Succession Planning

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Today's Discussion

- Transitioning a Family Business
- Observations of a Successful Transition
- What is Exit Planning?
- Business Valuation
- What Drives Value
- Determining a Company's DCF Value
- Factors to Improve a Business' Value
- How to Realize the Value of a Business

Transitioning a Family Business

- A family business is a tremendous asset
  - Builds wealth if effectively managed
  - Allows the family to work together
  - Excellent platform and resources for impacting people in your community

- Do not allow the transition to destroy the family… the business is an asset that can be sold or professionally managed

- Not many businesses are successfully transferred (**G** = generation):
  - 30% from G1 to G2
  - 12% from G2 to G3
  - 5% from G3

Observations on Successful Transitions

- They are actively planned to assure that family members are prepared for the transition
- Ownership is generally limited to actively involved family members or their spouses, especially smaller businesses
- Relative to the next generation management team:
  - An outside consultant has reviewed the family members to help identify strengths, weaknesses and potential issues.
  - Balance each other – skills/gifts/abilities to operate a business… generally there is a clear leader
  - People understand and accept their roles
    - Market compensation
    - Accept shareholders status and its rewards

Observations on Successful Transitions

- Next generation members are effectively mentored and experience various aspects of the business
  - Smaller businesses require greater diversity – “many hats”
- Experience outside the family business can be beneficial to helping the company grow, but is not always necessary.
  - Brings in another perspective.
  - Understanding of “working for” a business
- The business has a vision and mission that people rally around
- Both annual and strategic plans are completed on a regular basis
  - Vehicle for people to communicate and learn
  - Employee growth and transition should be part of the plan and/or annual employee review process.

Observations on Successful Transitions

- G1 members have a plan to exit and not meddle once gone
  - G1 should increasingly delegate more and more of his/her responsibilities and go on longer vacations to see how the business functions without them
  - Retire to something… another business pursuit, hobbies, ministry, travel, etc.
  - Possibly remain in a non-managerial role – e.g. R&D, COB, consultant/mentor

- G1 should not be financially dependent on the family business

- Any significant business should have an outside board of advisors that meets quarterly.

- Shareholder agreement to deal with situations where family member leave the business, die, or become incapacitated.

What is Exit Planning

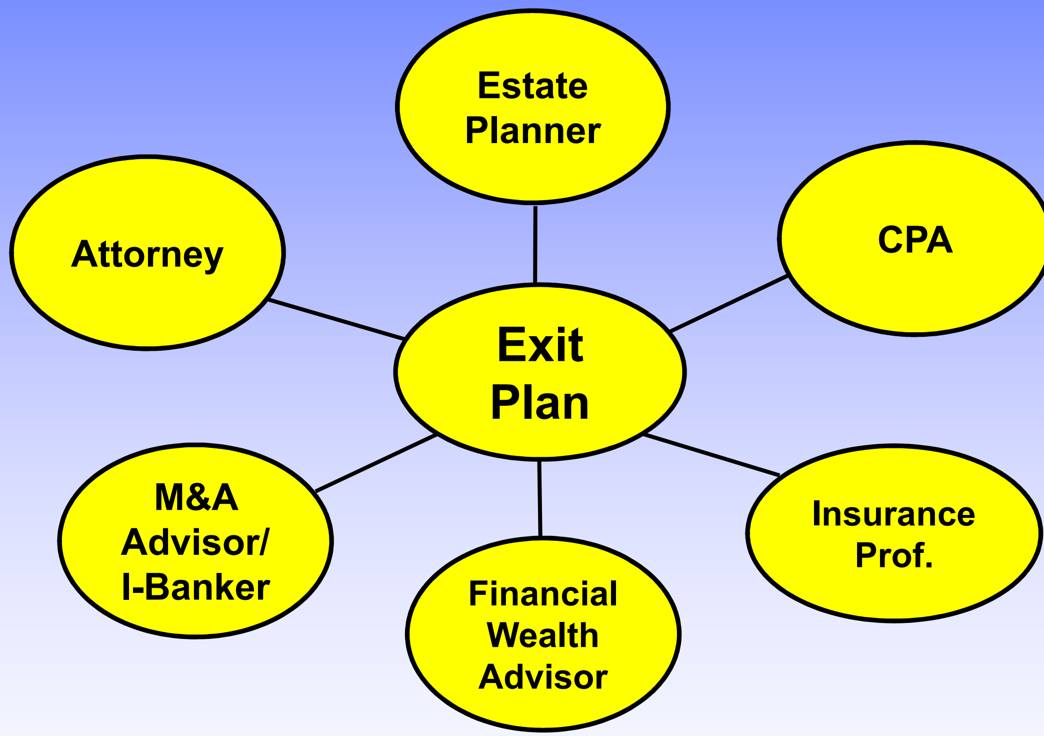
- Exit planning is a highly personal process and there is no off-the-shelf solution that is right for everyone.
  - Business owners need to embrace it and determine how they feel comfortable addressing it
- It basically considers four issues:
  1. When do I/we want to leave the business?
  2. What will be the level of my financial security for me and my family?
  3. Who should get the business?
  4. How will the above get accomplished?
- It should take into consideration all the various stakeholders
  1. **Primary:** shareholders, spouses, children, in-laws, key management
  2. **Secondary:** employees, customers, suppliers, community

