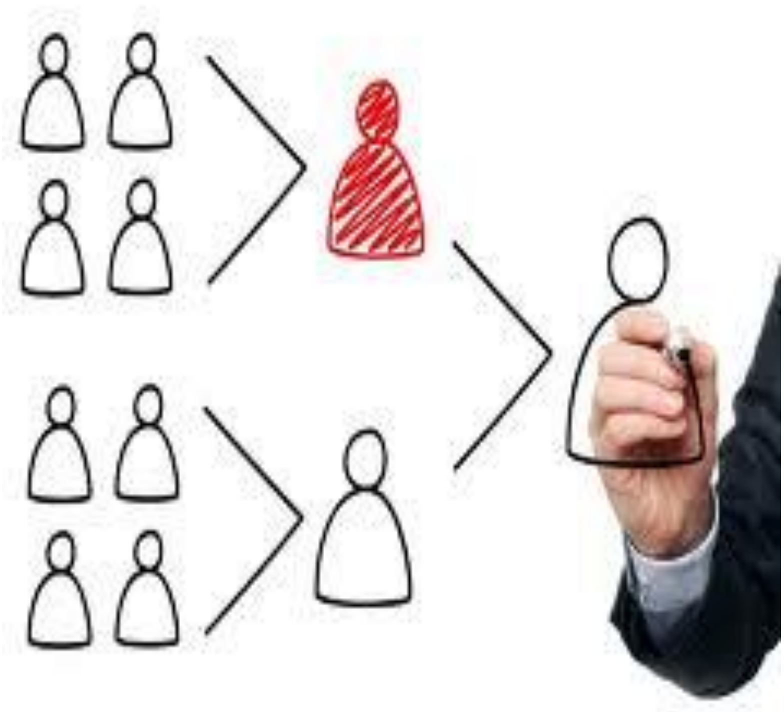
Browne & Mohan
Board & CEO Advisors, Management Consultants

Hanging the shoes in style!!: Planning & Preparing SME family business for profitable exit

Abstract: Family run small business form the core of economic activity of many countries. Most companies change hands in emergency situation such as illness or death of the owner. In this article, Browne & Mohan consultants share an approach the family business SME can use to plan and prepare for successful exit.



Dr TR Madan Mohan and R.M. Sanjay

Images are courtesy of copyright owners.

Introduction

Family run businesses are a significant segment of any nation's industrial structure. 5% of US GDP is contributed by family businesses and 35% of Fortune 500 is family owned. They generate close to 50% of employment and 59% of all new job creations (Institute of Family owned business, 2011). According to Inc magazine 65% of small companies, around 10 Million are likely to exit during the next decade. Shockingly 90% of then have no exit plan. In nearby Canada, the story is similar. According to CIBC, at least 5,50,000 owners are likely to exit their business and about $3.7 trillion business is going to change hands by 2020. There are around 3 Million family businesses in UK, about 75% of them are expected to retire soon and none have an exit strategy in place (Institute for Family Business). Closer home, in India 95% of business are family run, and 30% of BSE listed companies are family owned (CII, 2010). According to a recent IFC study, in India 65 Million people are employed in 298.8 Million MSME spread across the states. These companies product more than 6000 products, contribute to 45% of manufacturing output and 40% of the total exports of the country. While no official statistics is available on their closure, anecdotal data and secondary information indicates just about 20% survive for a first generation transfer and 95% of them become defunct within two decade of demise of founder. Many SME family business owners wish to pass their business on to a family member or a new owner. Entrepreneurs want to cherish their achievement and wish to see the benefits of their creation enjoyed by successive generations. Preparing for sale of a family led SME business is not just a micro issue that impacts the business involved. Companies changing hands can employ 2-3 million people in next five years and account for 10-15% of the GDP.

