MY BUSINESS, MY LIFE

THE CHALLENGES FACED BY BUSINESS OWNERS IN PLANNING THEIR RETIREMENT

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CONTENTS

OUR RESEARCH

We started this project by conducting two surveys, one for business owners within 10 years of likely retirement, and the other for those already retired. We wanted to learn of the challenges and worries faced by business owners, and, from those who had already retired, what advice they would give those to follow, and what if anything they would do differently if they had their time again.

This initial research yielded some interesting findings:

- 91.7% of business owners had some level of concern to the question, "How much am I likely to receive when I sell my business?"
- 83% had some level of concern regarding the question, "Should I be doing anything now to help get a better price at retirement?"
- 75% had some level of concern regarding, "Is my business saleable?"
- 75% had some level of concern on the question, "How much do I need to retire?"

Of those already retired, we found very few people who now regretted giving away the daily cut and thrust. Common advice was along the lines of this respondent:

"Have established and committed interests already in place to be developed further in retirement."

Following on from these initial surveys, we conducted one on one interviews with several people to dig deeper on some of the issues raised through our surveys. Excerpts from these interviews are contained within this paper.

Having conducted this research, we concluded that most business owners don't know how to go about planning for their eventual exit from their business. Many business owners will invest decades in building a successful business, and blindly assume they can rely on the value of their business when they sell it to give an adequate return on their efforts. The problem is that very often the owner's expectations of what their business is worth is greatly inflated, compared to what the market is willing to pay, and indeed often the business isn't saleable at all.

It is critical to ensure that your investment pays off and provides you with the financial rewards that you set out in business to achieve.

Planning and executing the exit from your business does not have to be difficult, but it does require a plan, speaking to the right people, and understanding who does what.

Whether you are an independent contractor with no staff, or operate a business with millions in turnover and a large team, the information in this paper will help you get started in planning for your retirement.

Excerpt from interview between Paul Benson of Guidance Financial Services and Phil Kreveld of PK Communications:

Paul: *"What advice would you give to a business owner who's thinking about retiring or semi-retiring?"*

Phil: *"You need to slide into things. And, furthermore, the way you slide into things, you slide into retirement, is by planning activities other than cruises – meaningful activities. Now, you know, if you're retiring as a business person and you've loved business, you have an opportunity, for instance – If we don't have the financial problem, monkey riding us on our back – to be engaged in mentoring. I've got some mates who have retired, so they play a bit of golf and they do a lot of mentoring, and they get an enormous kick out of this."*

"And no kidding, no exaggeration, I know you keep healthy by keeping fit physically, by eating properly and not drinking too much, etc, but just as important to your physical health is having lots of meaningful activity, you know, meaningful to you personally. Somebody else might think it's boring as batshit. You've got to have that zip in your step, to think, oh, I've got to get up this morning. I've got stuff to do."

"It's looked upon, oh, well, retirement, oh, well, you know? That's being able to lie in the cot till nine and have a leisurely breakfast. No, bullshit, no, no."

THE CHALLENGES FACED BY BUSINESS OWNERS IN PLANNING THEIR RETIREMENT

Our survey results demonstrate a deep-seated concern by business owners about whether the business is saleable and also the business's capacity to fund their retirement. Indeed, as noted above, our analysis reveals that three quarters of business owners had some level of concern in response to the question "How much do I need to retire?"

As an illustration we reproduce here some transcript from one of our interviews:

> *"The business of how much you need, that's a simple one to answer actually. All you need to know is when you're going to die."*
>
> *"I think from talking to several people on this, they can consider a virtual age of 80 as being the practical limit of where you need money. Beyond that you only need $9.95 for a novel because by the time you get to the end of the novel you can start and read it again, you've forgotten it."*
>
> *"What is retirement? Does it mean you're just going out to pasture, because, no, I'm not looking forward to that. If it's financial freedom and all the other things, and to do the dream that you've had all your working life and haven't done, well, that's another aspect. Or, in my case, where you've had your holidays, done anything you wanted to do, whether it was ride motor-bikes or sail boats or whatever, it takes a bit of the pressure off what you really need to do."*
>
> *"Also, your focus can change at this time too. We've just had grand kids , five of them now, and you suddenly get a very strong pull towards family and doing things around the family, whether it's going up to a unit and spending time with them, or with them at a family holiday house. All these things become very important, and the boat and the caravan and all the rest of the toys look like being sold off because you just don't need them anymore. So it's a really personal thing and a really changing time for everybody. I think some time about here we need to have a list created of what we need, what we want, and what we don't need, and work through it. It's time to do a bit of a restart on your life and figure out where retirement sits and where work sits and where family sits."*
>
> // A. Reeves, Polytech Plastics (Pty) Ltd

This paper is designed to give you an overview of the key processes and issues involved in planning an exit. It's not designed to give you all of the answers, simply because the topic is too broad and complex, and there is no 'one size fits all' solution.

