Northwestern Mutual
Wealth Management Company™

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Does Value-Building Equal Exit Planning?

Every day, we work with owners to build sustainable value in their companies. Some of these owners build value to make their companies more profitable, others build value with an eye on growth, while still others want to use systems that build value to become more organized. These are great reasons to build value, but we look at building value a little differently, because in Exit Planning, we take a longer view and help business owners prepare to exit their companies when they choose and for the amount of cash they desire.

Although building value is not the crux of Exit Planning, it is a necessary and principal part of every owner's Exit Plan. In turn, Exit Planning provides the context for building value. In other words, building value serves many masters, the most important of which is allowing owners to reach their ultimate goal of converting their lives' work into the post-business lives they desire.

When we talk about building value in the context of Exit Planning, we ask the following questions:

1. What is the company's current value?
2. What value must the company achieve to enable its owner to reach his or her lifetime income and other Exit Objectives?
3. Which tactics can owners employ to close any gaps between today's business value and the value they need upon exiting?
4. How can owners transfer business value most efficiently (in terms of taxes and otherwise)?

To answer these questions in an Exit Planning context, consider the case of Peter Daniels, a fictional business owner. Peter is 58 and married to Pam, who also is 58. He is the sole owner of Daniels Food Processing Inc. and has a salary of $250,000. His Exit Objectives are as follows.

- Exit at age 63 (five years from now).
- Post-exit income of $200,000 for 30 years. (Please note: Owners tend to underestimate the future amount of annual income they will want and need. In doing so, they set themselves up for a disappointing post-exit lifestyle. In Peter's case, he used a financial planner to arrive at a realistic income goal.)

Peter has no specific successor in mind. Now, consider the status of Peter's company, Daniels Food Processing Inc.

- Annual cash flow of $250,000
- Estimated current value of $1–1.25 million, as calculated by a business appraiser.

To finance the Daniels's post-exit income needs, given the number of years they want income and their assumed rate-of-investment return (7%), Peter needs to sell his company for $3–3.5 million to net $2.5 million. Thus, Peter must increase the value of his company by at least $2 million if he is to exit on his terms.

In Peter’s case, the Two Million Dollar Question is “How can Peter increase the value of his company by $2 million over the next five years and thus close the gap between the business value he has and the business value he needs?”

1. What is the company’s current value?

Based on an industry rule of thumb, Peter thought he knew his company’s current value. In Exit Planning, because the company’s current value is a cornerstone of the work to follow, guesses and assumptions about value are grossly inadequate. Owners must retain valuation experts to establish at least a thumbnail valuation to know what their companies are really worth.

2. What value must the company achieve to enable its owner to reach his or her lifetime income and other Exit Objectives?

In creating an Exit Plan, owners quantify the amount they will need to support the post-exit lifestyle they desire. Usually, they work with a financial-planning professional to establish the “working assumptions” that Peter established above (life expectancy, the future value of non-business assets, and rates of return on investments). Owners also must ask and answer hard questions about how lavishly or simply their post-exit lifestyles will be. Without an accurate and realistic assessment of where an owner is and wants to be, it is difficult to develop and implement any plan.

3. Which tactics can owners employ to close the gap between today’s business value and the value they need upon exit?

Only after determining the size of the gap between current and desired business value does it make sense for owners to decide what needs to be done to close it. Understanding how far one has to go within a specific time frame provides the context for achieving one’s goals. Without a time frame, most owners will not take the sustained action required to accomplish what is needed, instead pledging to plan right after “this crisis,” “this major project,” or “this busy season.” However, these pledges are rarely kept.

The time frame inherent in the gap analysis creates responsibility: It requires self-discipline, and each small step is subject to the accountability that we teach our children but fail to practice when it comes to Exit Planning. By using gap analysis as the foundation for Exit Planning, owners can identify and implement specific actions that will increase the value of their companies. While there are myriad value-building actions from which owners can choose, the most critical are those that enable a business to operate successfully without its owner's involvement. These include the creation of a stable and highly skilled management team, understanding and using current financial information to track and alter company performance, and the installation of sustainable, organization-wide systems.

An Exit Plan also should include collecting, interpreting, and using the data necessary to track progress toward an owner's goal. Tracking may include monthly, quarterly, and annual cash flow projections, as well as the creation of an annual business plan.

4. How can owners transfer business value most efficiently (tax and otherwise)?
Good Exit Plans view value-building and all other activities through an income-tax lens. Owners use every legal strategy and tactic to minimize taxes while they earn money, grow value, and transfer that value. Because taxes skim off value that takes decades to create, it is far more effective to act with a grasp of current and future tax consequences. Owners should use knowledgeable advisors long before the eventual transfer of their companies in a way that limits the tax burden (as far as legally possible) for both the owner/seller and the buyer.
Exit Planning's value-building tools can close the often significant gap between a company's current and desired values. We are eager to help you figure out whether you are facing such a gap and if so, quantify it and help you close it.

If you'd like more information about how we can help you increase the value of your business in the context of planning your business exit, please contact us.

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Any examples provided are hypothetical and for illustrative purposes only. Examples include fictitious names and do not represent any particular person or entity.