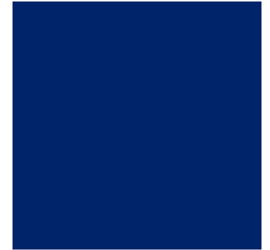
BUSINESS TRANSITION PLANNING

A guide for entrepreneurs



Exit your business with confidence

BUSINESS TRANSITION PLANNING

A GUIDE FOR ENTREPRENEURS

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GREAT OPPORTUNITIES

Canada will see a major shift in business ownership in the coming years as the baby boomer generation moves to retire. Three in five owners of Canadian small and medium-sized businesses are 50 or older, and many are already thinking about selling or passing on their companies.

A staggering trillion dollars of Canadian business assets—over half of Canada's gross domestic product—could be transferred to a new generation of owners by 2020, according to a 2011 survey by the Canadian Federation of Independent Business.

Such a massive ownership shift means great opportunities—but also significant challenges.

MANY ENTREPRENEURS AREN'T READY

Many exiting business owners haven't done any kind of transition planning. Some say they don't have time or aren't sure how to proceed. Others just don't want to think about leaving.

Thinking about your succession ahead of time can help ensure the process goes smoothly. If you want to sell your business, planning will improve your chances of getting the best sale price and conditions. That's especially important in a challenging economy that has delayed some entrepreneurs' transition strategies.

Planning helps you evaluate your options at your own pace and get ready in case you need to exit unexpectedly—for example, because of a health issue. It can also help you find a buyer, set up financing, ensure optimal tax treatment and lay a foundation for years of continued success at the business you've worked so hard to build.

REAL SUCCESS STORIES

This eBook will help guide you through transition planning—from identifying a successor or buyer to valuing your business, arranging financing and considering tax implications. You will also read about successful Canadian entrepreneurs, who share their experiences and advice about managing a smooth transition.

A business ownership change presents hurdles, but they are surmountable. This eBook will show you how to do it.

01_ GET READY FOR TRANSITION

Why do some business transitions succeed while others perform poorly or fail? An ownership transition is a moment of profound change in the life of a business. Entrepreneurs need to carefully plan the process with the help of experienced advisors.

When preparing for an ownership transition, it's important to consider several key elements and give yourself enough time to put your plan into action. A transition plan may take years to develop. It can be very costly to procrastinate.

"It's important to clearly articulate your plan—who will be involved and the steps you need to take in the transition," says Robert Duffy, Managing Director at BDC's Growth & Transition Capital team. "It's not the sort of thing you cobble together at the last minute."

Make it a top priority

Duffy, whose team at BDC finances business transitions, says he's seen numerous examples of entrepreneurs whose company declined in value or who even lost their business because they didn't have an exit plan. Some needed to sell their business in a hurry due to a health issue but weren't ready.

"Your business has value built up over years," Duffy says. "The planning process is a way to realize that value."

PLANNING STEPS

Here are steps to take in your planning.

- **Get advice**—A business transition is complex and the stakes are high. You should be sure to consult early and often with key advisors, including your bankers and other financial partners, your accountant, your lawyer and your advisory board, if you have one. To help plan your succession, you may also want to hire a consultant who specializes in business successions and/or mergers and acquisitions.
- **Choose the type of successor**—You will have to decide who you want to pass the business on to—a family member, company insiders (members of your management team, employees or both) or an outside buyer. Also, consider how much, if at all, you want to remain involved in the business after the transition, so you can structure the transaction accordingly. (See more information in the next section, "Your succession options.")
- **Prepare your successor**—In the case of family or insider successions, think about what skills or qualifications your successors will need and how you will get them ready. The training process can take years—another reason you shouldn't wait to get started with your preparations.
- **Structure the transaction**—Consider the details of the actual transfer of ownership. These include valuation, financing, tax considerations, the legal structure of the new business and a timetable for the transaction. (See more information on these topics in the sections that follow.)
- **Plan the handover**—Don't overlook the very important task of planning the handover of the business. An ownership succession can be stressful and disruptive not only for the departing owner, but also for employees, customers and suppliers. You should come up with a plan to ensure open and consistent communications with these stakeholders throughout the transition.
- **Review your plan**—Your plan is never really done. Review it regularly to keep it up to date.

