

THE EXIT MAGIC NUMBER™

THE MOST IMPORTANT NUMBER TO A BUSINESS OWNER

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PLANNING TODAY FOR TOMORROW'S EXIT

SUCCESS AT EXIT: ACHIEVING PERSONAL FINANCIAL FREEDOM

Benjamin Franklin is said to have coined the phrase that “nothing is certain except for death and taxes.” Respectfully, Mr. Franklin missed something. Another certainty is that all owners of closely held businesses will exit their business one day. Either the owner will sell the business, give it away, or as Mr. Franklin points out die—nobody owns a business forever. Nearly as certain as the eventuality of exit is the observation that successful business owners want to achieve “financial freedom” when they exit. That is, owners aspire to exit their business in such a manner that they do not *need* to work again post-exit. A national research study commissioned by the author revealed that reaching personal financial freedom at exit is nearly a universal primary objective for business owners.¹

Unfortunately, too many successful business owners receive incomplete or bad advice on this issue. Many owners have little to no idea of how much money they need to reach financial freedom beyond wild guesses. When somebody actually takes the time to crunch the numbers, often the figures are inaccurate. One common reason for the inaccuracy is living expenses commonly subsidized by the business during the owner’s working years. Medical insurance, travel, entertainment, meals and vehicles are often understated or altogether missed in the calculations.

THE FALLACY OF “MAXIMUM VALUE”

Perhaps the most common mistake in addressing owners’ ultimate desire to achieve financial freedom at exit is the misplaced focus on “maximum value.” Conventional wisdom suggests owners should focus on getting “maximum value” for the business at exit, which presumably means selling the business for the highest potential price. There are five major problems associated with using “maximum value” as a yardstick for exit success:

1. **Maximum value may fall short.** There is no connection between the business’s maximum sale price and the net amount the owner needs from the business at exit to achieve financial freedom. For example, the maximum value of a business might be \$5 million, and the selling owner nets \$3 million after costs, debt, and taxes. If he or she needed \$4 million to reach financial freedom, then “maximum value” was not enough. Unless compelled to exit for reasons such as poor physical health or a dying marketplace, most owners will not sell if the “maximum value” produces a net amount that falls short of what they need. If the maximum value falls short, the selling owner must get a new job, start a new company, or simply cut back on the lifestyle that he or she has enjoyed up to that point. Faced with those options, many owners will choose not to sell at that time. Selling for the maximum sale price does not necessarily provide for a successful exit.
2. **Maximum value results in different outcomes for different owners within the same business.** With multiple owner businesses, getting maximum value at sale may leave some owners smiling

and others crying. For example, assume a business with three owners: Owner A owns 60%, Owner B owns 30% and Owner C has the remaining 10%. Assume this business sells for a “maximum value” of \$30 million. Owner A grosses \$18 million (60% of \$30 million) and therefore may have a smile on his or her face. Owner B with 30% ownership grosses \$9 million and also may be happy at exit. Finally, Owner C receives 10% or \$3 million gross, and after costs, debt and taxes might take home only a fraction of that amount. While one or two million in the checking account sounds nice, it might fall far short of creating financial freedom for that particular owner. In this example, Owner C likely cannot block the sale or dramatically change the math. But in our experience Owners A and B may regret selling the business if the outcome results in their partner and friend falling short of personal financial freedom.

3. **“Maximum value” often produces maximum taxes.** Many tactics that reduce taxes at exit involve reducing the nominal value of the business, and bringing into the picture other means of compensating the seller, such as consulting agreements, employment contracts, and other devices. In most cases, taxes are the greatest cost at exit—focusing on top line sale price rather than the net result risks reducing exit success.
4. **The owner may sell for “maximum value” but that does not mean the owner will ever see all of that money.** When a small to mid-sized business is sold, one cannot pay attention simply to the sale price. Beyond the gross price, the timing and terms of the deal are critically important. For example, a business sale for \$20 million price might include \$5 million in cash and the balance in any combination of the buyer’s stock, earn out provisions, deferred payments, seller financing, and other mechanisms. The selling owner may need some or all of those deferred or contingent dollars to achieve financial freedom, but may never see some or all of it. For example, the buyer may default, the earn out targets may never be reached, the seller’s stock may crash. Any dollars not received by the seller at the closing table are at risk.
5. **Selling for “maximum value” is inconsistent with several exit strategies.** Owners whose exit strategy is to pass their businesses down to a successor family member are unlikely to get maximum value at exit. Quite the contrary—maximum value for family business transfers can mean maximum financial burden on the children and maximum exposure to estate or gift taxes. Likewise, owners who intend to sell their business to key employee internal buyers often forgo “maximum value” in favor of other considerations such as creating their business legacy and rewarding employee loyalty.

