

## Strategies to Achieve a Successful Business Exit – Transition Readiness in the SME sector

© 2017 ICMCI & Mike Thompson FCMC, AF;

Associate Professor, Faculty of Management, Royal Roads University, Victoria, B.C.



***“You can check out any time you like but you can never leave”***

Hotel California, The Eagles 1979

### **Introduction**

The objective of this paper is to present an approach that will allow SME (Small and Medium sized Enterprise) owners attain personal and organizational readiness to implement succession planning and transition strategies.

For the purposes of this paper, a SME would typically have revenues in the \$5 – 30M range, be profitable, have single or multiple shareholders and may have a board of directors/advisory board in place.

Many SME owners require objective and pragmatic guidance in navigating the chasm of poor succession and exit planning.

The research within this paper highlights the importance of the SME sector in Canada in terms of job creation and as a driver of economic growth – which is now threatened by an unprecedented demographic shift.

There appears to be a critical window of time where the next generation of leaders/managers in the SME sector have to be identified and placed in order to succeed the wave of retiring business owners of the boomer generational cohort.

In Canada, the Baby Boomer generation spans the birth years from 1946 to 1965 - in 2011, the first wave of baby boomers turned 65 with the last wave reaching 65 in 2030. This generational tidal wave is expected to set off a chain reaction of slower growth, weaker investment returns, government budget pressures and the prospect of inter-generational tensions.<sup>1</sup>

It is interesting to note that on the international stage, Canada has a more profound generational challenge with the retiring boomer cohort comprising 42% of the population at final retirement age in contrast to the UK where 21% is the corresponding figure.

A recent study by CIBC World Markets (Globe and Mail November 2013) indicates that \$1.9 trillion in business assets are poised to change hands over the next five years within Canada. Those companies employ 2 million people and account for a least 15% share of GDP. Yet, based

on the CIBC survey, close to 60% of business owners, aged 55 to 64 have yet to discuss exit or succession plans.

### **The Enterprise Transition Strategy model**

A three stage model has been developed based upon the writer's commercial banking and management consulting experience allied with extensive primary research in the form of interviews with SME owners and their professional advisors.

#### Stage One - The Situation Assessment

Before embarking on a challenging journey, travellers need to review their resources and capabilities to assure successful completion of their planned itinerary. Likewise, today's business owners, facing the potential for retirement and/or new opportunities, will need to critically assess their current resources including personal financial, corporate health and change readiness.

This assessment process will involve the following four action steps:

##### ***1) Detail Key Advisory Resources***

The business owner will need to document both his/her internal and external advisor resources. Internal advisors would include the company's senior management team, board and if applicable, family members.

External resources would include trusted professional advisors such as accountants, corporate lawyers, management consultants, personal financial advisors and commercial bankers.

##### ***2) Complete a Personal Financial Review***

The business owner(s) will have likely built a significant personal net worth as they steadily grew their enterprise from the start up stage to its current mature and hopefully established position. To get an accurate fix on the owner's personal financial situation, the following areas would need to be reviewed with their personal financial advisor and accountant:

- Completion of a current and detailed personal financial statement, recording all personal assets, liabilities, income, taxes etc. This would provide a snapshot of asset diversity and investment portfolio performance.
- Family needs and preferences will have to be reviewed with a frank assessment of the next generation's capacity and capability to assume managerial leadership and share ownership.

##### ***3) Conduct an Organizational Size Up***

The business will also need to undergo a rigorous 'health check-up' which can be accomplished by using the Business Diagnostics 'size up' methodology.<sup>ii</sup>

The following areas would be reviewed:

*The External Size Up* – a current review of high level PEST factors (Political, Economic, Socio-Cultural, Technological) and an analysis of the industry sector’s competitive conditions (Porter’s Five Forces). This review would also consider any market influences and/or trends, current or anticipated which may impact the business.

*The Internal Size Up* – a review of the company’s performance within the key functional areas of Finance, Marketing, HR, and Operations. Also a key consideration here is to detail what actual impact the company founder and owner, has had on the business (sales, innovation, leadership etc.)

