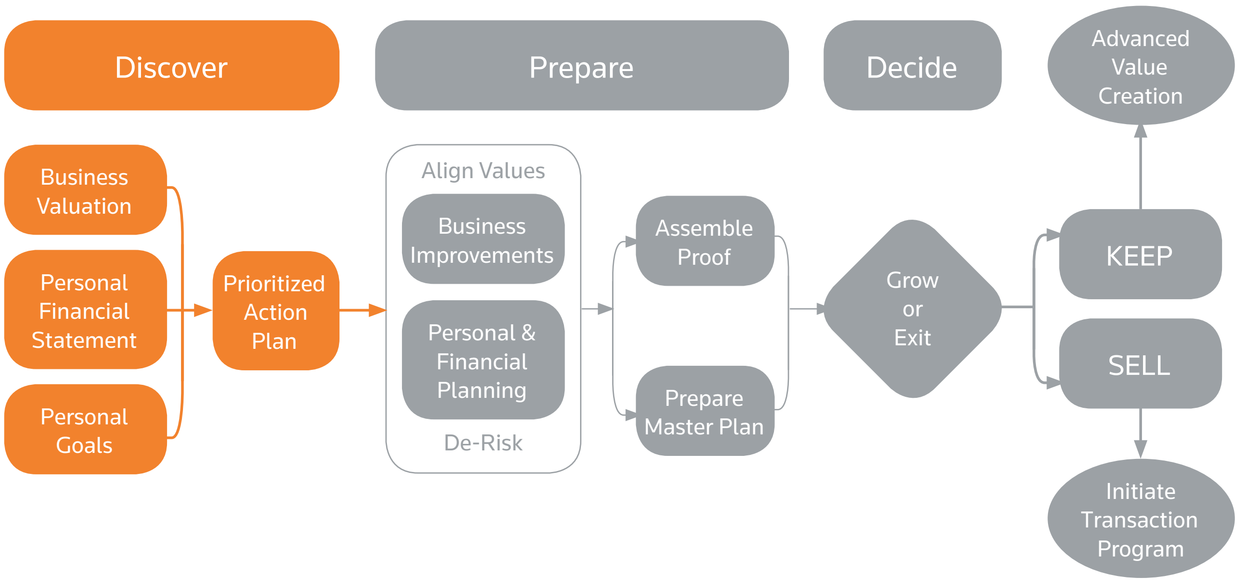
EXHIBIT 2

Value Acceleration Overview



1. Christopher M. Snider, "A Local Market Study: The State of Owner Readiness (Georgia)," Exit Planning Institute (2018).
2. Matthew Frankel, "9 Baby-Boomer Statistics that Will Blow You Away," https://www.fool.com/retirement/2017/07/29/9-baby-boomer-statistics-that-will-blow-you-away.aspx
3. BizEquity, LLC, "About BizEquity," https://www.bizequity.com/aboutbizequity
4. Exit Planning Institute, "The State of Owner ReadinessTM Research," http://exit-planning-institute.org/state-of-owner-readiness/
5. Christopher M. Snider, "A Local Market Study: The State of Owner Readiness (Georgia)," Exit Planning Institute (2018).

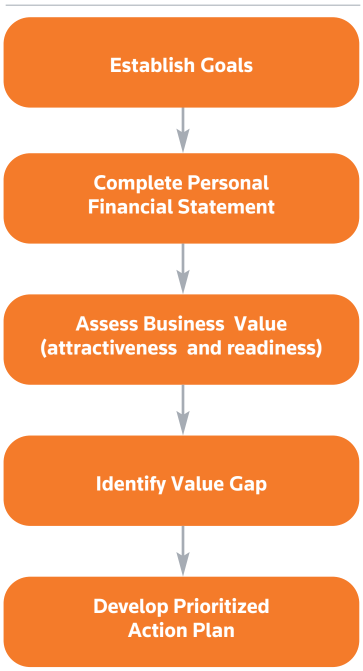
EXHIBIT 3
The Discover Stage



- Developing strategies to increase liquidity and retirement savings.

