Janmar Consultants Inc.

You Need to Begin With an End Goal in Mind and Build From There

Succession and Exit Planning

Selling a business can be a huge distraction since you not only need to run the business on a "business as usual basis", but you also need to provide all of the due diligence materials asked for by the potential buyer.

Who will purchase your business or take it over and how much will they pay?

Executive Summary

You need to begin with an end goal in mind and build from there – regardless of whether it's a family member sale or a third-party sale.

Nobody lives forever. Everyone is mortal. Accordingly, when you create or own a business you need to bear this in mind. When your time comes or before your time comes what happens with your business? Does it die with you or does it go on? If the business is built to be sustainable it will survive even after you are no longer involved.

It begs the question, who will purchase your business or take it over and how much will they pay? A family member? A third party? If it's a third party, are they a competitor or someone unrelated to your industry? How much will they pay or how will it be valued – multiple of sales, discounted cash flows, asset sale, multiple of Earnings Before Interest, Taxes, Depreciation and Amortization ("EBITDA") or another basis?

To sell your business it needs to be planned and the business needs to be groomed for the sale. You will leave significant value on the table if you wake up one day with a knee-jerk decision to sell your business. Additionally, you will realize better value if you are not actively selling, but an unsolicited bid comes in.

Selling a business can be a huge distraction since you not only need to run the business on a "business as usual basis", but you also need to provide all of the due diligence materials asked for by the potential buyer. Most of the preparation of these due diligence materials comes from the finance team and hence this puts a lot of pressure on them.

A Chief Financial Officer ("CFO") can be a huge asset when the sale of a business occurs, especially if they have been involved in the previous sale of a business. Their knowledge and experience of the sale process, including the due diligence process, combined with your intimate knowledge of your business, will allow you to realize the successful sale of your business on the most advantageous terms. If you can't afford or don't need a full-time CFO, a part-time CFO is the next best option for minimal cost in relation to their experience. The sooner you act the better prepared you and your business will be!

Who will purchase your business or take it over and how much will they pay?

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Introduction

We have all made a significant purchase – a house, a vehicle, furniture for our house, etc.

When doing so we need to weigh the excitement of the new purchase with the negative aspects of the purchase – the cost, and how are we going to finance it (cash, a loan, etc.).

The same thing happens when someone is acquiring a business – they need to weigh the excitement of the purchase with what it will cost them. This includes new liabilities both known and unknown, and how they are paying for the purchase (cash or additional debt).

Maximizing value for a business is all about making it look as attractive as possible. Leading up to the sale of a business, if possible, you do not want to have any normalizing or non-recurring adjustments or as few as possible (non-recurring or normalizing adjustments are adjustments to the past earnings of the business based on the premise that these events will not occur going forward). These adjustments will only lead to a discussion with the new owner and more than likely a decrease in the amount paid. Once the sale price has been established you also don't want any surprises that could derail the sale.

Maximizing value for a business is all about making it look as attractive as possible

Normally, the purchase price is based on historical earnings. The more volatile the historical earnings the lower the purchase price. If future earnings are included in the purchase price the discount is normally higher as these results are not guaranteed.

You will need an advisor to assist you with the sale of your business. You need to make sure you select them based on what is important to you:

- Highest sale price
- After-tax cash
- Retention of employees after the sale
- The business continuing as it is after the sale

Choosing the wrong advisor will cause nothing but frustration and heartache, or worse result in no sale.

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Considerations When Selling a Business

When selling your business there are a few things to consider. The sooner these items are dealt with the better it will be for a potential sale and the less complicated it will be to put them in place.

Some major considerations are the following:

- **What ownership structure is right for you?**
- **What should you do with any real estate related to the business?**
- **What is intellectual property and how is it impacted by a sale?**
- **What type of pension plan is right for your business?**
- **How are major contracts or agreements impacted by a sale?**
- **Do you need to do budgeting and forecasting?**

All of these items are different for each business and need to be considered.

Ownership – Proprietorship, Incorporated Business With Shares, Stock Options?

A proprietorship is an unincorporated business and there is no distinction between the business and the owner personally from a legal and tax perspective. An incorporated business is a separate entity from the business owners from both a legal and tax perspective. It also provides additional protection from the perspective of liability.

We would always recommend an incorporated structure as it is more flexible and allows more options on how to pay out proceeds of a sale process.

For an incorporated business if there is one shareholder this is the simplest structure as there is only one person that makes all the decisions and receives all money from a sale.

If there is more than one shareholder, is there a shareholders' agreement and does it address the sale of the company. If not, it should. It should also cover what happens if additional cash is required in the business. The shareholders' agreement also needs to cover what happens if all shareholders do not want to sell. What is the process to follow? What is the valuation method when succession/exit occurs? This should also cover if an exit occurs due to the death or terminal illness of a shareholder.