02_ YOUR TRANSITION OPTIONS

If you're not sure who to pass your business on to, you're not alone. Finding the right successor or buyer is one of the main challenges entrepreneurs face in transition planning.

You have three main options: selling or giving your business to a family member, selling to company insiders (managers and / or employees) or selling to an outside buyer.

To help you decide which is best for you, ask yourself about your post-transition or retirement goals. Is maximizing retirement income your main priority? Do you want to keep a role in the company? Do you dream of keeping the company in the family for generations to come? The succession option you choose will have an impact on how you achieve your goals.

FAMILY TRANSITION

Selling or giving the business to a family member is one of the most common exit strategies for Canadian entrepreneurs.

A family succession means your children and/or other family members get to benefit from your business legacy. In addition, companies passed on to family members and company insiders tend to perform better than those sold to non-family owners, according to a BDC survey. (See more details about the survey's findings on page 15.)

Consider the consequences

However, there may be financial consequences. Giving the company to a family member means the owner won't have the proceeds of a sale to fund his or her retirement. And even if the company is sold to a family member, the lack of a competitive bidding process may mean a lower price.

On the other hand, a family transition may lead to less disruption for the company after the handover. And a stable business means departing owners are more likely to get their money out of the company if they've supplied vendor financing, as is typical in family succession sales.

ADVICE ON FAMILY SUCCESSIONS

- **Communicate**—Emotions can be volatile in family successions. Entrepreneurs may find it hard to let go, and family issues can cloud good decision-making.

  Communication will help head off or defuse conflicts. Give family members ample opportunity to express their interest (or lack thereof) in the business and any concerns they may have. When you've finalized your planning, communicate the details clearly to reduce discord down the road.

- **Define roles and responsibilities**—Your plan should clearly define roles and responsibilities. For example, a family member might be a shareholder in the business but not involved in daily operations. By clarifying roles, especially differentiating between company governance and daily management, you can avoid misunderstandings.

  Clearly defined job profiles will also help you avoid conflicts over hiring relatives. Spell out the needed experience, skills and education.

- **Give yourself time**—Family business transitions can take much longer than many entrepreneurs realize. You need time to sort out family issues, pick successors, prepare them and carry out the transition.

  If your family successor isn't ready to take over, you can do a phased exit (a gradual transfer of ownership as the successor gains experience) or hire an interim manager to temporarily run the company. This might also be a good time to set up an advisory board to help guide the transition.

FAMILY BUSINESS TRANSITIONS CAN TAKE MUCH LONGER THAN MANY ENTREPRENEURS REALIZE. YOU NEED TIME TO SORT OUT FAMILY ISSUES, PICK SUCCESSORS, PREPARE THEM AND CARRY OUT THE TRANSITION.

Navigate family dynamics

Alex Pagnotta had ample time to learn the ropes at his Edmonton construction company, Pagnotta Industries, a BDC client. He started as controller in 1999, then took over running the company from his father, Mario.

Four or five years ago, Mario Pagnotta started talking about passing on the company entirely to Alex and Alex's two sisters.

The question was how to structure the succession. A number of considerations made the question sensitive. It had to be fair to all the siblings but at the same time allow the company to be managed and governed effectively.

Seek advice

Alex ran the company, while one of his sisters worked there as the office manager and the other sister wasn't involved at all. Alex wanted to take over full ownership, but he couldn't afford the financing it would take to buy the business outright from his parents. (His father was the majority owner, while his mother owned a minority stake.)

For advice, the family hired a consultant who specializes in family successions. The consultant interviewed everyone independently and suggested structuring options based on the family dynamic. A workable arrangement emerged from the discussions.

Alex got 55% of the common shares in the company, while his sister who works there got 25% and their uninvolved sister got 20%. Meanwhile, their parents exchanged their common shares in the company for preferred shares, which would pay them a dividend.

Communication is vital

They also used an estate freeze to lock in the company's value and capital gains tax liability. Any future growth in the company's value will accrue to Alex and his sisters. No money exchanged hands to complete the transaction.

Alex says the succession has gone well. His father is still active, helping out with business development, and the siblings are now discussing their roles and responsibilities.

Regular family/owner meetings are vital to work out differences, Alex says. "The biggest thing is clear communication and regular feedback."