Exiting for “maximum value” is not a recipe for success for many owners. It ignores most owners’ paramount desire to achieve financial freedom, downplays tax planning and likely misplays the needs of owners who anticipate family transfers or an internal sale. Exiting for “maximum value” sounds nice and may be the path to exit success, but its focus is misplaced.

THE EXIT MAGIC NUMBER™ CALCULATION

A superior approach in exit planning uses what the author's organization calls the Exit Magic Number™ calculation. The Exit Magic Number™ calculates how much capital an owner needs to receive from the business between now and the exit to achieve personal financial freedom. Note that analysis focuses on how much an owner *needs from the business*, not what the business is worth. This is a different focus compared to the "maximum value" approach. If the owner's primary requirement for a successful exit is to achieve financial freedom, then a sound exit plan must place primary importance on measuring and reaching this outcome. If an owner receives anything above the minimum needed for financial freedom, the extra is gravy. Before going after "maximum value," owners need to first address if they have their bases covered with minimum risk and taxes.

HOW TO DETERMINE THE EXIT MAGIC NUMBER™ CALCULATION

The Exit Magic Number™ models the owner's financial needs. Anybody familiar with a financial calculator can do the math, so long as accurate data is used and the two-steps outlined below are carefully followed.

The first step is to determine the "net capital needed" to support the owner's net lifestyle costs after exit. In other words, how big of a nest egg will the owner need to afford his or her desired lifestyle after exit, taking into account inflation and taxes? This involves quantifying the current lifestyle costs and then projecting out for the future with inflation. For people who do not own a business, this is a straightforward exercise in retirement planning: tabulate what is spent at home, project future spending wants and needs, and then calculate the size of the financial nest egg. For business owners, doing the analysis the same way generates an inaccurate, and often highly understated, calculation.

Business owners must review not only what gets spent at home, but also what is spent at the company to support the owners' desired lifestyle. Too many owners (and their financial advisors) overlook expenses that the business pays today, but the owner will personally bear after exit: insurance, meals, travel, entertainment, vehicles, phones, computers and club memberships are all common. Missing or underestimating these expenses results in an erroneously low Exit Magic Number™ calculation, which can lead to big problems at and after exit. The author routinely encounters business owners and traditional financial advisors that have already calculated an "exit magic number", but upon further review it is revealed that their figure is too low by 25% to 50%.

The first step therefore is to determine the net capital needed, and for business owners it is imperative to carefully review lifestyle wants and needs that are paid not only from personal funds but also those paid within the business. We will use the fictitious example of Mary Smith, owner of ABC Manufacturing, to illustrate the Exit Magic Number™ calculation process.

Mary is currently 50 years old and wants to exit from ABC Manufacturing at her age 60 with \$250,000 of net annual income in today's dollars. Mary assumes a life expectancy of age 85, so she will need the post-exit income for 25 years. Therefore, the first step in calculating Mary's Exit Magic Number™ is to determine how big of a nest egg she will need to create \$250,000 per year of income in today's dollars starting at her age 60, increasing each year to stay current with inflation. Assume for illustration that this figure is about \$6 million. This figure represents the total "net capital needed" for Mary to achieve financial freedom.