Benefits of Exit Planning

- *"Every moment in planning saves three or four in execution"*
  - Crawford Greenwalt – former CEO of DuPont Company
- It provides a sense of security or peace of mind when you have thought it through, *"This is where I am at today, and this is where I want to be."*
- Reduces employee and family uncertainty -- preserves family harmony
- Evaluate the strategic exit options – family, employee, third-party, liquidate
- Maximize the value of the business by preparing or positioning it for transition, particularly with a third party sale.

Exit Planning Advisory Team

- There should be a multidisciplinary advisory team
  - One of members on the team generally drives or manages the process for the owner(s)



"A wise man will hear and increase in learning, and a man of understanding will acquire wise counsel."

Exit Planning Process

- **The Exit Planning Advisory Team** meets to *first* develop a plan and then meets annually to review and adjust the plan until it is implemented. Ideally it should be a written plan consolidated into one binder.

1. Owners personal objectives and dreams
2. Personal financial plan and retirement needs analysis
3. Determination of current value of business
4. Plans to improve value of business
5. Business exit strategy and plan
   (should also develop "hit by a bus" scenario)
6. Estate Plan
7. Tax minimizations strategies
8. Insurance needs
9. Investment plans with proceeds from sale
10. Pre due diligence review

	No. of Months	
Activity	**Low**	**High**
Prepare Exit Plan	6	12
Implementation of Value Enhancement and Tax Planning	12	24
Sale/Transition of Business	6	12
Transition involvement	6	24
Total Months	**30**	**72**
Years	**2.5**	**6.0**

Why Understand Business Value?

- To understand the value of this asset today and where it needs to grow to meet your retirement objectives.
- Creates a value mind-set in an organization
  - Have we improved the value of the business over time and by how much?
- Allows management to evaluate the implications of pursuing various strategies with an objective risk-reward methodology.
- Management compensation system – pay for improving value, not status quo.
- Management is prepared to deal with potential interested buyers
  - Offer to good to refuse
- Examine the implications of an acquisition

Business Value

- The investment banking community focuses on Enterprise Value **(EV)**.

- EV is defined as the value attributed to net operating assets of the business independent of its capital structure.
  - Standardize valuation from which the market evaluates operating results
  - Market valuation statistics e.g. multiples of EBIT[1], EBITDA[1], revenues

- For a public company the EV is typically defined:
  - \+ Market value of the common stock
  - \+ Market value of preferred stock
  - \+ Market value of debt
  - – Cash and equivalents and other non-operating assets

[1] **EBIT** = **E**arnings **B**efore **I**nterest and **T**axes **EBITDA** = **E**arnings **B**efore **I**nterest, **T**axes, **D**epreciation and **A**mortization

What drives the EV?