*Strategic Direction* – entails documenting the organization’s current strategic pathway (status quo) along with an assessment of other potential directions including one that involves the owner’s eventual planned departure.

*Preliminary Valuation* – at this stage in the transition process, company accountants should be engaged to complete an informal valuation which would be based on the historical and projected income statements. This valuation process will determine the desired sale price range of the business.

This would be a ‘broad strokes’ determination of a value range to ensure that the owner does not have unrealistic expectations as to the company’s expected sale price to either internal or external buyers.

#### **4) *Initiate a Change Readiness Review***

With the company’s leadership transition in play, the final component of the Situation Assessment is to assess the organization’s appetite for significant change and transformation. To evaluate the company’s ‘change readiness’, we have adapted the Drivers for Change model (Anderson and Ackerman) <sup>iii</sup> into the two following areas of focus:

##### **External focus**

- **Marketplace Requirements** – what will be the impact of the planned transition on the aggregate set of customer requirements that determine what it takes for a business to succeed in its marketplace and meet its customers’ needs? Does the CEO have deep and enduring client relationships which may wind down upon the departure of the company leader?
- **Business Imperatives** – what must the company do *strategically* to be successful post transition, given its customers’ changing requirements? Are there any risks associated with the potential for disruptive change within the industry sector that could influence client buying preferences?

- **Organizational Initiatives** – what changes will take place in the organization’s structure, systems, processes, skill base, and staffing to implement an eventual transition action plan.

### **Internal Focus**

- **Cultural Imperatives** – denote how the norms, or collective way of being, working, and relating in the company, must change to support and drive the organization’s new design, operations, and strategy.
- **Leader and Employee Behavior** – collective behavior creates and expresses an organization’s culture. Therefore, as part of the transition process, the new leaders and existing employees will behave differently as they work to re-cast the organization’s culture and organizational design successfully.

### Stage Two - Transition Pathway Review and Selection

#### **1. Do nothing and pray**

##### **Overview**

It is a sad reality that many business owners will do nothing except hope for a serendipitous event whereupon their business is unexpectedly sold and their journey on to new pastures is assured. The potential for such an ‘unexpected buyer’ materializing is remote at best.

This is known as the ‘Hail Mary Strategy’ which inevitably culminates in either a voluntary or forced wind down of the business operations rather than a miracle sale.

##### **Voluntary Wind down**

In terms of potential benefits, this is the simplest exit strategy to implement; all assets are liquidated, cash proceeds are used to pay off liabilities, with the residual proceeds distributed to the shareholders.

There are however, a number of key concerns arising from such a voluntary wind down decision:

- While deciding to wind down the business by a defined date may have some merit in terms of expediency and simplicity, such a process will invariably be demanding and involve the liquidation of fixed and current assets along with the settlement of any outstanding liabilities.
- The resultant cash represents the net equity of the enterprise but there may be significant foregone proceeds due the company not being sold as ‘a going concern’ with an independent buyer paying market value for the enterprise. Client lists, brand and reputation equity, along with supplier relationships would be lost in a liquidation with no opportunity to recover their value.<sup>iv</sup>

##### **The Forced Wind down**

Clearly there are no positives here with this stage being more of a consequence than an action.

The brutal reality is that if the company is neither solvent nor viable, the company creditors will

commence formal liquidation and wind-down will take place through Receivership or Bankruptcy proceedings.

The forced wind down is the most demanding and stressful transition scenario and takes place when a company finds itself assailed by creditors who have the legal right to exercise remedies which may lead to the business closing down.

Causes of such business difficulties are usually attributable to one or a combination of the following factors:

The business owner checks out either physically and/or mentally leading to:

- Managerial or key employee problems.
- Financial difficulties.
- Product and/or market related challenges.
- Poorly recognized external factors such as industry consolidations, adverse regulatory changes to name a few.