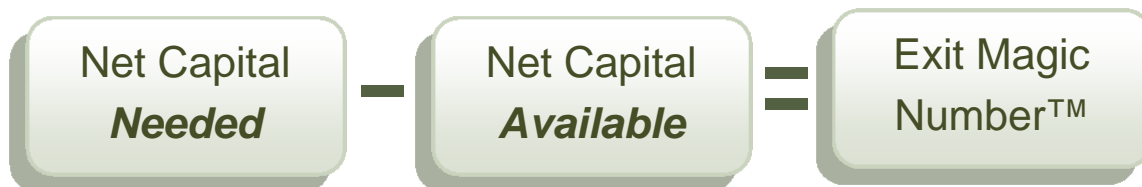
After determining the total net capital needed, the second step is to *subtract* from this figure the amount of net capital and available income an owner expects to have already *outside the business at the exit date*. Note the important elements here—we subtract any dollars or source of dollars (meaning income producing assets such as rental properties, other businesses or pension plans) projected to exist outside the business by the time of exit.

Mary owns a commercial office building in a personal LLC and leases it back to her company. She estimates the building's net equity will be \$1 million by her exit date in ten years. With this potential \$1 million already outside the business available for income (either by selling the building and reinvesting the equity, or by keeping it and continuing to earn rental income after she exits) then, her Exit Magic Number™ decreases from \$6 million to about \$5 million.

The Exit Magic Number™ calculation forecasts the amount an owner needs to extract from the business leading up to and at exit in order to achieve financial freedom. The more capital or income sources an owner has outside the business by the exit date, the lower the Exit Magic Number™ result.

Mary sets up a profit sharing plan at her business. Her advisors calculate that her account balance in the plan could grow to \$500,000 after taxes by the time of her exit, assuming a certain amount of contributions and investment growth. Mary's projected Exit Magic Number™ calculation is further reduced, from \$5 million to \$4.5 million.

Subtracting from *the total capital needed* the *available amount of capital and income* the owner expects to have outside the business at exit date produces the Exit Magic Number™ calculation. The equation, simply stated, looks like this:



A STATEMENT OF FINANCIAL DEPENDENCY

At its heart, the Exit Magic Number™ calculation is *a statement of financial dependency on the business*. The higher the owner's figure, the greater his or her financial dependency on the business. Mary *needs* \$4.5 million in the example above to achieve personal financial freedom for the lifestyle she desires. The most common misunderstanding about the calculation is that it is tied to what the business is worth. The two numbers are completely unrelated. If Mary's business is worth \$2 million, her Exit Magic Number™ calculation is \$4.5 million. If Mary's business is worth \$20 million, her Exit Magic Number™ calculation is still \$4.5 million. "Maximum value" focuses on how much the business might be worth; the Exit Magic Number™ focuses on how much the business owner needs.

A higher Exit Magic Number™ calculation means the owner is more dependent on the value locked within the business to achieve financial freedom. Consider Mary's example. If she did not have the office building or funds in the profit sharing plan as illustrated above, her number would increase back up to the \$6 million original figure. The problem is that the greater the owner's dependency on the business, the harder it often becomes to successfully exit.

For this reason, the ideal Exit Magic Number™ calculation is zero. At first, this may seem counterintuitive for owners who continue to connect the Exit Magic Number™ with their businesses' value. As we have seen, the Exit Magic Number™ and the business's fair market value are unrelated. Because the Exit Magic Number™ quantifies the financial dependency on the business, a low or zero number means the owner has little to no financial dependency. An owner with little to no financial dependency on the business sits in the ideal position—he or she has nearly limitless freedom and flexibility to define their exit strategy.

An example of how a lower number is advantageous involves income taxes. At sale of the business, mechanisms such as installment sales and stock swaps can defer and potentially reduce the selling owner's income taxes. However, both of these tactics usually put the seller's dollars at risk. Deferred payments might never be received. The buyer's stock might decline in value. (There are practical considerations with taking stock, too—stock certificates cannot pay the mortgage, buy groceries or put gas in the car.) The more cash at closing a selling owner *needs* in order to sustain financial freedom, the less ability he or she has to take advantage of these and other tax planning tactics. Dependency reduces flexibility—and potentially increases taxes.

THE MOST IMPORTANT NUMBER

There are two reasons why the Exit Magic Number™ calculation is arguably the most important number in exit planning for closely held business owners. One reason is "defensive" and the other is "offensive".

