TAX & WEALTH ADVISOR ALERT: CREATING A SUCCESSFUL SUCCESSION PLAN: VALUE

A successful succession plan maximizes the value of the business in order to take care of the people the owner cares about. Of course, that raises an important question: “What factors maximize the value of a business in transition?” That question leads to another important question: “Why does a buyer want a particular business?” The answer to this question is of course that the buyer wants a business that will produce sufficient post-transfer cash flows to provide the buyer with (1) sufficient cash to service the debt or equity raised to facilitate the purchase, and (2) earn a rate of return commensurate with the risk of the purchase. Essentially, a buyer wants a business where post-transaction cash flows are projected to grow. With that in mind, here are some of the factors the buyer will find important:

1. A large, diverse customer base – the more customers that are producing the revenue that leads to cash flow, the safer the cash flow will be to the buyer. Contrarily, if the revenue comes from fewer customers, the riskier the replication and retention of the cash flow, and the less the buyer will be willing to pay.
2. Available capacity – the more the business’s revenue can grow from the current capital and people, the more the buyer will be willing to pay. The reason, of course, is that any growth in revenue should lead to a commensurate growth in profit. On the other hand, if revenue growth will require substantial investments in people and capital, the less the buyer will be willing to pay.
3. Innovative product or service – the more unique and valuable the business’s product, the more the buyer will be willing to pay. If the product or service is easily replicable by competitors – or worse, is viewed by the marketplace as a commodity – the less the buyer will be willing to pay.
4. Is the owner Michelangelo? – The question I often ask my succession planning clients is, “how much would you pay for Michelangelo’s sculpture studio?” The answer, of course, depends on whether Michelangelo will continue to sculpt. If so, you would pay top dollar (presuming Michelangelo will not demand all of the profits in compensation for his unique skills). If not, you would pay nothing. Likewise, if the cash flow depends on the skills or relationships of the seller, the buyer will pay less. If, on the other hand, the revenues depend on the talents and relationships of the team the seller has built, the buyer would be willing to pay full value presuming that team is willing to stay.
5. Age of the capital and/or team – if the revenue-producing equipment and/or people are getting too old to be counted on for the long term, and as a result the revenue generation capabilities of the business depend on finding and investing in new equipment and/or people, the buyer will be willing to pay less than if the equipment and

team have a long useful life.

6. Do the financials tell the true story? – Again, the buyer is purchasing future cash flows, and certainly the best indicator of those cash flows is the business's historic revenues and profits. Oftentimes, the seller has used the business checkbook to pay for personal items, and when that has happened, the seller will seek to add back expenses to cash flows to "normalize" expenses; in other words, to show the buyer what the business is expected to produce when run as a business, not as part business, part personal checkbook. The problem is, the more add-backs the seller applies, the less credible the books become to a sophisticated buyer (not to mention the greater the perceived business risks for a company that was not run compliantly).

With these value drivers in mind, for a seller looking to transition his or her business, it is important to audit these factors and, if possible, remedy the weaknesses. If the owner can better empower the team, report expenses accurately, and focus more on customer diversity, the seller can potentially add 20-25% to the purchase price. And, of course, the time to start addressing these concerns is 3-5 years before the business is to be sold. Any time later than that has a much lower probability of success.