Exit for family led small and medium businesses happen predominantly through three channels: M&A, IPO or natural death. Unfortunately, many SME family businesses are ill prepared for the ownership transition. Most companies change hands in emergency situations such as illness or death of an owner or partner. Consequently, many SME family businesses (or their heirs) are forced to accept a transaction that is less desirable. Most SME family business owners do not discuss the exit plans with their family or partners. SME family business owners must plan the exit if they are eyeing retirement or a new venture. Insufficient planning prevents the SME business owner from capitalizing on ideal valuation. SME family business owners need to develop an exit strategy with a target date in mind and prepare the company to move ahead under new leadership. They need to plan sufficiently in detail and in advance to systematically execute the transition. Some business owners may shy away from creating an exit strategy because they are fine with the status quo or believe once it is planned and executed, the plan can't be changed. Preparing a business for ownership change may bring in many an upside benefits even if the business is not finally sold. The inadvertent benefits that emerge because of planned changes may unbundle the hidden value of the company. In this paper, Browne & Mohan consultants share the approach that could be used by SME family business owners to profit from planned exit.

Preparing the SME family business for sale: a three step process

Goal Setting

One of the important components of a family business exit is to have a clear perspective of what is the end goal. Have a clear business plan and strategy for at least 2 to 3 years on what the business has to achieve for them or their heirs, how will they extricate themselves and how the transition is going to be in near term quarters and couple of years. This is to show the road map, the growth plan, investments required and vision for the company. It helps clarify purpose and reinforces the vision of the buyer or investor. Clarity on the type of capabilities that need to be built to reach a certain goal is important. Detailed plans in other functional areas will also help to show that much of what is being done has been thought through carefully.

Identifying Gaps

Once the goals are clear, visualize what should be status of the company to receive that valuation. Analyse the limitations of your current business, how it is run, how it is managed and monitored. Identify gaps that exist within the firm in the form of individual talent, a second level of leadership, functional expertise etc that need to be fortified. Gaps could also be in the form of missing performance management systems to professionally manage the company, a weak sales and marketing organization that is reactive in nature, an unsuitable organization structure that hinders the firm from responding effectively to the market, or systems that are not facilitating share of information for effectiveness. Benchmarking with competition is useful to identify these gaps and bridge them.

SME business owners must have a time frame in mind and develop an improvisation plan to coordinate the schemes of activities to be pursued and resources. Any SME family business exit can never happen early. Three to five years lead time is required to adequately plan and execute a profitable exit plan.

Pursue improvisations

To secure the best valuation, the company must pursue actions that help to fill the gaps and optimize company value. SME business owners must consider all tasks and activities that improve value from both strategic and financial buyers perspective. Acquiring investors would look at free cash flow, the risk and scalability of the business. Value drivers that enhance value of the organization need to be identified and the transformation plan should revolve on putting in place systems, processes and people to increase value along these lines in sales, marketing, alliances, for review and control. The PSPD (Predictability, Sustainability, Profitability and De-risking) methodology can be used to identify these drivers. Making cash flows predictable and stable, building customer diversity, de-risking from certain technology platforms, building and executing a realistic growth plan, systems and procedures, product diversity, an effective sales engine, human resources and leadership are all drivers of business value.

Profitable business exit for SME businesses is all about holistic change companies need to undergo to basically grow faster or become more relevant to the market. This change can be implemented incrementally with small measured steps. There surely would be resistance on the path. The first question when companies attempt transformation is which process to touch. In most businesses, the easiest function that is amenable change and one without too much dependencies and investments is “sales”. Moreover, any minor changes in sales function has a direct impact on the “outcome”, be it new customer acquisition, or more orders from existing customers. Any win, however small, can uplift the mood for change and thaw the resistance to change.

Implementing the “Build to sell” agenda

From an SME perspective, the value drivers which they need to work on to enhance the company’s value are:

- Goodwill and brand value
- Employees, capabilities and competencies

- Profitability
- Costs
- Intellectual property
- De-risking on technology, customers and geographic markets