The other consideration when selling a business is are there any employees you want to reward with part of the sale proceeds. Alternatively, are there people that are expecting to be shareholders or people that you need for the sale and should be rewarded. These people can be rewarded with stock options. **To properly structure these stock options, you should check with your advisors to ensure you follow the applicable tax laws as they do change from time to time.**

Real Estate

First recommendation we make is if you own the property your business is located on, it should be in a separate company from the operating business.

This way it is protected so that if anything negative ever happens to the business the real estate is protected. Normally it is a significant asset and very seldom does real estate go down in value. Retaining this property is a good way to have retirement income once the business is sold.

If the plan is to sell the real estate as part of the sale you should have an appraisal done so you know exactly what the property is worth and not have either you or the purchaser trying to guess what this value is. You should also perform a Phase 1 environmental assessment which will make sure there are no environmental issues with the property that will impact the value.

Some purchasers will view owned real estate as a negative to a sale transaction, unless the property is critical to the business' operations. You may need to either dispose of the property or retain ownership of it and lease it to either a new business or the purchaser. Many purchasers want to realize efficiencies in administration, etc. so having real estate that ties them to a certain location can be seen as a negative. Accordingly, owning it in a separate legal entity from the operating business provides the most flexibility when it comes to a sale.

A purchaser will want certainty and flexibility with respect to operating the business once they acquire it, and hence they will not want any agreements in place that constrain them from operating the business the way they want. If you own the real estate related to the business and it is leased to the operating business, you need to make sure it is not seen negatively by a purchaser. For example, is a long-term lease of more than 5 years a good idea?

If selling real estate with a sale transaction have an appraisal and Phase I environmental performed.

Intellectual Property

Intellectual Property ("IP") is an intangible asset that has no physical form or substance but has value and hence is an asset of the business.

Many businesses have registered patents, trademarks, copy rights, etc. that legally protect them from other businesses using their knowhow.

Does your business have anything like these that have been developed that can be legally protected? It will cost you some money to protect this, but it may have significant value in a sale transaction. If your business has specific IP related to its operations, a purchaser will want to know this IP is protected so competitors can not use it to their advantage.

Another benefit to developing IP is the Canadian government provides preferential tax treatment to research and development done by a business through the SR&ED program. Check with your adviser as to how this can benefit you and your business.

Pension Plans

Your pension plan should be a defined contribution plan, not a defined benefit plan. This will ensure there are no unfunded liabilities that may have a significant impact on the business' sale price.

Contracts and Agreements

As part of the sale preparation you should make sure you have copies of all contracts and agreements related to the business. They should also be reviewed to see what covenants they contain. Are there any change of control clauses and what is the impact on the business? Can the new owner extend the contract, or does it remain in place on a sale?

Are there any significant customers or sole sourced suppliers and if so, what is their opinion of your business? The purchaser will want to speak with any significant customers and suppliers, so you need to ensure these relationships are solid. For significant customers (over 20% of overall sales) can you decrease your dependency on them? For any sole sourced suppliers, you need to find a secondary supply source. This is just good business advice whether you are selling or not.

Forecasting and Budgeting

Does your business forecast and budget? Do you track how you perform in relation to these forecasts and budgets? Do you achieve your forecasted results?

If you consistently achieve your budgets and forecasts potential purchasers will gain confidence in your business and what you say it can and will do. The business also needs to have more people driving it forward than you, the owner. **The more involved other people are in the business the more confidence a purchaser will have that the business will continue to successfully operate when you are no longer involved.** If you are the main driving force in the business, the risk of removing you from the business can be mitigated if you are willing to stay involved for a transitional period of time after the sale.

Achieve your budgets and forecasts, and potential purchasers will gain confidence in your business and what you say it can and will do.

Ideally, to maximize value, the business should show increasing profits and cash flow over the last few months and years leading up to a sale. If not, as discussed previously, these normalizing events need to be explained to provide the purchaser confidence they will not recur going forward.

What is Due Diligence and How Does it Impact a Sale?

Due diligence is the process a purchaser follows to ensure that what they have been told is supported by fact. Normally a purchaser will engage their own due diligence teams for this – analysts, accountants, lawyers and industry specialists.

It is normally a very stressful and time intensive exercise that is a huge distraction when you are trying to have the business function as normal as possible during a sale process.