- **Underlying value of the assets**
  - It is the <u>base</u> value of a business
  - If the business is only worth the value of the underlying assets, management has been ineffective in managing the business and/or they are operating in a very competitive market

- **Expected cash flow generated by the business**
  - Predictable/maintainable/definable **Key cash flow attributes**
    - Customer or Supplier Diversity
    - Industry concentration/diversity
  - Trend – up, down, or level
  - Capital expenditure and working capital needs
  - Return on invested capital – **excess over minimum EBIT**

Enterprise Value Driver – Cash Flow or Assets?

(MM$ except per share amts.)	Cintas	Core Molding Tech
Latest Twelve Months (LTM)	08/31/18	06/30/18
Revenues	$ 6,563	$ 209
EBIT	1,049	6.7
% of Revenues	16.0%	3.2%
EBITDA	1,346	14.1
% of Revenues	20.5%	6.7%
Current Stock Price 9/25/18	212.96	7.16
52 week Hi	217.34	23.85
Lo	141.76	7.16
Book Value Per Share	31.27	12.95
Shares Outstanding	107	8
Enterprise Value		
Cash/Investments	$ (299)	$ -
Total Debt	2,536	43
Preferred Stock	-	-
Common Equity	22,787	57
Enterprise Value (EV)	$ 25,024	$ 101
Book Value of Common Equity	3,346	104
Net Assets Employed	$ 6,309	$ 155
EBIT/Net Assets Emp.	16.6%	4.3%
Tangible Net Assets Employed	2,924	115
EBIT/Tangible Net Assets Emp.	35.9%	5.8%
Market Valuation Statistics:		
EV/EBIT	23.9X	15.0X
EV/EBITDA	18.6X	7.1X
EV/Revenues	3.8X	0.5X
EV/Tangible Net Assets Employed	8.6X	0.9X
EV/Net Assets Employed	4.0X	0.6X
Stock Price/Book Value	6.8X	0.6X

Enterprise Value Driver - Trends

		Cintas	Core Molding Tech
Fiscal Year End Month		May	Dec
Revenues	LTM	$ 6,563	$ 209.2
	2017/2018	6,477	161.7
	2016/2017	5,323	174.9
	2015/2016	4,796	199.1
	2014/2015	4,370	175.2
	Growth 2014/15 to LTM	50%	19%
EBIT	LTM	$ 1,049	$ 6.7
	2017/2018	1,032	8.6
	2016/2017	853	11.5
	2015/2016	769	18.7
	2014/2015	684	14.8
	Growth 2014/15 to LTM	53%	-55%
EBIT ***% of Revenues***	LTM	16.0%	3.2%
	2017/2018	15.9%	5.3%
	2016/2017	16.0%	6.6%
	2015/2016	16.0%	9.4%
	2014/2015	15.6%	8.4%
EBITDA	LTM	$ 1,346	$ 14.1
	2017/2018	1,311	14.8
	2016/2017	1,050	17.7
	2015/2016	934	24.8
	2014/2015	839	19.8
	Growth 2014/15 to LTM	60%	-29%
EBITDA ***% of Revenues***	LTM	20.5%	6.7%
	2017/2018	20.2%	9.2%
	2016/2017	19.7%	10.1%
	2015/2016	19.5%	12.5%
	2014/2015	19.2%	11.3%

Determining the EV of a Company

1. Prepare a strategic plan
2. Develop a long-term financial forecast – worse, expected, and best case scenario
3. Ideally develop a forecast on each strategic business unit within the company
4. Apply the discounted cash flow (DCF) methodology to future cash flows to determine the enterprise value of various scenario.
5. If the DCF value is not significantly above the estimated fair market value of its net assets employed, then an appraisal of the company assets should be secured (both fair market value in-place and orderly liquidation value).