Our respondent above is not atypical and points to a strong undertone that a business owner is seeking financial freedom at the closure of his or her business ownership life. That's not an unreasonable ambition, but it requires more than hope and a prayer. A plan is essential. Your plan must be developed specifically for the needs of your business and financial objectives.

Craig Phillips of DMA Clinical Pilates on one of the challenges faced by business owners today:

> *"The expectations of Gen Ys and even Gen Xs, in the emerging workforce is far greater than previous generations. It is shaping up as a more fickle workforce and while business owners look for employees to develop responsibility, loyalty, and a long term view, the new breed want it all and they want it now. This will be a challenging prospect for building any business and setting long term plans."*

WILL MY BUSINESS BE SALEABLE?

When you look at Sir Richard Branson and his empire you realise one thing: he cannot possibly have built that empire without the help of hundreds of people around him. He directly or indirectly controls hundreds of businesses, but importantly he has hundreds of managing directors who run and often have some ownership in these businesses. What is his secret? For the purpose of our work here, the takeaway message is that Branson is not hands on in his businesses because all have been built to NOT be dependent on him (perhaps with the exception of his incredible ability to attract publicity). And each is eminently saleable – witness his sell down of equity in Virgin Australia, turning an investment of $40 million into $450 million equity and realised value.

Are You Running a Business or Working for Yourself?

There are two potential paths a business owner can follow:

1. Grow the small business to a larger business so that it is saleable.
2. Stick to the 'one man band' and wind up the business at retirement.

It is not the case that one path is superior to the other. Different people have different skills and strengths and what is right for one business owner may not be right for another. It is essential, however, that you recognise which of the above two paths you are on.

If your strategy is the first one – grow – then it's all about systems and a quality team within your business, so that the business can operate without you.

If instead you are a 'one man band' such as a consultant, the challenge is not so much a case of building systems to replace you, but rather to ensure that your business, consulting firm or professional practice is building an investment pool out of your fees that will enable you to fund a secure retirement, in other words, establishing a self-funding strategy based on your professional income. You need a financial plan that takes full advantage of the superannuation system, and perhaps utilises tax strategies such as negative gearing.

Simon Jones of Simon Jones & Co (accountant) on the common trap that he sees business owners make:

> *"...relying upon their business as a form of superannuation, because the reality is that not all businesses are going to be successfully sold and the yields that they'll get might be less than what they think they're going to be."*

A Note on Systems

Building a business that can operate without you (for at least 6 weeks!) is not beyond the average business.

For the more conventional business, every activity undertaken in your business should be clearly documented. This needs to be done clearly and effectively, and can mean the difference between a business sinking or swimming in your absence, or the absence of other key officer bearers.

Michael Gerber, the US author, has, in his excellent book The E-Myth Revisited, written about "turn-key" systems which work just like a McDonald's franchise and which can be handed over on the "turn of a key", so a new owner can come in, turn the key and get started. So too should your business be "systemised." You need a written system for how to open the restaurant each morning. Within that system you need systems for howto unlock the doors, turn on the lights, ready the cash register, prep the tables and start the coffee. Within those systems, you need to explain the order in which to do these things, which coffee to use, how long to brew it, how to keep it warm, when to replace it - and on it goes! It is detail, detail but once done it's then documented and can be embedded as part of the whole turn-key system.

Once thorough systems are established, a business owner can focus on maximising the return on their investment; and consider when is the best time to sell, and the best ways to negotiate and finalise a deal.

EXIT PATHWAYS

It is crucial that a business owner consider all options for a succession plan or an exit strategy for their business. Assuming they have grown their business beyond being owner dependent for day to day operations, there are a number of possibilities. Is there a financial buyer for your business? Perhaps there is a trade buyer? Maybe someone within your business might have an interest in taking it over. Or perhaps the buyer will be someone completely external to your business who is just looking for the right opportunity.

The Financial Buyer

In a financial sale, the entire return on investment (ROI) for the buyer comes from the earnings and cash flow generated by the seller's business as an independent entity. Most commonly, Big Company A acquires Small Company B and sets it up as a wholly owned subsidiary. Company B then continues to operate essentially as it did before it was sold.