Normally as part of a due diligence exercise a data room is created. Examples of items that will be included in the data room are as follows:

- Articles of incorporation, by-laws and minute books
- Minutes of all board meetings and board resolutions
- Copies of board and management presentations
- Property deeds and leases, regulatory certificates and permits, environmental reports
- IP listings – patents, trademarks, copyrights
- Fixed asset listings with net book value
- Details of insurance and claims history
- Customer and supplier contracts
- Listings of top customers and suppliers with contact details
- Loan agreements and lien searches
- Employee contracts, key employees including pension and severance obligations
- Audited/Reviews/Notice to Reader financial statements for the last 3 years
- Audit letters and recommendations
- Tax returns and HST returns for the last 3 years
- Budgets/Forecasts and actual results for the last 3 years
- Detailed accounting policies and procedures
- Details to support that all government remittances are up-to-date and details of any audits for same – HST/PST/GST, employee deductions, corporate income taxes
- Details of commitments and contingent liabilities
- Competitor(s) analysis
- SWOT analysis (strengths, weaknesses, opportunities and threats)
- Details of bank accounts, loans, mortgages, etc. and contacts for same

You want one person responding to the questions as they come in, to make sure all information ties together. If not, it could cost you significant value.

You need a thorough understanding of the business to prepare due diligence materials and to know what should and should not be placed in the data room for the purchaser and their advisers to review. You also need to be very careful about who interacts with the purchaser. We have seen many sale transactions fall apart due to too many people responding to due diligence questions as the focus was on responding to the questions and not making sure the information was correct. For example, a simple question like who are your top 10 customers can have more than one answer? Is it based on sales dollars, sales volume? If based on dollars is it in Canadian dollars or US dollars?

Ideally you want one person responding to the questions as they come in, to make sure all information ties together. If not, it could cost you significant value.

Lastly, don't worry if all requested due diligence items are not provided. Very seldom are all provided – just make sure the important ones are. If you are missing some minor agreements don't worry, but make sure you have the important ones.

As touched on before, do not underestimate the impact a sale process can have on your employees and your day-to-day business. There is a real danger the focus on the sale will defocus your staff from their normal routines. You should consider bringing in an outside contractor/professional to manage the project internally.

Lastly, not all potential sale transactions are successfully concluded. The last thing you want is a failed sale transaction and your business negatively impacted as a result of focussing on the potential sale.

How a Part-Time CFO From Janmar Consultants Can Help Maximize Your Sale Value

First and foremost, one of the criteria of becoming one of our part-time CFO's is experience in merger's and acquisitions and the sale of companies. This gives you the advantage that you will have an experienced person on your team that has "been there, done that", as opposed to being in uncharted territory.

They will understand what is required and can help assist or even lead your team through the process. They will ensure the process is managed efficiently as well as minimize the challenges and minimize advisors' costs, so you keep as much of the purchase price as possible. They will also help create credibility with the purchaser which will minimize the risk of the purchase price being negotiated downward. Some of what a part-time CFO will do is as follows:

- Protect shareholder(s)' interests in accordance with the shareholder(s)' agreement
- Identify costs that can be eliminated or reduced to maximize profit and hence value
- Help develop plans and incentives to retain key management personnel
- Determine how best to hold property such as real estate – own or lease
- Ensure Intellectual Property is protected where possible
- Be the lead on compiling all necessary due diligence materials to minimize the disruption to the business
- Ensure there are current copies of all contracts, agreements, etc., the company is compliant with them and what, if any, impact a sale will have on them
- Identify any significant customers and suppliers, and assist with mitigating risk related to same
- Ensure the forecasting process is in place and that budgets and forecasts are realistic
- Ensure compliance with all government requirements (i.e. Corporate taxes, employee deductions, GST/HST/PST)
- Provide you with advisors to help with the sale process (i.e. legal, corporate finance)
- Assist with the preparation of all sale process materials and presentations

Conclusion

If succession or exit planning is important to you as a business owner, the most important thing is to ensure your vision is realized. Is it highest sale price, after-tax cash, retention of employees after the sale, the business continuing as it is after the sale, or something else? The main thing is to ensure the entire business is aligned to achieve this goal.

A part-time CFO from Janmar Consultants can help make your plans become reality by minimizing the stress and burden a sale process can place on you and your team. Our team of experts have successfully navigated these waters before to the benefit of all stakeholders, and they will do the same to your benefit.

To minimize the risk of a price reduction and maximize the sale price, you need to convince the potential purchaser that your business is under control and will continue to operate as well or better after the sale. Ideally, you want the purchaser to think they can run it better than you have or can. This is done through the preparation and supply of accurate and timely information including presentations, meetings, reports, forecasts, budgets, actual results and all other due diligence materials.

Contact us today to book your free one-hour consultation to see how we can help you realize your dreams.

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