Many business owners are caught in the ‘activity trap’ (Steven Covey – The Seven Habits of Highly Effective People) where their ‘busy-ness’ results in constant preoccupation with no thoughts as to the ultimate destination. In effect, their exit strategy is death.<sup>v</sup>

## **2. Sell internally**

### **Family – same/next generation**

There are many attractions in ‘keeping the business in the family’ with the all-important caveat that the successor generation has the inclination and ability to take over the ‘reigns’:

- Assuming the interests of family members are aligned, the timeframe on this type of succession transaction can be quite short, relatively efficient and carry low legal, accounting and intermediary fees.<sup>vi</sup>
- The risk of the underlying deal structure collapsing tends to be low in family business transactions, especially as there is typically less due diligence completed. Also a family owned enterprise will tend to focus on longer term investment decisions, experience great employee engagement (extension of the family) and make more decisive strategic decisions due to the closer links between shareholders and management.<sup>vii</sup>

There will be instances where family business succession may be disadvantageous and lead the owners to explore other transition options:

- A recent Family Firm Institute study indicates that only 30% family owned businesses make it to the 2<sup>nd</sup> generation, only 12% making it to the 3<sup>rd</sup> and a dismal 4% making it through to 4<sup>th</sup> generation and beyond.<sup>viii</sup>
- Inter-familial sales tend to have lower values due to the ‘non-arm’s length’ of such transactions – as a result, the exiting senior family member(s) will typically receive lower cash proceeds as opposed to a sale transaction with external, unrelated parties.

### **Management buy-out (MBO)**

Another internal transition pathway to consider is the sale of the business to a team of senior management who have the determination and resources to continue growing the business. This strategy may be attractive for the following reasons:

- A sale to the management team will typically carry lower legal, accounting fees and may be completed in a relatively short timeframe. The services of a business broker or M&A firm will not usually be required with resultant commission savings in the 3-5% range.
- Management, having had experience in the business and a close working relationship with the outgoing ownership will be more likely to preserve the intangibles like branding, culture, along with enduring client and supplier relationships than an outside buyer.
- To meet the transaction financing requirements, many banks and credit unions, along with organizations like the BDC (Business Development Bank of Canada) can structure loan facilities which can provide a significant portion of the funding required to cash out the existing shareholders and owners. Please refer to Appendix 2 for further details.

Such a buy-out structure can also have significant downsides, which need to be clearly recognized by both the outgoing owner and the incoming management team:

- The corporate strategic vision of the succeeding management team versus the departing shareholder(s) may not be aligned with the potential for conflicts and disputes, especially if some form of 'earn out' or deferred payment structure has been negotiated.
- Due to the sometimes limited financial resources of the MBO team, the funding assistance of commercial lenders/financing may be required to facilitate the transaction. By leveraging company assets, the resultant debt load may impede the ability to raise future working capital financing (operating lines of credit) and therefore constrain future growth.
- Sometimes, the company does not qualify for MBO financing due to concerns around the company achieving sustainable EBITDA and/or lack of supporting collateral from the management team. This leaves the owner with the option of structuring vendor (take-back) financing and perhaps withdrawing surplus cash resources (ensuring that the company's working capital position is not adversely impacted).

### **Employee buy-out (EBO)**

A similar structure to the MBO but involving a broader employee based group, this can be an attractive option where employees may retain their jobs. An employee buy-out, by its very nature, guarantees a high level of stakeholder involvement from employees themselves.

This type of transition pathway is typically difficult to achieve as it will usually have involved some form of past financial distress which may have made other exit structuring options unavailable.

This might be the ‘last resort’ with employees involved to preserve their jobs. Such an employee group will also likely require financing to achieve what will essentially be a leveraged buyout. Potential lenders may be deterred by the complexity in dealing with a larger, more disparate group of borrowers with uneven personal financial resources.

Given there will be more individual stakeholders involved, a host of complex governance issues will emerge, especially the demarcation between the employee leadership (who will perform a quasi-managerial function) and the rest of the workforce.

There may also be significant roadblocks to successful deal structuring if there are union negotiations in progress.