A Trade Sale

In a trade sale, the ROI for the buyer also includes the increase in earnings and cash flow brought about through synergies across the two businesses, for example eliminating duplication in respective head offices.

For deals under $5m it is highly likely that a strategic trade sale will yield a higher price (often a significantly higher one) than a traditional financial sale. The return more than justifies the investment of time and resources by the ownership/management to build the company into an attractive strategic acquisition candidate.

Making the Business More Attractive To a Strategic Acquirer

Plausible? For sure. The best way is to learn what constitutes the valuable strategic acquisition candidate in this particular industry, and then undertake initiatives to bring the strategic profile as close as possible to what the prospective buyers have indicated they find valuable (through recorded industry trade sales). There are advisers that can help here, but it is critical to have an attractive P & L history and current financial condition. Positive numbers will enhance the price; negative numbers will, at a minimum, decrease the price and can cause the prospective buyer to walk because of concerns about management competence.

By planning ahead, well in advance of sale time, business owners can take steps to prepare for a profitable sale. That includes getting to work on a financial plan that will assist your exit strategy and beyond.

Management Buy-Out

Employees often become buyers of a business especially if the employees have been given shares in the business as an incentive or reward. Often it is a manager or a team that can be assembled to be the entity that becomes the 'buy-out' entity for purchasing the business. In many cases (in particular where there are assets, such as plant, equipment and building involved) bank finance can be arranged where the assets of the business can become collateral security. In some cases (where a transaction value of more than $5 million is involved), there may be private equity investors who would fund a buy-out from an employee-management group. Often they will also seek an equity interest.

External Party

Small businesses are very often sold to someone outside the industry and unknown to the current owners. They may be people who have resigned or been made redundant from their previous role, and are looking to run their own operation. This may include middle managers who have considerable knowledge and expertise, but who have reached the limit of where they could climb up the corporate pyramid.

Increasingly, migrants are looking to purchase businesses, as this can be a way of meeting visa requirements. Immigrants often look to purchase businesses in sectors they are familiar with. Franchised businesses may be attractive to these purchasers as their systems allow someone unfamiliar with Australian requirements (e.g. super and Work cover) to get started with minimum risk.

DETERMINING THE VALUE OF YOUR BUSINESS

There are many ways to value a business. Most are based on some measurement of past profit and a determination of what that profit is worth in 'today's dollars'. Most business valuations involve an assessment of:

- The industry in which the business operates
- The business risks and future prospects
- The profitability, cash flow and financial position of the business

Valuing your business is integral to the exit process. Your accountant should be able to give you some guide as to the likely value of your business. This could be refined further by obtaining a formal valuation from a qualified business valuer. For a relatively simple small business, you should expect to pay around $2,000 to $3,000 for such a valuation, so it's not something that is prohibitively expensive.

Some industries have rule of thumb valuation multiples. For example, a mortgage broking business will typically sell for around two times its annual recurring earnings. If you operate in an industry with a standard valuation approach, you will likely know about it.

Tougher are the businesses for which there isn't a standard. Whilst there are formal valuation methods, which we detail further in this paper, a good start would be to put yourself in the shoes of the potential purchaser of your business. If they buy your business, how much profit will they earn? Does that profit make sense given the purchase price they will need to outlay, and the hours they will need to put in? How certain is it that they will make a similar profit to what you have been generating?

Case Study

Let's look at an example of a cake decorating shop. Currently it is operated by the owner and one employee. The owner works 40-50 hours per week in the business and the employee typically 30 hours. The owner will usually have 4-6 weeks off each year, mostly over Christmas, when the shop closes. The business's revenue and profit are fairly stable, and the owner usually makes about $150,000 per year, a pretty good result for 40-50 hours' work per week. There is minimal plant and equipment involved in this business.

So what is this business likely to be worth? Given this business is still very owner dependent for its operations, it is unlikely to be sold to a financial or trade buyer. It could be that the employee purchases the business, or most likely an external third party will be the acquirer. Someone working in this industry, working those sort of hours, would never earn that level of income. So it's certainly an attractive proposition for the right person. Steady profit performance is also very helpful.

Would someone invest $500,000 to acquire a profit stream of $150,000 and requiring 40-50 hours of work from them? Probably not, unless they saw potential for some very rapid growth. Most likely, the business will sell for between one and two times its annual profit. At this rate the purchaser gets an attractive return on their money, sufficient to warrant taking on the risk of running a business, and justify the time commitment required. The employee provides continuity and reduces risk as the former owner leaves the business.