The last stage in the process is the *Decide* stage. At this point, business owners choose between continuing to drive additional value into the business or selling it.

EXHIBIT 4
General Framework



The Discover stage

The Discover stage of the Value Acceleration process is called the "triggering event." In the Discover stage, business owners take inventory of their personal, financial, and business goals. These three sets of goals are referred to as the "three-legged stool" of Value Acceleration. When taking inventory of their personal, financial, and business goals, owners should note ways to increase alignment and reduce risk.

The objective of the Discover stage is to gather data and assemble information into a prioritized action plan, using the following general framework.

Almost everyone has plans and priorities outside of their business. Accordingly, the first leg of the three-legged stool in the Discover stage is to explore one's personal plans and how they may affect business goals and operations. What comes next in one's personal life? What needs to happen to support these plans?

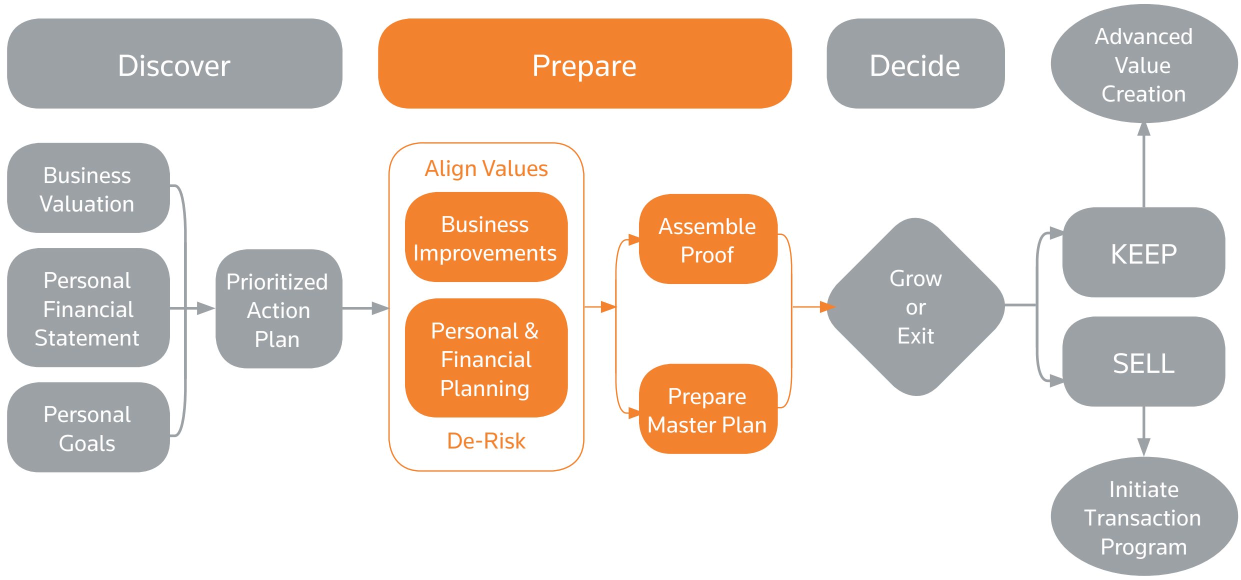
The second leg of the stool is exploring one's personal financial plan, and how this interacts with personal goals and business plans. What does one currently have in investments? How much is needed to fund other goals?

The third leg of the Value Acceleration three-legged stool is business goals. How much can the business contribute to one's other goals? How much is needed from one's business? What are the strengths and weaknesses of one's business? How do these compare to other businesses? How can business value be enhanced? A business valuation can help to answer these questions.