Let's go thru an illustration of XYZ Company

Enterprise Value via DCF Model

XYZ Company

Income Statement

(000's)

Succession Planning Illustration

		Actual			Projections				
		Y/E Dec. 31			Years Ending Dec. 31:				
		Year 1	**Year 2**	**Year 3**	**Year 4**	**Year 5**	**Year 6**	**Year 7**	**Year 8**
Incomes Statement									
Net Sales		$ 41,000	$ 38,000	$ 40,000	$ 42,000	$ 44,100	$ 46,305	$ 48,620	$ 51,051
Cost of Goods Sold		30,400	28,880	29,600	31,974	33,569	35,244	37,003	38,850
Gross Profit		10,600	9,120	10,400	10,026	10,531	11,061	11,617	12,201
SG&A		2,000	1,800	1,900	1,948	1,996	2,046	2,097	2,150
Income From Operations		$ 8,600	$ 7,320	$ 8,500	8,078	8,534	9,014	9,520	10,052
Other Expense (Income)					-	-	-	-	-
Interest Expense (Income)					142	93	43	(11)	(63)
Earnings Before Taxes					7,936	8,441	8,972	9,531	10,114
Income Taxes	35%				2,731	2,908	3,093	3,289	3,493
Net Income					$ 5,205	$ 5,534	$ 5,878	$ 6,242	$ 6,621
Depreciation & Amort.		$ 613	$ 633	$ 653	$ 684	$ 715	$ 747	$ 781	$ 817
EBITDA		9,213	7,953	9,153	8,763	9,249	9,762	10,301	10,868
Net Sales		100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Cost of Goods Sold		74.1%	76.0%	74.0%	76.1%	76.1%	76.1%	76.1%	76.1%
Gross Profit		25.9%	24.0%	26.0%	23.9%	23.9%	23.9%	23.9%	23.9%
SG&A		4.9%	4.7%	4.8%	4.6%	4.5%	4.4%	4.3%	4.2%
Income From Operations		21.0%	19.3%	21.3%	19.2%	19.4%	19.5%	19.6%	19.7%
Depreciation & Amort.		1.5%	1.7%	1.6%	1.6%	1.6%	1.6%	1.6%	1.6%
EBITDA		22.5%	20.9%	22.9%	20.9%	21.0%	21.1%	21.2%	21.3%
Sales Growth		9.9%	-7.3%	5.3%	5.0%	5.0%	5.0%	5.0%	5.0%
Gross Profit B/4 Depreciation		27.3%	25.7%	27.6%	25.5%	25.5%	25.5%	25.5%	25.5%
Effective Income Tax Rate					34.4%	34.4%	34.5%	34.5%	34.5%
Interest Rate					5.80%	5.80%	5.80%	5.80%	5.80%

Enterprise Value via DCF Model

XYZ Company — **Succession Planning Illustration**

Balance Sheet

(000's)

	Actual				Projected				
	Y/E Dec. 31				At Dec. 31:				
	Year 1	**Year 2**	**Year 3**	**Pro Forma**	**Year 4**	**Year 5**	**Year 6**	**Year 7**	**Year 8**
Balance Sheet									
Cash	$ 144	$ 866	$ 1,301	$ 1,301	$ -	$ -	$ -	$ 1,189	$ 2,982
Accounts Receivable	5,055	4,685	4,932	4,932	5,040	5,292	5,557	5,834	6,126
Inventory	2,998	2,848	2,919	2,919	3,150	3,308	3,473	3,647	3,829
Prepaids	300	384	443	443	210	221	232	243	255
Total	8,497	8,784	9,595	9,595	8,400	8,820	9,261	10,913	13,192
Gross Property	6,600	6,800	7,000	7,000	7,210	7,431	7,662	7,905	8,160
Accum. Depreciation	1,700	2,333	2,985	2,985	3,669	4,384	5,131	5,912	6,729
Net Property	4,900	4,468	4,015	4,015	3,541	3,046	2,531	1,993	1,431
Goodwill	2,000	2,000	2,000	2,000	2,000	2,000	2,000	2,000	2,000
Total Assets	$ 15,397	$ 15,251	$ 15,610	$ 15,610	$ 13,941	$ 13,866	$ 13,792	$ 14,906	$ 16,623
Accounts Payable	$ 1,666	$ 1,582	$ 1,622	$ 1,622	$ 1,470	$ 1,544	$ 1,621	$ 1,702	$ 1,787
Accrued Liabilities	250	200	250	250	192	201	211	222	233
Current Liabilities	1,916	1,782	1,872	1,872	1,662	1,745	1,832	1,924	2,020
Short Term Debt	4,500	1,070	904	904	488	315	55	-	-
Long-Term Debt	-	3,210	2,711	2,711	1,463	945	164	-	-
Total Debt	4,500	4,280	3,615	3,615	1,950	1,259	219	-	-
Equity	8,981	9,189	10,123	10,123	10,329	10,862	11,740	12,982	14,603
	$ 15,397	$ 15,251	$ 15,610	$ 15,610	$ 13,941	$ 13,866	$ 13,792	$ 14,906	$ 16,623
Net Assets Employed	$ 13,337	$ 12,603	$ 12,437		$ 12,279	$ 12,122	$ 11,960	$ 11,793	$ 11,622
RONAE	69.1%	63.1%	73.6%		71.4%	76.3%	81.6%	87.3%	93.5%
Borrowing Capacity (2.0 times EBITDA plus cash less debt)	$ 14,069	$ 12,491	$ 15,991		$ 15,575	$ 17,239	$ 19,304	$ 21,791	$ 24,718