The biggest thing is **clear communication and regular feedback.**

— **ALEX PAGNOTTA**

INSIDER BUYOUT

In a management or employee buyout, company insiders pool resources to acquire all or part of the business. Funding typically comes from a mix of personal resources, vendor financing and external sources.

The owner and manager must first agree on a sale price, which is confirmed by a valuation. Managers then draft a shareholder agreement, approach financial institutions and develop a transition plan that incorporates tax issues.

The full transfer of decision-making and ownership powers to the successors can take place gradually, over a period of months or even years. The new owners then pay back the financial institution at a time and pace that will not unduly slow the growth of the business.

As in a family succession, insider buyers are already familiar with company culture and clients, and are more likely than outsiders to keep the owner's legacy intact. An insider is also more likely to have a good handle on the company's value.

A transition that went smoothly

That's what happened at Miralis, a kitchen cabinet-making firm in Rimouski, Quebec, after a management group organized a successful buyout. The transition went smoothly because the new owners already knew the company inside and out.

"We maintained a very close relationship with our employees, suppliers and customers," says Daniel Drapeau, the CEO who led the management buyout. "You want to create a good relationship of confidence between them and the new team that's taking over."

A management team may also welcome the seller's continued involvement in the company, since they likely have a good longstanding relationship. That can help assure business stability after the transition, which makes it more likely the company will repay any vendor financing the entrepreneur provided.

ADVICE FOR AN INSIDER BUYOUT

You want to create a good relationship of confidence between them and the new team that's taking over.

— DANIEL DRAPEAU

- **Be transparent**—Good communication between the owner and managers is important. For example, the owner should be sure to fully disclose information about the company that managers may not have known before.
- **Focus on the financials**—Management buyouts usually require substantial financing, which in turn reduces cash flow. Cost cutting, improved productivity or increased revenues may be needed.

  Do a thorough financial analysis of cash flow, sales volume, debt capacity and growth potential. This will provide valuable information on the buyout's prospects.
- **Choose skilled managers**—You will need to put in place managers with the right combination of skills to take the company through the transition period and run the business profitably.
- **Share equity fairly**—Establish reasonable incentives for everyone involved.
- **Retain good relationships**—If the buyout bid fails, the owner and employees may still need to work together.

EXTERNAL SALE

A third option is to sell your business to outside investors. An external sale is likely to lead to the best price for the seller, BDC's Robert Duffy says.

"The best way to maximize the value is to have multiple offers," Duffy says. "The impact can be millions of dollars in some cases."

The downside is a higher risk of disruption during the transition, since outside buyers may not be familiar with the company's culture and may be more likely to take the business in new directions.

New directions can lead to new opportunities, but the change can also lead to financial underperformance. And that could increase the entrepreneur's risk of default or repayment delays on vendor financing.

Advisors can help

To find a buyer, you can put out the word through your circle of industry acquaintances and consult advisors such as accountants, lawyers and financial partners. These professionals often keep an eye out for businesses for sale. Your advisory board, if you have one, could also provide leads.

Other avenues are to hire a business broker, contact industry consolidators and advise industry associations that you are interested in selling.

You may also want to consider creative options, such as approaching competitors, an outside management group financed by private equity investors (known as a management buy-in, or MBI) or an external group of managers who buy into the business in cooperation with an internal management team (a buy-in management buyout, or BIMBO).

Put yourself in the buyer's shoes

Chartered accountant Barry Wood has a lot of experience with purchases and sales of companies to external buyers. He has personally led six successful business acquisitions.

His advice to business owners selling their company: Think about what you would look for in a business if you were buying one yourself. Buyers often have exacting criteria for what they want to see in an acquisition target.

Putting yourself in their shoes can help you market your company to buyers and see what you need to do to get it ready to fetch the best price.

In Wood's latest acquisition, he looked at 60 to 70 businesses to acquire before settling on Ontario Excavac, a fast-growing excavation and utility service company in Mississauga, Ontario.

Buyers have specific criteria

Wood had very specific criteria in mind, such as the company's growth potential, size and industry, and his own budget. He got to know Ontario Excavac's owner during a chance meeting at a business event. The owner wanted to retire and sell his company. The two men hit it off, and Wood quickly realized his long search for an acquisition target was over.

With the owner's help, Wood did due diligence on the company's financials, industry and other key areas. Both men had little trouble agreeing on a valuation for the business. They soon struck a deal and finalized it in 2014, just six months after they had met.