A business valuation is an essential component of the triggering event. A business valuation can clarify the standing of a business regarding the qualities buyers find attractive. Relevant business attractiveness factors include the following:

- Market factors: barriers to entry, competitive advantages, market leadership, economic prosperity, and market growth.
- Forecast factors: potential profit and revenue growth, revenue stream predictability,

EXHIBIT 5
The Prepare Stage



and whether revenue comes from recurring sources.
- Business factors: years of operation, management strength, customer loyalty, branding, customer database, intellectual property/technology, staff contracts, location, business owner reliance, marketing systems, and business systems.

The company's performance in these areas may lead to a gap between what a business is presently worth and what it could be worth. Armed with the information from this assessment, one can prepare a plan to address this "value gap" and look toward the future.

The Prepare stage

In this stage, business owners should regularly ask themselves the top three areas of improvement right now for the business. Ideas for business improvement are often uncovered in the Prepare stage of the Value Acceleration process. The Prepare stage focuses on how to increase business value by aligning values, decreasing risk, and increasing the intangible value of the business.

Align values. Aligning values may sound like an abstract concept, but it has a real-world impact on business performance and profitability. For example, if a business has multiple owners with different future plans, the company can be pulled in multiple competing directions. An example of poor alignment would be if a shareholder's business plans (such as expanding the asset base to drive revenue) compete with personal plans (such as pulling money out of the business to fund retirement). Friction creates problems. The first step in the Prepare stage is therefore to reduce friction by aligning values.

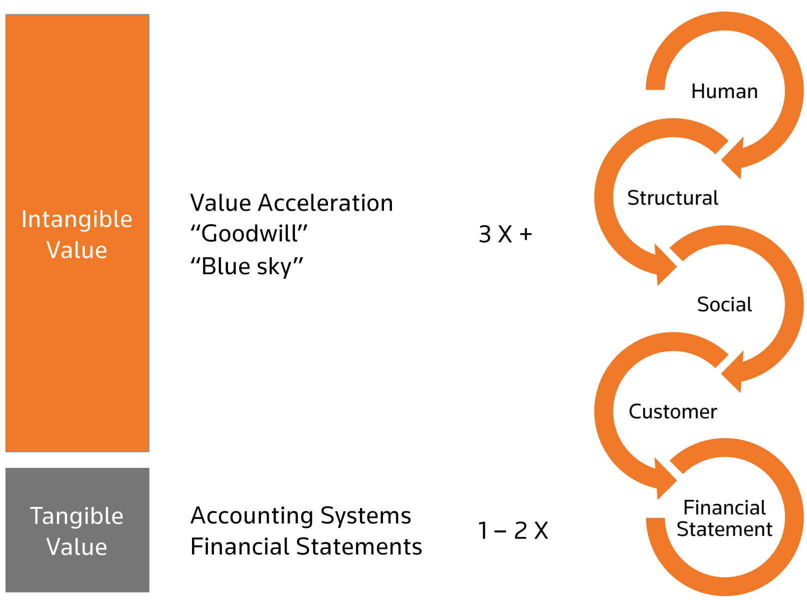
Reducing risk. Personal risk creates business risk, and business risk creates personal risk. For example, if a business owner suddenly needs cash to fund unexpected medical bills, planned business expansion may be delayed to provide liquidity to the owner. If a key employee unexpectedly quits, the business owner may have to carve time away from their personal life to juggle new responsibilities.

Business owners should therefore seek to reduce risk in their personal lives, (e.g., life insurance, time management planning, and the use of wills, trusts, medical and financial directives, and other planning strategies) and in their business, (e.g., employee contracts, customer contracts, supplier and customer diversification, etc.).