### **3. Sell externally**

#### **The Strategic Buyer**

There are a number of compelling reasons to consider the sale of the enterprise to a strategic buyer who may be a competitor, supplier or a conglomerate seeking to add to its portfolio of diversified companies:

- This option opens up a landscape populated by a wide variety of potential suitors to choose from and rank order in terms of attractiveness and strategic fit.
- Strategic buyers seeking synergies with the target business may find their product/service portfolio to be unique or may be seeking vertical or horizontal integration opportunities within their industry sector.
- If the business has strategic value to the acquirer, there will usually be a ‘goodwill’ premium on the price paid for the business, which is typically the highest of all the transition pathway options.
- In some cases, depending on the sophistication of the sales support selected (C.A firm, M & A specialists), there may be the potential for a bidding war between rival strategic buyers with a consequent enhanced selling price.

There are also some important cautions to consider with a strategic buyer identification and selection strategy:

- A sale to a strategic buyer will typically involve a long timeframe, often nine to eighteen months, or longer if there is a high level of complexity which entails a greater degree of due diligence.
- Disclosure of sensitive or confidential material is also a key issue - Non-disclosure agreements (NDAs) provide some protection but extreme caution must be exercised in maintaining a cloak of confidentiality, especially with employees and other key stakeholders like clients and suppliers.
- As sale negotiations commence, the buyer may endeavor to structure the deal where the seller is bound by an ‘earn out’, a process where a significant portion of the sales proceeds are tied to future annual financial performance (usually pre-tax earnings).

This entails the exiting shareholder(s) being tied to the management of the business – and their proverbial ‘feet being held to the fire’ for a contractual period (one to three years).

- There may also be a ‘vendor take back’ or deferred payment negotiated by the buyer (without financial performance earn out targets) which often involves the exiting shareholders and executive team ‘staying on board’ until the final payments are made. For example, 50% purchase price paid at closing, followed by 25% payable over the next two years.
- It is important that the business is properly positioned for a successful sale to a strategic (or financial) buyer. This would involve the following:
  - Demonstration of professional business planning and forecasting.
  - Identification of the primary attributes and value of the enterprise, for example intellectual property protection or unique sales channels or partnerships.
  - Focus on increasing revenues along with maximized and consistent profitability.
  - Cleaning up the Balance Sheet via surplus asset disposal and liability write offs if warranted.
  - Documenting all important contracts with clients, supplier’s management and employees.
  - Ensuring that management succession and continuity has been addressed so that the buyer has the reassurance that key capabilities and relationships are retained in the business.<sup>ix</sup>

A final key insight is that trust between the buyer and the seller is absolutely critical if the transaction is to succeed – if there is no transparency and commitment to reach a mutually agreeable deal, then the negotiation process will either stall or fail.

### **The Financial Buyer**

Financial buyers are also known as Private Equity Groups (PEGs) who administer funds which invest in various geographic areas and industry sectors. It is estimated that there are 5,000 or so such funds in North America with a focus retiring baby boomer business owners. Minimum EBITDA requirements are typically \$5M with PEGs often executing a ‘roll up’ strategy where they acquire a number of smaller companies in an industry vertical and then consolidate into one larger entity - also known as accretive bolt-on acquisitions.<sup>x</sup>

PEGs will structure their acquisitions with various debt instruments from banks and subordinated debt lenders, with typical transactions underpinned with rigorous financial test covenants including a Total Debt: EBITDA ratio.

The attractions in dealing with a financial buyer are detailed as follows:



- Financial buyers are rarely direct competitors or industry participants – they have a ‘strategic disinterest’ with a primary focus in seeking superior returns on their investment.
- Financial buyers will often move the transaction forward quickly offering a cash deal, in contrast with strategic buyers who may endeavor to structure an earn out or a deferred payment.

There are also some inherent risks in commencing negotiations with financial buyers:

- They may not share the long-term vision of the (exiting) business owners as they focus on a short-term return on investment and their own financially driven exit strategy (perhaps an IPO or sale to larger strategic buyer).
- To optimize their cash investment into the deal, the financial buyer may place a higher emphasis on debt financing to grow the business with resultant increased pressure on the remaining management team and employees.