Enhance Goodwill and brand value: A SME business acquires goodwill through better customer service, innovation and common good business principles (credit policy, quality and legal framework adherence). The result is reflected in the valuation of the business as measured by the mentioned factors. Companies building to exit must first evaluate where they stand on these parameters. From a quality perspective strengthen the QMS maturity of the organization. Invest n best practices, adopt and get certified on ISO and other industry standards, and eliminate non-standard business practices. Emphasize to drive these vigorously with quarterly improvement plans. Marketing outcomes like winning of sponsored awards, sponsored research, industry and government recognition increases the visibility of the company. SME owners planning to exit their business must pursue outcome drive engagement with industry association, nominate their company for winnable government and non-state actors awards, sponsored publications. Having eminent professionals on board (management) and being associated with market renowned institutions provides that extra mileage or push the company requires to position itself in the market or related industry. Companies often get noticed because of their management or investors. These professionals/institutions play a major role in the market perceptions about the company and its credibility. Leveraging the standing of these entities or persons, the company can signal the market about its arrival, potential and capabilities.

Focus on Improving Profitability: Profitability is the primary goal of business ventures and investors look at companies that have predictable YoY growth profit making companies. Two aspects that are vital for the business owners planning to build their companies for sale. An untiring focus on top line revenues and bottom line profit is a must. SME owners can pursue quick and faster impacting strategies such as increase in the customer base or increase in price to gain the top line revenues. Again, these decisions need to be made considering the market in which the business operates and the type of product sold. The profit to sales ratio when compared to historical results and industry averages need to favourable signifying efficient management of revenue and costs.

For, SME companies that are building to sale in long term, major consideration would be increase in the market share, investment in R & D and best quality resources thereby enhancing the quality of the product and constant innovation in products to become a reliable and long term player in the market. Companies with long term exit windows must use the surplus cash for growth strategies, such as investing in research and development, expanding capacity and exploring new geographic markets.

Optimize Cost: SME companies that are planning to exit must get its hands over cost structure and cost management at earliest. To create a business with predictable revenue on periodic basis, a company needs to create opportunities and business models so as to keep the revenues coming and expect continuous returns. The more the company makes profits by reducing its costs, the more lucrative it becomes to the buyers. Companies built to sell focus would be on generating maximum revenue and increased profits by making efforts to reduce the costs and generate maximum benefits with the available resources. The reduction in operating cost of a company is the primary financial objective for many good companies. Eliminate non-value adding activities and expenditure that have an impact on the financial performance or revenue of the company. The efficient utilisation of resources and minimal wastage with good quality are key elements to create a profitable and attractive business. Determining how to cut costs without disturbing the company’s ability to generate revenue and survive over the long term is a challenging issue. Companies should evaluate what is the immediate / long term impact on the value drivers due to cost savings. Unprofitable product lines, bloated sales organizations, inefficient delivery organization, inadequate marketing department are the right candidates for cost optimization. For SME owners building to sell, the focus should also be on utilizing near 100% capacity. This would indicate the buyers that the organization has enough work on hand and the cost per unit is also minimised wherein there is optimum utilization of resources. The firm is assumed to be using all of its fixed assets effectively; therefore the profits should be high. Two approaches that could increase capacity utilization could be by reducing the factors of production employed or move into smaller premises/ cut down investment on facilities.

A company's proportion of short term and long term debts are key areas of evaluation. The debt equity ratio is an indicator of the company's internal and external liabilities. It reflects the financial position of the company as it is a measure of the financial leverage. A high debt equity ratio would mean that a company has been aggressive in financing its growth through external debts. A low ratio is considered good as the company is less exposed to interest rate increases. But a good interest coverage ratio can back the high debt by indicating a better operating income to meet its obligations. Built to sell companies must tend to maintain less long term obligations and improved liquidity positions. The profit to sales ratio when compared to historical results and industry averages tend to be favourable signifying efficient management of revenue and costs. Creating positive cash flow cycles is a pre-requisite as buyers need not commit their capital to fund daily operations and positive cash flows do not incur financial expenses. The favourable liquidity ratios indicate the company's position in leveraging the current assets to pay off the immediate/short liabilities. Working capital, if managed efficiently proves to be an add-on in the buyer's list to consider the company.