Intangible value and the four C's. Now more than ever, the value of a business is driven by intangible value rather than tangible asset value. One study found that intangible asset value made up 87% of S&P 500 market value in 2015, up from 17% in 1975.[6] Therefore, the most effective way to increase business value is to focus on increasing intangible asset value. Specifically, there are four primary drivers of intangible value, which are referred to as the "four C's": human capital, structural capital, social capital, and customer capital. These components

[6] Jorge Franganillo, "Annual Study of Intangible Asset Market Value from Ocean Tomo, LLC" https://www.oceantomo.com/media-center-item/annual-study-of-intangible-asset-market-value-from-ocean-tomo-llc/

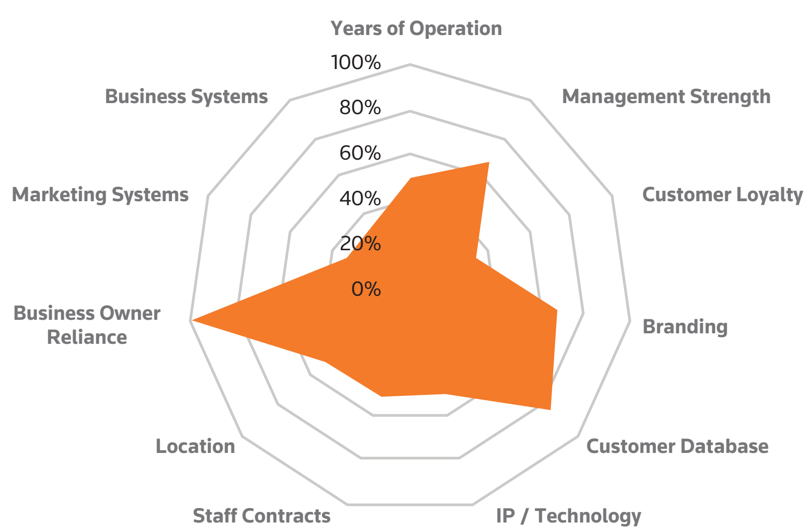
EXHIBIT 6



enhance the transferrable value of a Company and increase the probability of successful transfers.

- Human capital is the intangible value associated with a workforce. Are top-level team members being recruited, trained, and retained?
- Structural capital "captures the knowledge assets within your company, converting that mental process into company property, and therefore makes it transferable."[7] Structural capital includes the knowledge and processes that allow a company to offer a competitive product or service. Structural capital is valuable to potential acquirers of a business when it is documented and transferable.

EXHIBIT 7



- Social capital "represents your culture, your brand, the way your team works, the rhythm of the day-to-day operations and communications, and the way you communicate with customers."[8]
- Customer capital relates to the strength and transferability of a customer base. Factors that make customer lists more valuable include the presence of contractual agreements as well as customer tenure, diversity, loyalty, reliability, and transferability.

One model to diagram company performance on the underlying drivers of the four C's is the exit and succession planning software prepared by MAUS Business Systems (MAUS). Using this model, analysts assess a company's performance in key areas that relate to intangible value.

MAUS then generates a report that includes a series of diagrams like the one in Exhibit 7. Business attractiveness factors are positioned around the outside of a polygon. If a company performs well regarding a particular factor, a point is plotted toward the outside of the polygon. If the company performs poorly, a point is plotted toward the center of the shape. The points are then connected to visualize a company's risk profile. The larger the shape is, the higher the Company's intangible value. This tool is useful for identifying and assessing the areas for greatest potential improvements.

By aligning values, decreasing risk, and improving the four C's, business owners can achieve an increase in cash flow and business value, while securing liquidity to fund plans outside of the business.

Planning and execution. At this point in the Value Acceleration process, business owners have identified a number of action items to increase business value and liquidity. How these action items are introduced and executed may be just as important as the action items themselves.

A hypothetical business owner had a plan to sell her business and start a new one, a bed-and-breakfast on the coast. She earmarked 70% in cash proceeds from the sale to bolster her retirement accounts. The remaining 30% was designed to generate cash for the down payment on the bed-and-breakfast. And the proceeds are stuck in escrow or, worse yet, tied to an earn-out. Now, the waiting begins. When does she get to move on to the next phase? After all that hard work in the Value Acceleration process, she still didn't get where she wanted to go. What went wrong?