Enterprise Value via DCF Model

XYZ Company **Succession Planning Illustration**

Cash Flow

(000's)

	Projected				
	Years Ending Dec. 31:				
	Year 4	**Year 5**	**Year 6**	**Year 7**	**Year 8**
Net Income	$ 5,205	$ 5,534	$ 5,878	$ 6,242	$ 6,621
Depreciation and Amortization	684	715	747	781	817
Change in Working Capital	(316)	(337)	(354)	(371)	(390)
Capital Expenditures	(210)	(221)	(232)	(243)	(255)
Other	-	-	-	-	-
Annual Cash Flow	5,363	5,691	6,040	6,409	6,792
Beginning Cash	1,301	-	0	(0)	1,189
Dividends	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)
Increase (Decrease) in Debt	(1,664)	(691)	(1,040)	(219)	-
Ending Cash Balance	$ -	$ 0	$ (0)	$ 1,189	$ 2,982

Enterprise Value via DCF Model

XYZ Company
DCF Enterprise Value
(000's)

	Projected				
	Years Ending Dec. 31:				
	Year 4	**Year 5**	**Year 6**	**Year 7**	**Year 8**
Adjusted Cash Flows					
Annual Cash Flows	$ 5,363	$ 5,691	$ 6,040	$ 6,409	$ 6,792
Interest Expense Adjustment	82	54	25	(7)	(36)
Adjusted Annual Cash Flows	$ 5,446	$ 5,745	$ 6,065	$ 6,402	$ 6,756

Present Value of Annual Cash Flows	$ 21,331
Present Value of Residual Value	26,472
Enterprise Value of Business	**$ 47,803**

	Multiple of EV	
	Year 3	**Year 4**
EBITDA	5.5X	5.5X
NAE	3.8X	3.9X
Sales	1.2X	1.1X

EBITDA Year 8	$ 10,868
Multiple of EBITDA	4.4X
Residual Value	$ 47,915
Multiple NAE Yr. 8	3.3X

Cost of Capital					
Capital	**Amount**	**% of Total**	**Pretax Cost**	**After Tax Cost**	**Weighted Cost**
Debt	18,305	38.3%	5.8%	3.8%	1.4%
Equity	29,498	61.7%	27.7%	18.0%	11.1%
Total	47,803	100.0%			12.6%
		Assumed Cost of Capital			**12.6%**

Cost of Capital	Enterprise Value
11.5%	$ 52,099
12.6%	**47,803**
13.0%	46,404
14.0%	43,228