Identification of revenue leakages would be a prime focus to attain sound financial performance. Revenue leakage could occur due to misappropriation of funds by the staff, errors in documentation or recording transactions, lack of trained staff and operational issues in control systems. Streamline with appropriate controls in all the areas of the revenue cycle. Consolidating and co-relating all revenue related information and constant reconciliation could identify and minimise potential losses and associated risks. Automation of processes and industry best practises like Six Sigma, ISO and CMMI could also prove to be a method by which standardisation of activities and processes could be brought about in the organisation.

Identify, prop and protect Intellectual property: It is very important for Owner led SME companies that are planning to benefit from knowledge integration. Productization of services help in creating standard business lines that are standardized and scalable revenue sources. Corporate valuation relies greatly on a company's intellectual assets such as patents, and trademarks. SME owners can gain value by creating skunk teams that quickly integrate the "implicit knowledge" underlying a service and convert that into a demonstrable explicit work-flow based product.

De-risk from customer, market and technologies: SME owners planning to exit their business must prepare to de-risk their companies from customer and market dependencies. In short term incentivize the sales team to acquire new logos, preferably large and recognizable firms in the market. Pursue market ecosystem strategies where partners, business agents and OEM could provide new opportunities. Investing in a partner program sales engine is a good investment that SME owners planning to exit must invest. Expanding the market with existing products and strive for a wider portfolio with a gamut of products catering to multiple needs of the customers. Seek out opportunity to evolve from single or few product / solution to an array of product/ solution company. Extension of the product would mean the enhancement and improvement of the existing product to suit the current market need and technology. Versioning the product could create a market for the product at multiple levels. A comprehensive product is separated and developed into individual products to facilitate the ease of selling and quicker revenue generation. Though a risk mitigation strategy the company has to constantly drive these products and evolve itself to excel and compete.

Focus on Integration, eliminate "unrelated variety" : SME companies planning to sell must know the power of integration and quickly eliminate unrelated variety. Integration in terms of common parts, processes, and people offers great economies of scope advantages. SME owners must pursue integration of production or delivery process, conversion of "implicit knowledge to explicit knowledge", common parts and competencies approach to gain from alignment and improved valuation. Look for Processes or activities which can be automated. This reduces the time taken to perform, manpower cost and manual errors leading to re-work. Consolidation is an integral part of the strategy as it reduces duplication of work and aggregates activities/resources with similar tasks thus reducing the cost and time. Try and eliminate all the activities that prove to be adding least or no value to the company. Modifying the structure, process and incentives of an organisation to support the objectives and revive the existing function yields better results.

For SME companies building to sell, it is better to focus on a few products that are scalable. A single product focus is best – especially a product that is complementary to a large market leader, or perhaps a standardized product with minimum customization. To scale, small companies must stop responding to all and sundry RFPs and not spread themselves too thin. Focus on high margin business. Expand the customer base for this product and grow revenues here. The product should also be scalable, where one is able to foresees future requirements and build in the ability to modify the product with minimal effort. Amidst all the noise and a plethora of products in the market, be careful to avoid commoditisation and make sure the product is valuable to customers, and that they keep coming back for repeat business. The routines to build the product or service also need to be standardised so that owner is not sucked into it. Only when the owner is free from this routine and it becomes executable by the second level of staff, will scaling really happen. SME owners planning to sell their companies must restrict projects with complex work contracts and customization. High Customization and clauses in work contracts may necessitate too project specific investments and might not be acceptable or in good taste with the buyer. The buyer would look at contracts which are hassle free, less binding and ease of execution.

Invest in Employee competency, and capability development.

Many SME are identified by their owners and may lack formal leadership engine to drive the growth. Many may lack formal "how to" instruction manuals in place to run the organization like a well oiled machine. SME company owner planning to exit their business must identify possible leadership resources, invest in them to drive ownership and outcomes so that they are prepared to drive under new management. SME owners can broadly group their associates into doer, improviser and innovators. Bring in formal system to engage doers and provide opportunities for improvisers and innovators to drive change in short term. Help them in picking in low hanging improvement programs so that they taste the sweet taste of success of their initiatives and grow in confidence to own and drive more changes. Simultaneously, Identify and put in place a pool of leaders. These leaders need to be in a position to identify goals, customers, markets and basically address "What is to be done". They also need to work on the execution plans which talks about "How to do it".