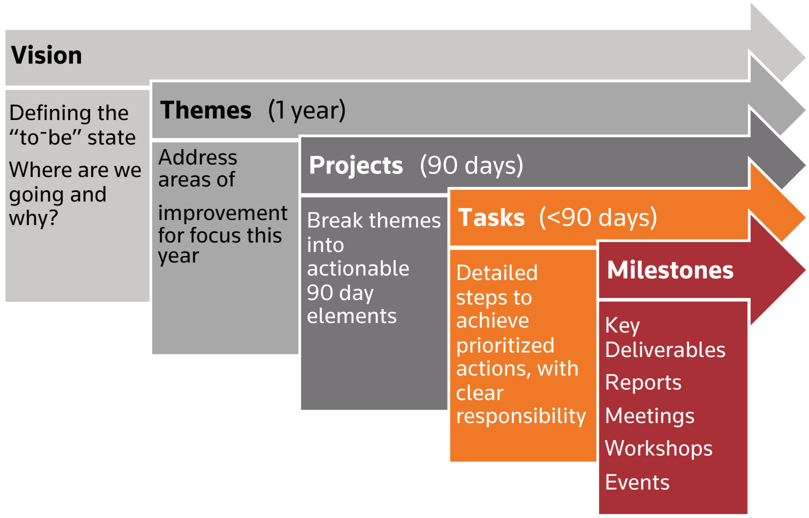
Many business owners stumble at the end because they lack a master plan that incorporates their business action items and personal action items.

Business valuation master plan steps to take. A master plan should include both business actions and personal actions. Master plan business improvement action items may include the following:

- Customer diversification and contract implementation.
- Inventory management.
- Use of relevant metrics and dashboards.
- Financial history and projections.
- Systems and process refinement.

A comprehensive master plan should also include personal action items. Personal goals and objectives play a huge role in the actions taken by a business. As with the hypothetical bed-and-breakfast example, personal goals may influence appropriate exit options and the selected deal structure.

EXHIBIT 8



Master plan personal action items may include:

- Family involvement in the business.
- Needs vs. wants.
- Development of an advisory team.
- Life after planning.

A master plan incorporates many of the previously identified action items into an implementation timeline. Each master plan is different and reflects the underlying realities of the specific business. However, a practical framework to use as guidance is presented below.

The Value Acceleration process requires critical thinking and persistence. A master plan enables business owners to execute action items in an efficient and effective manner.

Decide

In the Decide stage of the Value Acceleration process, business owners decide whether to grow their business or exit, and which liquidity options are available for each path. In a closely held business, ownership means more than business value. To many owners, it is about identity, personal fulfillment, developing a legacy, and much more. The valuation process not only estimates the economic value of a business, it also provides a roadmap for implementing value enhancing strategies.

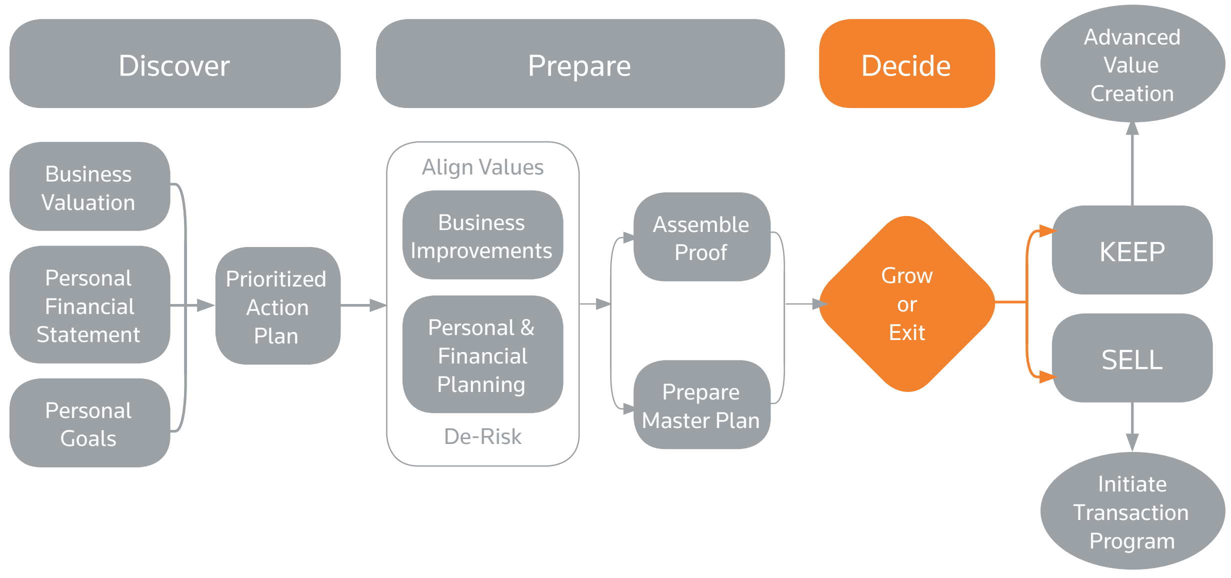
While it may seem counterintuitive, it is best to delay the decision to grow or exit until the very end of the Value Acceleration process. After identifying and implementing business improvement and de-risking projects in the discover stage and the prepare stage (see below), business owners may find themselves more open to the idea of keeping their business and using that business to build liquidity while they explore other options.