For financing, Wood tapped a combination of sources: his own capital, financing from private investors, secured debt, financing from the owner (who stayed on as a minority shareholder and board member) and, finally, mezzanine financing from BDC.

Consider mezzanine financing

Mezzanine financing is often useful to round out a transition financing package because it offers highly flexible repayment terms and doesn't rely on specific assets as collateral. Flexible terms can be important in an acquisition to ensure the business has enough cash on hand during the transition period (see section 5 "Financing the transition," for more details).

After the Ontario Excavac transaction went through, the former owner agreed to come in a couple of days a week to give Wood a hand and help ease the transition. "It's far better to put together a transition with the former owner and management team. I don't think it's wise to cut the cord," Wood says.

It's far better to put together a transition with the former owner and management team. I don't think it's wise to cut the cord.

— **BARRY WOOD**

6 KEY FINDINGS FROM BDC'S CHANGE OF OWNERSHIP STUDY

Why do some business transitions succeed while others perform poorly or fail? To answer that question, BDC studied nearly 200 small and medium-sized companies where a change of ownership had occurred.

1 Transitions by insiders tend to perform better

Transitions involving family members or an internal management buyout tend to perform better than acquisitions by outside parties. This is likely because new insider owners benefit from longstanding relationships and company knowledge.

2 A change of ownership puts pressure on a company's finances

Financing a change of ownership often leads to an increase in a company's debt and a corresponding decrease in profitability due to higher debt-servicing costs. This new reality, combined with a tendency to underestimate the costs of a transition, could lead to a liquidity crisis.

3 Good due diligence leads to good transitions

New owners are more likely to have a successful transition when they've taken a hard look at the business's strengths, weaknesses, opportunities and threats before investing. They're also more likely to have sought outside advice.

4 Forecasts need to be conservative

Few businesses achieve projected financial results in the first year following a transaction. Therefore, entrepreneurs should be conservative in forecasting how their new business will perform and, in turn, how much money will be available to service the company's post-transaction debt.

5 Synergies are harder to achieve than planned

We found, in many cases, synergies expected by new owners fail to materialize after the transaction. When they do, it's seldom in the expected timeframe, or to the extent anticipated by the new owners.

6 The new management team is the foundation of future success

We found that the management team is the driving force in a successful or failed transition. The make-up of that management team is extremely important. Successful managers had the courage to make difficult decisions in response to changing conditions.

DID YOU KNOW?

61%

The percentage of companies that don't achieve expected financial performance one year after an ownership transition.

40%

Average percentage by which companies fall short of their financial forecasts one year post-transaction.

51%

Chances a company is growing one year post-transaction.

03_ HOW TO PREPARE YOUR BUSINESS FOR SALE

An ownership change is one of the most important moments in your life as an entrepreneur. To maximize the sale price, you must ensure your business is solid and has enticing prospects.

Buyers are likely to look at your profitability, growth potential and operational efficiency, and whether you have a strong vision and viable business strategy. They'll also wonder how well the business will function when you leave.

ADVICE ON PREPARING YOUR COMPANY FOR AN EXTERNAL SALE

- **Profits and ongoing investment are crucial**—Don't expect high offers if you're just breaking even. It's important to make sure you can show solid business performance and profitability in recent years. Valuation is usually tied to your growth prospects and historic profitability—except in cases of a business that has valuable intellectual property.

  Good retained earnings on your balance sheet—the portion of net income not distributed to shareholders—tell buyers and their financiers that the business has been profitable over the long run and is healthy.

  As retirement approaches, some entrepreneurs make the mistake of taking a lot of money out of the business, neglecting maintenance and/or reducing investment in new equipment. That's a fast way to reduce the value of your company.

- **Lower expenses and boost sales**—It's true for all businesses, but even truer when you're planning to sell. You need to be lean. Analyze your processes and look for ways to increase efficiency, cut waste and control inventory without affecting operations. Consider hiring an operational efficiency consultant for advice.

  Also, brush up your marketing plan and focus on ways to boost sales, including tapping new markets or offering new products and services. Work on creating a diversified customer base that generates repeat business.

- **Create or update your strategic plan**—A plan that presents measurable goals and milestones for the coming years will give your company credibility as a growing concern with long-term potential.