### **Merger/Strategic Partnership**

In terms of achieving a successful exit, the company owner may elect to merge or craft a strategic alliance with an outside entity as a potential interim step towards a formalized strategic sale. Such a move would confer the following benefits:

- A potential merger partner may pay a premium on merging with or partnering with the company if there are perceived strategic values and synergies.
- Depending on the deal structure, the exiting shareholder may be able to sell 50% of the company and enjoy the upside of the enhanced growth performance of the newly merged entity.
- Even if the merger were to consist of a share swap between each entity (with no cash consideration), the resultant synergies (1+1=3) could position the entity for successful sale down the road to another external player along with an enhanced valuation due to improved pre-tax earnings performance.

There are also challenges associated with such merging or alliance opportunities, specifically cultural and organizational challenges as the two merged management teams strive to reach consensus on strategic and operational direction. Incompatible cultures are cited as the principal cause of failed mergers.

Post-merger integration often will see weakened profit and productivity as valued employees leave the organization as they struggle to cope with new job roles, new reporting relationships and uncertainty as to the future.<sup>xi</sup>

The harsh reality is that there are rarely ‘mergers of equals’ and thus, significant change management issues will need to be recognized and addressed.

#### **4. Grow - and then sell**

##### **Overview**

This transition pathway provides an opportunity for the business owner to take a strategic step back and develop either incoming (external) or upcoming (internal) talent to lead the business. Building ‘bench strength’ through new hires or internal promotions will ensure there is a logical succession process in place along with continued revenue growth before eventual sale of the business to either internal or external parties.

In essence, the business owner ‘moves upstairs’ into a board, oversight role and either redefines the executive team (C suite) via external hires or refreshes the team via internal promotions.

##### **Board chair – redefined C-Suite (external hires)**

The business owner/shareholder makes a carefully defined decision to set up a new governance structure by taking a board seat (providing strategic and operational oversight) and hires a replacement CEO and potentially other new members of the executive team.

This ‘hired gun’ approach is an interim step to eventual sale of the company and shareholder exit and can often result in a refreshed corporate strategic direction and enhance revenue/earnings performance, along with potentially higher valuation multiples.

As with any transition pathway opportunity, there are some downside issues to consider:

- This option does not provide cash liquidity that the business owner would receive by selling the business or winding down the assets of the business.
- A new leader, who will likely want to make executive team changes, will face cultural and organizational challenges in attempting to ensure that the ‘right people are in the right seats on the right bus’.

##### **Board chair – refreshed C-Suite (internal promotions)**

In this scenario, the company owner builds bench strength from within by developing a younger generation management team that will progress to the C suite and allow the older executive team, including the business owner, to take on board oversight responsibilities.

The benefits of this transition pathway include the business owner continuing to work with management he or she is familiar with from the boardroom. There would be few continuity problems with regard to strategic vision as the management team (internally promoted) would already know the strengths and weaknesses of the business.

It is also interesting to note that the boomer generation occupy many senior management positions in companies as well as the company owner(s). This outflow of retiring talent will

have serious macro-economic repercussions both from the standpoint of consumer demand and also business continuity. While Canada continues to enjoy immigration of 250,000 people each year along with employees often electing to take later retirement, these factors may still be unable to offset the demographic impact of the boomer cohort moving through their retirement years.

There may also be inter-generational and cultural challenges as the 'old guard' are supplanted by the younger internally promoted CEO and executive team. This can usually be addressed by an external management consultancy engagement which would use focus groups and surveys to build common ground.

### **Harvest – maximize cash withdrawals**

If attempts to sell the business are problematic or protracted, it may be expedient to maximize cash generation by 'harvesting' cash through the sale of non-core assets (such as real estate) or a defined program of cash dividend withdrawals.

### **Sale of non-core assets**

This pathway would see the streamlining of the business with a sole focus on its core cash generation capabilities supported by lean and concise decision-making and financial reporting. Any non-core assets, such as investments in subsidiaries, a redundant division (which may be attractive to an outside buyer) or real estate holdings would then be sold to generate an infusion of cash. Other assets that could be divested include low margin products and services, high maintenance and low return customers or complete product lines where significant but non-viable development efforts are required.