		Spread
Five-Year Treasury	2.80%	3.00%

Factors to Consider to Improve EV

- **Strong management team with depth**
  - Need to encourage owners to increasingly delegate and reduce the dependence on them and **build succession plans**
    - Is the business highly dependent on an individual or small group?
    - Is there a succession plan for key positions?
    - Incentive plan that rewards building value?
    - Owner may want to consider "clip coupon strategy"
- **Planning process**
  - Annual business plans with budgets
    - Goals and action plans that that help improve the value of the company
  - Strategic plans that:
    - Delineates where the business stands in the market
    - Where it is going and how its going to get there
      - Marketing, Production/Operations, Technology, Human Resources
    - Basis for a confidential business memorandum

Factors to Consider to Improve EV

- **Competitive position**
  - Leader in the market or highly fragmented… buyer's want leaders
  - Entry barriers (patents, size, process, systems, distribution, etc.)
  - Low relative cost
  - Reputation and brand management in the market
- **Customer Base**
  - Do not become overly dependent on one customer - diversify
  - Longevity and loyalty of customer base
  - Reputation in the marketplace
- **Supplier Base**
  - Dependency on any particular supplier
  - Adequacy of supply

Factors to Consider to Improve EV

- **Accounting/information systems**
  – Accurate and reliable MIS systems
  – How does management use the system to drive the business
    - What are the key metrics that are used to manage the business
  – Level of outside review – audit, review, compilation
    - As you get closer to potential sale consider moving to review or audit

- **Documentation** (removes uncertainty)
  1. Keep track and document unnecessary expenses (for recasting)
  2. Corporate records up to date – minutes, by-laws, articles of incorporation
  3. Buy-sell agreements are up-to-date and with appropriate valuation method.
  4. Review of outstanding liens or potential liens
  5. Organize and review all major contracts – especially larger non-cancellable
  6. Policies and procedures manual are current
  7. Employee benefit programs – relative to market
  8. Workers' compensation – safety programs
  9. Environmental compliance – need for environmental audit
  10. Repair and maintenance (PM system)
  11. Current fixed asset ledger (possibly appraisal)

Factors to Consider to Improve EV

- **Culture of the business**
  - Is the environment encouraging where the employees have a clear sense of direction and perform at a high level?
    - Have an outside firm survey the employees
- **Housekeeping**
  - **Inventory** -- take a physical and eliminate slow moving and obsolete
  - **Accounts receivable** -- collect or write-off overdue accounts
  - Clean and organized facilities and equipment

The "How to Exit" or Realize EV
The Decision Process:

Liquidity Alternatives

- Objectives
- Alternatives

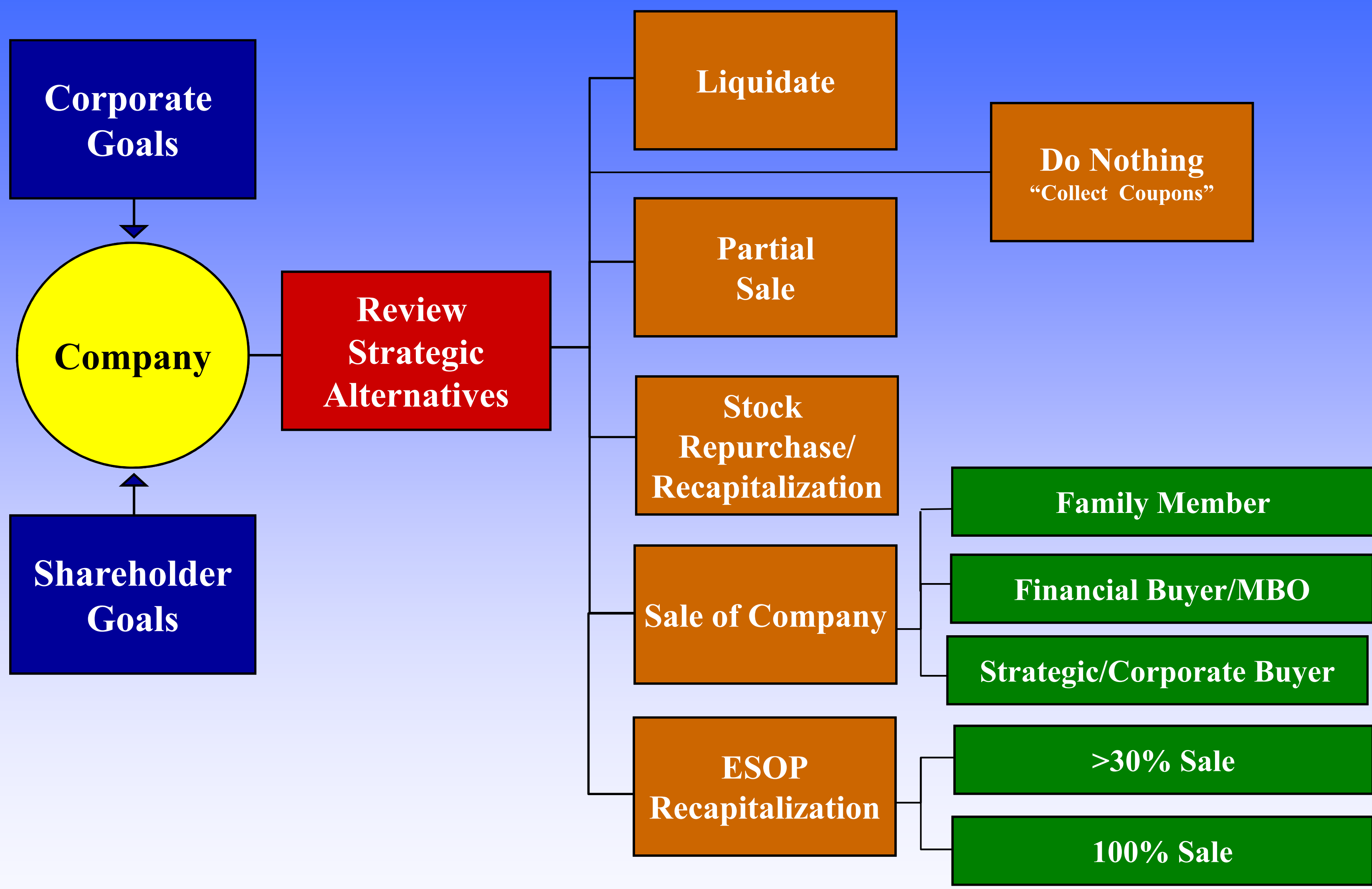
What are my objectives?

- Do I care about involving/rewarding key employees?
- Do I or don’t I want to remain active?
- Do I have a succession management team?
- Do I or don’t I want a continued equity interest in the company?

What are my objectives?

- How does this asset fit in my estate plan?
- How does it fit with my portfolio diversification goals?
- Do I have family in the business and/or key management to protect?

Alternatives to Realize EV



Types of Buyers

A. ***Strategic*** -- can generally pay the highest price for a business because of the potential synergies, e.g. eliminate duplicate costs, improve pricing in the market, capitalize on channels of distribution, avoid start-up costs, etc.

B. ***Financial (private equity)*** – the purchase price is based on a financial model of what they can do with the business. They need to generate a return for their equity investors and tend to capitalize on leverage (50% to 75%). They may have a vision or plan to improve the business is such a way that they can pay more than the strategic buyer. They could be a strategic buyer if they are looking for add-ons to an existing business.

C. ***Management/Employee buyout (MBO/ESOP*)** – Typically management does not have the capital to acquire business apart from partnering with a private equity firm. Thus the management or employee group will generally offer a lower price and the owner has to assume more risk and take payments over time thereby assuming more risk.

Planning for the Transition
Summary

- **Develop an Exit Planning Team** – CPA, Attorney, M&A Advisor, Financial Advisor, Insurance Advisor, Estate Planner
- **Develop an Exit Plan (written) –** financial plan, estate plan, business development, business transition, and retirement plan (retire to something)
- **Annual meeting with the Exit Planning Team –** review plan and make adjustments
- **Continue to build the value of the business –** what can we do to improve the business
- **Sell the business, transfer to family, or liquidate**
- **Enjoy retirement**