Develop repeatable processes and empower your people—The processes in the business need to be repeatable and teachable, advises John Warrillow in his book Built to Sell: *Creating a Business That Can Thrive Without You*. "If your business can't function without you, you will have a hard time finding a buyer," he says.

Also, train, motivate and empower your people. Pay particular attention to the management team. Work to solve any internal conflicts, and strive to keep employee turnover low.

Stand out from the crowd—Selling your company is in many ways a marketing challenge. It's important to showcase to potential buyers whatever differentiates you from the competition.

For example, ask long-time clients for testimonials explaining why they do business with you and what keeps them coming back. Use social media and your website to help define your unique brand.

Take the time to do it right—Keep in mind that, as with most sales situations, if you are in a hurry, you may not realize the return you want. Buyers are likely to see through cosmetic changes made at the last minute.

Seek advice—Consider working with experienced outside consultants who can help prepare your business for sale by, for instance, advising you on strategic planning, operational efficiency and sales and marketing. BDC consulting can advise you on the business challenges you need to address.

Consider your tax liability—Make sure to consult a tax expert early on. The structure of the transaction can significantly affect your tax liability, and you may need ample time to implement the most advantageous structure. Some of the issues to consider include the following:

- the possibility of deferring your tax liability;
- the best use of your lifetime capital gains tax exemption;
- the criteria the company must meet to be considered a qualified small business corporation, which means it qualifies for the capital gains exemption;
- an estate freeze, which provides certainty about exposure to capital gains tax in a succession;
- taxation of goodwill;
- allocation of the purchase price to various assets;
- sales tax;
- land transfer tax.

04_ HOW MUCH IS YOUR BUSINESS WORTH?

Valuation is obviously a key issue for entrepreneurs seeking to exit a business. Establishing a fair value for a company isn't easy, but the sale price you come up with will be an important focal point of your transition plan.

Many entrepreneurs have an unrealistic idea of how much their company is worth. That's not surprising, since research shows that people almost invariably attach a higher value to things they own than to things that aren't theirs, according to an article in the *Harvard Business Review.*

Differing expectations can cause conflict

This means you may have a different value in mind than your family successors, potential buyers, financial partners or tax assessors. That can cause conflict and affect your retirement plans.

Even if you're giving the company to a family member, you may require an objective valuation to ease family disputes, plan your estate and optimize your tax treatment.

Because of the complexity and stakes, it's helpful to hire a professional valuator to help you set a selling price and determine whether a buyer's offer is reasonable. A tax expert can also tell you how the various valuation options impact your tax liability in a sale.

An outside valuation will hold more sway with potential buyers than numbers generated in house. The process may also help you identify weaknesses in your organization and find ways to maximize its value.

Earnings are key to valuation

The most common method used to determine a fair sale price for a business is calculating a multiple of EBITDA (earnings before interest, taxes, depreciation and amortization), which is a measure of a company's ability to generate operating earnings.

The multiples vary by industry and could be in the range of three to six times EBITDA for a small to medium-sized business, depending on market conditions, says Catherine Tremblay, a board member at the Canadian Institute of Chartered Business Valuators.

Many other factors can influence which multiple is used, including goodwill, intellectual property and the company's location, Tremblay says.

After arriving at the EBITDA-based figure, a valuator typically seeks to confirm it by applying other valuation approaches—first, calculating the value of the company's tangible and intangible assets and, second, checking what comparable businesses sold for, says Tremblay, who is also a Montreal-based partner and National Leader of Valuations at accounting firm MNP.

If the three valuation approaches yield different numbers, the valuator investigates why and may adjust the EBITDA multiple, if appropriate. "A lot of judgement and estimates are involved," Tremblay says. "It's part science, part art."

Assets may be attractive

Your business may also be more valuable in pieces than as a whole. For example, a buyer may find your real estate holdings more attractive as an asset than the entire business.

Finally, keep in mind that the price you get for your company may differ from the appraised market value and can be affected by unexpected factors. For example, a company may be willing to pay a premium for your business because it's a good fit.

05_ FINANCING THE TRANSITION

Financing an ownership change is often the biggest obstacle to a successful outcome for both owners and successors. It can make or break the deal.

The financing package has to be equally advantageous to both sides. For sellers, financing is of vital interest because it's central to whether the deal goes through, what price is paid and how much vendor financing they have to provide.