Business valuations are complex. What about a business with high levels of plant and equipment? The value of these hard assets needs to be reflected in the price. Consideration needs to be given to the outlook for the industry in which the business operates, and the sales trajectory of the business in question.

Establishing what your business is worth is a tricky proposition, but a starting point is to put yourself in the place of the prospective purchaser and think, "What would I pay for this profit stream?"

Formal Methods of Valuing a Business

Should you engage a valuer to obtain a formal valuation, one or more of the following valuation methods is likely to be utilised. In addition, the valuer is likely to consider past sales of similar businesses in your industry, where such data can be found.

1. Liquidation or Net Realisable Value
This method of valuation is based on what price could be achieved if all of the business's assets were to be sold. For businesses that are planning to continue, this method simply provides an indication of 'minimum value' since it does not take into account any of the business's actual or potential earnings. As a benchmark, the assets employed in a business should generate more in earnings and cash flows than they would if they were to be sold.

2. Discounted Cash Flow
This method of valuation seeks to calculate the present day value of the business's projected future net cash flows. It requires an analysis of likely future cash flows, capital structure, the costs of capital and an assessment of the value of the business at the end of the forecast period. Forecasts, by their nature, are inherently uncertain as they are necessarily based on assumptions, many of which are beyond the control of the business and/or its management. The actual future results may be very different to those forecasted, and as a result this method is not popular, although it is often used to estimate the value of start-up businesses.

3. Capitalisation of Future Maintainable Earnings
This method determines a valuation range based on the capitalisation of future maintainable earnings. It is appropriate for businesses that:

    - Are a going concern
    - Have been in existence for a number of years
    - Are not undergoing any significant transformation
    - Have historically stable profitability
    - Are not likely to experience significant growth or decline
    - Have products that do not face technological obsolescence

In our view, businesses should always be run with a view to being as valuable as they can be at any point in time. The basic value drivers are:

Other attractive features would also include a unique product or service, dominant position in your market, important customers, strong gross margins, projections of positive cash flow and high return on equity.

By contrast, lesser value is related to characteristics which include being poorly capitalised, a commodity technology or service, stable or contracting market, ineffective operating teams, inadequate gross margin, projections of continuing cash-flow deficit and low return on equity.

From this list, it should be obvious that there is no quick fix to achieving an optimal value but there will be areas that can be addressed, for example:

- Ensuring that everything that can be documented and systemised is indeed set up as systems.
- Eliminating any loss making activities to improve gross margins.
- Employing a GM who can replace founder-owner.

You would be well advised to seek external advice if you wish to look forward to a secure and fulfilling retirement. We all face the never ending problem of "we don't know what we don't know."

SHOULD I GROW MY BUSINESS?

Sometimes you need to think about growing your business before selling it. For a business to be saleable, it would typically need to be able to operate in your absence. That means it needs to be large enough to support multiple employees. As a minimum, as with the cake shop case study earlier, their needs to be at least one employee who can provide continuity within the business and knowledge transfer to the new owner.

There's nothing exceptional about the basics of growing a business. If you don't have customers you don't have a business, and growing a business essentially boils down to getting more customers, and/or increasing the average sale to each customer and keeping them coming back more often. Getting more customers is the area where most business owners focus most of their time, effort and money.

In 1957 Igor Ansoff created the following matrix for growth options within business, and over 50 years later, its simplicity and clarity remain compelling.

	Existing Products	New Products
Existing Markets	**Market Penetration** Sell more of your existing products to your existing customers.	**Product Development** Sell new products to your existing customers.
New Markets	**Market Development** Find new customers for your existing products.	**Diversification** Sell new products to new customers.

Be the Best in Your Industry

One way to get up on the radar screen of a strategic buyer, is to be (or perceived to be) the best in the industry. Perhaps by writing articles which demonstrate unique and valuable expertise. Have a first-rate website that reflects well on the company and on management, as well as articles. Find out what constitutes the valuable strategic acquisition candidate, and proceed to become that.

Alternatives

So what if your business isn't of a scale where it can operate in your absence, and you don't wish to pursue one or more of the four business growth options mentioned above? Then it is essential that you start building up wealth outside of your business, and develop a financial plan such that your retirement is not contingent upon the sale of your business. Assume your business will simply be shut down upon your retirement. It may be that some sale price is realised, but if you work on the basis of a zero sale price, then whatever you receive will be a bonus.