These proceeds could then be withdrawn by the business owner (mindful of any adverse personal tax implications) or reinvested in the core areas of the business to enhance further revenue/earnings growth as a prelude to an attempted sale.

### **Optimize Cost structure + defined dividend withdrawals**

Another harvesting option is to craft a plan to critically examine the organization's cost structure, reduce operating and margin costs where appropriate and then dividend out surplus proceeds at each year end.

Such a process often takes place when the search for an internal or external buyer has been unsuccessful despite the business having a demonstrated capability in generating attractive surplus cash flows.

There are however some drawbacks which need to be considered:

- The dividend withdrawals which are extracted from the company may have negative tax implications for the business owner given those salaries and/or dividends are taxed more highly than capital gains.
- There is also the risk that dividends, which are ‘foregone’ retained earnings, will leave the business ‘capital starved’ and unable to react to any future operational cash flow challenges.

### Stage Three – Transition Plan and Implementation

Having completed a detailed Situation Assessment (Stage 1) and Transition Pathway Review (Stage 2) the business owner now commences the all-important Transition Planning and Implementation process (Stage 3).

Based on feedback from our primary research respondents, a suggested Transition Plan outline (with implementation steps) follows:

#### **Transition Plan for ABC Company**

- Situation Assessment – key findings
- Preliminary Valuation
- Transition Pathways – best options (2) and supporting rationale

##### Internal buyers (Family/MBO/EBO)

- Readiness assessment and key successors
- Planned ownership and management structure

##### External buyers (Strategic/ Financial/ Merger)

- Strategic positioning plan – to identify potential candidates

##### Grow and Sell (Refresh or Replace c-suite)

- Planned ownership and management structure

##### Harvest and optimize cash withdrawals

- Cost optimization initiatives
- Tax efficient cash withdrawals

- Training and Development initiatives
- Communication plan
- Contingency plan
- Critical path (completion dates) and timelines
- 

This process needs to be accompanied by rigorous sell side ‘Preparatory Due Diligence’ by stepping into the shoes of future potential buyers. This allows the seller to identify critical operational issues and concerns in advance of negotiations and inspire buyer confidence and the avoidance of any unexpected surprises.<sup>xii</sup>

Part of this research project has resulted in a deeper understanding of the nature and characteristics of the professional support that a business owner will require. A review and listing of key advisory firms in B.C is presented in Appendix 3.

## **Conclusion**

A positive outcome of this paper will be increased dialogue around the challenges with SME succession – exit issues via the introduction of the Enterprise Transition Strategy model which will serve as a useful ‘road map’ for business owners to navigate with more confidence and professional support. The various insights will also resonate with families, external advisors and internal management teams.

It is also anticipated that many useful best practices arising from this paper will be communicated within the business community to enhance SME capacity building and performance.

## **Endnotes**

---

<sup>i</sup> Globe & Mail Report on Business November 7<sup>th</sup> 2015

<sup>ii</sup> Business Diagnostics – Evaluate and Grow Your Business. Richard Mimick and Michael Thompson.

<sup>iii</sup> Beyond Change Management – Dean Anderson and Linda Ackerman 2010.

<sup>iv</sup> Robbins, Stever. "Exit Strategies for Your Business." *Entrepreneur* 2010.

<sup>v</sup> Bo Burlingham – Finish Big – Portfolio Penguin – 2014

<sup>vi</sup> Veracap Corporate Finance Limited, *Exit Strategies for Business Owners* 2007.

<sup>vii</sup> Globe & Mail Report on Business – ‘Staying Private’ January 2013.

<sup>viii</sup> Globe & Mail Report on Business – ‘Staying Private’ January 2013.

<sup>ix</sup> BDO – Christopher Porter, Be Prepared 10 things to do to facilitate a transition

<sup>x</sup> Bo Burlingham – Finish Big – Portfolio Penguin – 2014

<sup>xi</sup> Harold Schroeder FCMC ‘The Art and Science of Mergers’ May 2012.

<sup>xii</sup> PWC – Getting what you want for your business