Sellers also have a stake in the financing because the better the company does after the transition, the better the chances they will get their vendor financing back.

Successors, for their part, do better if they have a manageable debt burden, maximum repayment flexibility and diversified financing sources.

Financing is critical

Because financing is such an important part of a transition, it's crucial to get financial partners involved early in the process. You want enough time to negotiate a package that works for everyone.

FINANCING OPTIONS

Here are the main sources of financing. They are typically used in combination with one another.

A. **Buyer equity**—Buyers will almost invariably be required to invest their own money in a company so as to reduce the amount of outside capital needed and to show other participants their commitment to the business.

B. **Vendor financing**—Some financial participation by the current owner is also usually required to clinch the transaction. While normally described as financing, this typically involves the owner agreeing to be paid some percentage of the sale price over time with interest.

   Such financing comes with risks because the new owners may delay or default on repayments if they experience financial problems after the transition. That's why it's best for entrepreneurs to try to get as much money as possible up front, BDC's Robert Duffy says.

C. **Secured debt**—Financing sources can include term loans, lines of credit and commercial mortgages—collectively known as senior or secured debt. Such financing is secured by the company's assets, such as its real estate, equipment, accounts receivable and inventory.

   Here, it's important to shop around. Remember, finding the lowest interest rate shouldn't be your sole focus. It's also worth looking for loan terms that offer repayment flexibility and free up cash flow. Examples are longer repayment periods, payments tied to the company's cash flow cycle, the option to postpone capital payments at the start of the loan and prepayments with no penalty.

D. **Mezzanine financing**—This specialized type of financing isn't secured by specific company assets. Instead, it's based on historic and expected future cash flows of the company. While interest rates are higher than those for secured loans, mezzanine financing is a source of patient capital. It is often useful for rounding out a transition financing package. That's because it offers highly flexible terms, requires no specific collateral, and requires limited or no personal guarantees.

E. **Outside equity**—Another way to raise funds for a transition is by selling an ownership stake in the company to outside investors. Equity capital may come from a private equity fund, individual investors, or a financial institution's venture capital or private equity arm.

"The mix of financing tools that you use can dramatically change the return the buyer realizes and what kind of risk the buyer and sellers are facing," says Duffy, who has financed dozens of transitions in his role at BDC's Growth & Transition Capital.

When the founder of kitchen cabinet-making company Miralis was ready to retire, he turned to five youthful managers led by Daniel Drapeau, who had been named the company's CEO a few years earlier.

It proved to be a textbook case of a management buyout. The company, with 240 employees, makes high-end custom cabinets at its state-of-the-art 125,000-square-foot factory in Rimouski, Quebec.

Seek flexible financing

To fund the transaction, Drapeau and his management group turned to BDC Growth & Transition Capital for mezzanine financing because of its flexible terms. For example, the company was able to keep more cash on hand during the initial period after the transition.

The financing conditions also didn't require Miralis to create a board of directors, as likely would have been the case if the new owners had taken an equity investment. "That would have hindered our flexibility and our ability to make decisions," Drapeau says.

As existing managers, Drapeau and his team were able to shepherd the business through the ownership change without disruptions and keep sales growing. Miralis's revenues are up about 30% since the transition, and the company has paid back a substantial portion of its mezzanine financing.

Watch a video on Miralis's management transition.

CLICK TO VIEW ON YOUTUBE

A SUCCESSFUL OUTCOME

It's not easy to think about passing on your company. It's your baby and hard to let go. But the right planning and preparation can make the transition easier and increase the chances of a successful outcome for both you and your successors.

In Edmonton, Alex Pagnotta and his family managed to navigate the sensitive and tricky process of family succession with the help of a consultant—and found a way to keep family patriarch Mario Pagnotta's construction business thriving.

Daniel Drapeau in Rimouski, Quebec, led a management buyout that allowed the company's owner to retire while putting his kitchen cabinet-making firm Miralis in talented young hands.

And in Mississauga, Ontario Excavac's Barry Wood deployed patience, discipline and due diligence to ensure a successful acquisition of the excavation company. Wood advises vendors to put themselves in the buyer's shoes when making plans to sell their business.

These successful Canadian entrepreneurs demonstrate by their example how a well-planned transition can benefit all parties.

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