Make an appointment to see a financial planner (hopefully Guidance!) now, as the sooner you start, the easier it will be to achieve your goals.

Philip Kreveld – PK Communications, reflecting on two businesses he knows well, one a single person business, the other a business with a dozen staff:

> *"…yeah, but you have actually an organisation, so you've got some sales engineers, you've got some office support, and you have something that basically you can tout as a functioning business. The problem with the owner-operator type businesses, you come to the end of the road, so to speak, not necessarily meaning death, but the end of the road for your working life, and actually unless you have built up, unless you've been able to take a lot of cash out of the business and invested elsewhere, you're – to use a technical expression – cactus."*

THE ROLE OF PROFESSIONAL SERVICE FIRMS

We've all heard the expression "he's a jack of all trades but a master of none". Most successful business people have recognised that there are certain things they are very good at and others where they are better off employing others to assist.

To achieve the optimal result in exiting your business, you will likely need the assistance of three skilled professionals – Accountant, Financial Planner, and Business Broker. As a financial planning practice, we find people struggle sometimes understanding what gap it is that the financial planner will fill, and therefore why they need that relationship. First let's put into perspective the role of professional service firms that will assist you in successfully exiting your business:

The Accounting Firm

The accounting firm is essential in preparing your accounts. One of the first things a prospective buyer will request is the business financials, typically the past three years. If these aren't prepared accurately and professionally, the buyer will quickly walk away. Where the sale price is below $350,000, a Section 52 notice will need to be prepared by your accountant. During the sale process the buyer might also request interim figures. Your accountant will be invaluable in preparing these. Accountants also provide advice on business structures and strategies available to you to legally minimise your tax. Accountants are tax experts.

The Financial Planner

The financial planner's role is to develop a financial road map and then work with you over time to see it achieved. The starting point will typically be defining your objectives, such as having the option of retirement at a certain age on a certain level of income. It might also involve risk management objectives such as protecting the business in the event that the owner was incapacitated for an extended period. With your objectives defined, your financial planner will develop a strategy to meet your needs, and work with you over time to help ensure you stay on course, and make adjustments as changes arise.

Financial planners are licensed to provide investment advice and would typically have detailed knowledge of the operation of Australia's superannuation system, which includes the generation of retirement income.

The Business Broker

The business broker is often used by a business to sell a business as a going concern. They will provide information on the likely value of your business based on industry benchmarks, as well as valuation methodology similar to the ones noted earlier in the paper. A business broker will prepare a full Information Memorandum to support a business sale, which provides prospective buyers with information about the business, including financials. A business broker will handle interest from prospective buyers, and endeavour to get your business sold. Business brokers are typically paid on the basis of a success fee, so they have a strong incentive to achieve your desired exit.

Excerpt from interview between Paul Benson of Guidance Financial Services and John Thompson:

> Paul: *"John, what advice would you give a business owner thinking about retiring?"*
>
> John: *"Well, there's different ways, obviously, of retiring. I guess we would have preferred that our daughter might have wanted to take over the business so that I could sort of gradually phase back and let her take over, but she had other plans and aspirations, so that didn't quite work out. Certainly, look, we put so much into super that at times when things were getting us down a bit, we just said, well, we could just shut the doors tomorrow and not even worry about selling the business. So pouring as much into superannuation as possible and building up that portfolio of investments just gives you so many more options in what you can do. And if the unthinkable came along, that because of health reasons we had to sell and we couldn't quite get the price that we'd planned for, at least if you've got the superannuation it's not such a big impediment then."*

HOW GUIDANCE CAN HELP

Guidance provides specialist financial planning advice to business owners and the self-employed. Guidance has been operating since 1999, and we currently manage over $81 million for our clients.

If you are ready to take charge of your financial life, we'd welcome the opportunity to meet with you and explore how we can help. Big or small, makes no difference to us. We can tailor our services to fit your needs.

We're about relationships. We listen, to gain an understanding of your goals, and then work with you to develop strategies to achieve them. You gain access to someone who understands you and your circumstances, and who can use their expertise to make you aware of opportunities others might miss.

Phone us on 03 9870 6544, or visit our website at www.guidancefs.com.au and complete a "Contact Us" form. We will look to set up a meeting with you. Face to face is preferred wherever possible; however, if you are outside metropolitan Melbourne, let us know and we can explore options such as Skype or a teleconference.

We welcome your feedback and look forward to working with you over the coming years.

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