



# Exit Planning and Business Value

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The Value of a Business or Professional Practice (Enterprise) will influence the funding requirements needed to meet the retirement or estate planning needs of a Principal (or their families).

To date nevertheless correctly ascertaining the value of a Business has rarely been initiated with much forethought to any Enterprise Exit Strategy.

What follows is an overview of Enterprise Succession Valuation items in respect to Business Financial Planning that need to be considered in the context of a Principal planning to exit a Business or Professional practice in the event of Retirement, Illness or Death post Ripoll.

## 1. Enterprise Model

Review the Enterprise Model to ascertain how best to maximise wealth from the Business.

**Implication:** Depending on the Enterprise Model wealth can be maximised from an Enterprise either during the Enterprise lifecycle or on sale of the Enterprise Entity or a mixture of both. Nevertheless few Principals fail to understand this basic concept and therefore

mistakenly prepare their exit plans against wrong strategies until it is too late.

**Action Required: Correctly ascertain the correct Enterprise Model and Maximise Wealth accordingly.**

## 2. Perceived Value

Many Principals believe that their Enterprise is valued higher than the Actual Value.

**Implication:** If the Actual Value of the Enterprise is lower than the Perceived Value of an Enterprise a shortfall of Capital may occur to fund the retirement income of a Principal or the estate planning needs of a Principal's family in the event of death or disablement.

**Action Required: Overcome the perception of Perceived Value by correctly ascertaining the value of the Enterprise.**

## 3. Planning the Enterprise for Exit

Plan and prepare the Sale of the Enterprise.

**Implication:** Unless correct planning and preparation is undertaken over a period of time maximum value from the sale of the Enterprise may not be achieved.



**Action Required: Correctly plan and package the Enterprise for Exit**

#### **4. Preparing the Exit of the Enterprise**

**Implication:** Many Principals spend very little time preparing the Enterprise for sale and thus try to sell the Enterprise with improper accounts, employee or taxation liabilities or debt obligations that impinge on the value of the Enterprise.

**Action Required: Prepare the Enterprise for sale by removing impediments that hinder the Value of the Enterprise.**

#### **5. Timing**

Time the sale of the Enterprise Correctly

**Implication:** Timing the Sale of any Enterprise will impact the Value of the Enterprise. If an Enterprise is sold in tough financial conditions the value achieved maybe lower than what could have been achieved in an environment where market conditions were excellent.

**Action Required: Plan the timing of the sale of the Enterprise.**

#### **6. Prepare and Plan for all Exit Events**

Business Succession Planning involves planning for retirement and the contingent events of death or disablement.

**Implication:** Unless all the exit events including retirement, illness or death

are funded a capital shortfall will occur. Whilst this issue maybe stating the obvious few Business Succession Strategies involve planning and funding all three exit events.

**Action Plan: Plan and Fund for all three exit events - retirement, illness or death.**

#### **7. Select the Appropriate Valuation Method**

**Implication:** In respect to exit strategies there are three basic formulas that may be followed.

##### **7a Set Value**

A set value agreed between parties appears to be relatively simple approach to establishing an Enterprise Value.

**Implication:** Many Principals (especially in the early years when the prospect of engaging a business Valuer or accountant is financially daunting) decide to estimate a value for the Enterprise themselves. For example, two Principals may estimate that the Enterprise will be valued at \$100,000 should any transfer event occur. This methodology is simple and inexpensive; it works when the estimated amount agreed upon is one the remaining Principal could raise, if necessary, to buy out a departing Principal. Seldom is this method fair to all parties when the business interest is valuable; nor is it one the Australia Taxation Office (ATO) is likely to embrace!



It is typically used when:  
1) Enterprise value is minimal; and 2) the exit event is a) funded by life insurance or b) small enough that the ownership interest payout can easily be funded through future business cash flow (for example, a minority owner with only a 10 percent interest exits). This valuation approach may be “better than nothing” in the early years of a business, but a successful Enterprise is likely to soon outgrow such a method.

**Action Required: Utilise the Set Value Method in an early start-up Enterprise where a formula or set market value maybe difficult to achieve.**

#### **7b Formula**

A pre-established formula to determine the value of the Enterprise should a transfer event occur is a second common valuation method. Formulas are as varied as the Enterprises that create them, but they generally fall into three categories: book value at the time of transfer, some multiple of cash flow (or EBITDA) or a combination of the two.

**Implication:** The formula approach is relatively straightforward and inexpensive to use – as opposed to one requiring a formal Enterprise valuation. A primary disadvantage can be that the ATO may not be bound to accept the value – even if pre-stated in an agreement. In addition, rapidly changing.

circumstances, in or outside of the Enterprise, which dramatically affect value are not “built in” to the formula. As a result, depending on the circumstance, either the buyer or the seller can be disadvantaged (one paying too much or one receiving too little) if an exit event occurs requiring a purchase and sale.

**Action Required: If utilising a formula method for valuation purposes seek advice on whether the formula approach is appropriate in the circumstances.**

#### **7c Fair Market Value**

The last common valuation method is to require a business valuer or an accountant, at the time a transfer occurs, to establish a Fair Value for the Enterprise utilising valuation standards and procedures stated in an agreement.

Many Principals prefer this method over the others because it captures the value of the Enterprise at the time of the transfer and buyers don't overpay and sellers get what they deserve. Nevertheless it has the potential for a shortfall in capital.

**Action Required: Utilise a fair market value method with appropriate funding arrangements to prevent capital shortfalls.**



## 8. Agreement in Advance

Disputes occur unless Agreements are not made in advance.

**Implication:** As difficult as it may be to decide the valuation method which may be used in all transfer events, arrangements to agree after an event may be more difficult. The buyer will naturally want the lowest value and the seller the highest value. This conflict can all too easily result in anger, legal expense and valuation expense.

**Action Required: Agree on the Valuation method in advance.**

## 9. Terms

No matter the type of valuation method chosen for an Enterprise the terms of payment will need to be considered. The co-Principals will decide how much time the buyer will

have to purchase and what down payment will be necessary. The co-Principals may decide that the interested buyers will have to personally guarantee on unpaid amounts. Will those unpaid amounts carry a minimal interest rate, the prime rate or the rate the Enterprise is charged by its bank? What penalties will be imposed for late or non-payment? All of these terms should be clearly stated within any agreement.

## Conclusion

Unless the Enterprise Valuation issues are considered underfunding in the event of Retirement, Illness or Death of a Business Entity could occur. To correctly advise and participate in ili programmes and resources in respect to their Exit Succession strategies visit the ili website [www.ili.com.au](http://www.ili.com.au).

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