Building an effective sales organization is crucial for SME companies planning to exit. Experienced salespeople have to be brought in, who lend a sense of professionalism, lend credibility and make the organization look larger than it really is. It helps in better reach and branding too. Sales metrics, processes and reviews have to be designed and implemented to function effectively. Put in common sense tracking systems that help regularly track prospects, pipeline and conversions, shows buyers that there is visibility into sales, and it can be forecasted.

Employees should not feel threatened by change; instead they must be allowed to participate in this change – especially the critical members of the team who are key influencers. It must vibe with a sense of growth and pride in the organization. Such changes convince fence-sitters that change is good and doable. A highly visible short term win will also enable the top leadership of the firm to start change on a winning note.

Once this clarity of purpose is communicated through initial changes, it becomes necessary to get the second level involved and broaden the base. Create groups to improve their respective functions, ask them to identify and drive changes where they feel empowered. Next involve people in information, communication and advocacy changes. Ask the employees to suggest changes to website, the sales and marketing collaterals that work best and ask them to drive these improvements. Their buy-in is absolutely essential to drive the second-order change. Now that we have a broad based team that believes in the new vision, we need to build a sense of urgency so that the change that has been demonstrated can be capitalized upon. Once this happens, creative inputs on products, offering and markets start to pour in. It also gives everyone a chance to delve deeper into the core offering and strengthen it. Once we have the top and second level of leadership involved in this exercise, they believe in the new vision and positioning, especially since it is their aspiration that has been translated into the firm's vision and strategy. Training and reviewing team members to drive this, building their capabilities and motivating them becomes essential. Working as teams and leveraging off each other needs to become a habit, a new way of working. Once success can be shown in a couple of inter-functional initiatives, a broad base of employees becomes adept at adopting such structures across the entire organization. Making change happen in other functions and departments new becomes a lot easier. Hence managing transformation in stages with the right vision, by building the right capabilities, help build the foundation for a large business transformation. To bring about change for building and organization to sell, the implementation needs to be faster, and hence a top down approach is suitable.

Conclusion

Unplanned exit for an SME family business has both microeconomic and macroeconomic impact. Unplanned exit results in a low valuation not commensurate with the toil and sweat that has gone into building it. The key to get the right valuation for the company is to transform it over at least a year to build in certain capabilities that will make it look attractive to potential suitors. This transformation from an SME business owner driven to a new ownership involves crafting a carefully thought out plan with clear goals and timelines, and implementing it with least disruption. An SME family business considering exit must be aware that actual exit is a result of building a great business. A successful exit strategy requires a clear understanding of the company, what the business owners want out of their business, and consciously building a sellable company over three to five years.

Bibliography

Burbank, T.P. Wealth Building Exit Strategies for Owners of Private Companies: Are you Creating Wealth or Just Making Money, Parker Nelson Publishing, 2011

Burgelman, R.A. A Process Model of Strategic Business Exit: Implications for an evolutionary perspective on strategy, Journal of Strategic Management, 2007

Burlingham, B. Finish Big: How Great Entrepreneurs Exit Their Companies on Top, Penguin, 2014

Chien, C, Work Toward Reward: Building Business Value Today for a Well Deserved Future, iUniverse, 2012.

Jacklim, R.E and Phillips, P. The $10 Trillion Opportunity: Designing Successful Exit Strategies for Middle Market Business Owners, Exit Planning institute, 2007

Hawkey, J. Exit Strategy Planning: Growing Your Business for Sale or Succession, Gower Publishing, 2002.

Manheim, S. Exit Strategy: The Art of Selling a Business: The Vertical Horizontal Method, US Publication.com, 2009

Mill, J. Hire Your Buyer: a philosophy of Value Creation, 2014

Wannberg, K, Wiklund, J, DeTienne, D.R, and Cardon, M.S. Reconceptualizing entrepreneurial exit: Divergent exit routes and their drivers, Journal of Business Venturing, July 2010.