Once business owners and their teams have completed the Discover stage and the Prepare stage and are ready to decide whether to exit or grow their business, the conversation is framed around personal and business readiness. Many personal readiness factors relate to what ownership means to each person. In this process, business owners should ask themselves the following questions:

- Am I ready to not be in charge?
- Am I ready to not be identified as the business?

[7] Snider, Christopher M., *Walking to Destiny*, ThinkTank Publishing House (2016).
[8] *Id.*

EXHIBIT 9
Decide



- Do I have a plan for what comes next?
- Do I have the resources to fund what's next?
- Have I communicated my plan?

On the business end, readiness topics include the following:

- Is the team in place to carry on without me?
- Do all employees know their role?
- Does the team know the strategic plan?
- Has risk been minimized?
- Have I communicated my plan?

Whether owners decide to grow the business or exit, various faucets of liquidity are available. If keeping the business, liquidity options may include 401(k) profit sharing, distributions, bonuses, and dividend recapitalization. Alternatively, if one chooses to exit the business, liquidity options include selling to strategic buyers, ESOPs, private equity firms, management, or family.

One topic that often comes up when discussing the sale of a business is the use of earn-outs. In an earn-out, a portion of the price of the business is suspended, contingent on business performance. Earn-outs are most effective over a two- to three-year time period. When selecting a metric on which to base the earn-out (such as revenue, profit, or customer retention), consider what is within one's control. Will the new owner change the capital structure or cost structure in a way that reduces income? Further, if the planned liquidity event involves merging one's company into another company, specify how costs will be allocated for earn-out purposes.

Another topic that often comes up is the use of rollover equity (receiving equity in the acquiring company as part of the deal structure) and the use of warrants/synthetic equity (incentives tied to increases in stock price). Here are some of the key points related to these topics:

- Ensure it is clear how to turn rollover equity into cash.
- Understand potential dilution of one's rollover equity if the acquiring company continues to acquire other targets.
- Ensure the percentage of equity relative to total deal consideration is reasonable.
- Seller financing typically has lower interest rates and favorable terms, so warrants are often attached to compensate the seller.
- Warrants are subject to capital gains tax while synthetic equity is typically ordinary income. As a result, warrants often have lower tax consequences.
- Synthetic equity may work well for long-term incentive plans and for management buyouts.

Conclusion

The Value Acceleration process is a valuable framework for business owners, management, and their advisors as they consider a potential change. Many strategies are available to increase business value and liquidity. How and when these strategies are put into use can be just as important as the steps themselves.

An important part of this process is assessing one's personal and professional goals and how they align with business goals. Through the Value Acceleration process, business owners are able to increase business value and liquidity, giving them control over how they spend their time and resources. ■