On the defensive side, the issue is simple but critical—if the owner exits for a net amount short of the Exit Magic Number™ calculation, he or she will fail to achieve personal financial freedom in the manner he or she aspires. The owner who falls short must either reduce his or her post-exit lifestyle, take on higher post-exit investment risks than he or she is comfortable with, go back to work, or some combination of the three. Few owners would happily choose this outcome.

Knowing one's Exit Magic Number™ allows the owner to make decisions today and at exit that defend against coming up short. For example, identifying the number well before exit helps the owner forecast how big the business must grow to in order to not come up short, and make strategic decisions that drive the business toward the owner's exit success. In another example, an owner seeking to sell the business can use his or her Exit Magic Number™ calculation to negotiate the deal terms with an eye towards receiving sufficient cash at closing to reach personal financial freedom. The selling owner who walks away from the closing table with net cash sufficient to achieve personal financial freedom is assured that any additional dollars in the transaction not received at closing and therefore at risk, such as deferred payments, earn outs, seller financing etc., will not compromise his or her financial security.

Owners who know their Exit Magic Number™ calculation can play “offense” too. We have already seen how the owner who knows his or her number can take advantage of tactics at business sale that defer and reduce income taxes. Knowing the number may help an owner combat other taxes too, such as estate and gift taxes. Having an accurate estimate of the Exit Magic Number™ allows owners to consider estate tax sheltering strategies without undermining their future financial freedom.

In Mary's situation, her Exit Magic Number™ calculation was \$4.5 million. Mary's business is estimated to be worth \$20 million, with an estimated potential net value at sale of \$14.5 million. This means Mary needs \$4.5 million net at exit, and has \$10 million in potential value which Mary does not *need* for financial freedom. Mary and her advisors consider putting a large portion of her business stock in a trust to help reduce future estate taxes. Knowing her Exit Magic Number™ calculation enables Mary to be proactive in her estate tax planning.

There are many ways in which an owner who knows his or her Exit Magic Number™ can play “offense” in exit planning—especially if that owner works to reduce the number between now and exit.

LOWERING THE EXIT MAGIC NUMBER

Knowing the Exit Magic Number™ calculation is good; lowering it is better. (And the ideal number is zero.) Because the number is a statement of financial dependency on the business, a lower number creates more flexibility and control. We just presented several examples where a business owner can “go on the offense” in income or estate tax matters. The reader may have noticed already that the lower the Exit Magic Number™, the greater the flexibility to address tax planning. There are other benefits

beyond tax planning for the owner who lowers his or her Exit Magic Number™ calculation prior to exit, such as:

- **Timing control:** The owner with a lower number is in a better position to control the timing of his or her exit. The owner with little to no financial dependency on the business often feels little to no financial pressure to exit before he or she is personally and emotionally ready.
- **Family succession:** Owners who seek to pass the business down to a family successor but have a high number, often will struggle to create their personal financial freedom without financially strapping the business and their children. Conversely, owners with a low number will be able to pass the business down to children for little financial cost and burden, and potentially lower taxes as well.
- **Employee succession.** A lower Exit Magic Number™ calculation helps owners seeking to sell to one or more employees, because the selling owner has more flexibility to deal with the reality that most employee buyers lack cash and collateral. Owner financing, installment sales, earn outs and other mechanisms that facilitate an internal sale are more feasible and tolerable for an owner with a low number.
- **Multiple owner situations.** Businesses with multiple owners face the challenge that different owners usually have different Exit Magic Number™ calculations. At a minimum, younger owners often have a much higher number than older owners simply because younger owners have more years to live post-exit and therefore need a bigger nest egg to achieve financial freedom. If one or more of the owners has an Exit Magic Number™ calculation significantly higher than his or her partners, this can make exit success difficult for everybody. A majority owner with a high Exit Magic Number™ might block anybody from exiting if he or she cannot afford to sell. Even if a minority owner has the high Exit Magic Number™, few owners will be insensitive to a situation where one of their peers comes up short at sale. Consider the following narrative:

Tom and Jerry co-founded a successful consulting firm which they owned on a fifty-fifty basis. Tom was 61 and had an Exit Magic Number™ calculation of \$2.4 million. Jerry was 50. His younger age and the fact that his three children were not yet through college drove Jerry's Exit Magic Number™ calculation up to over \$5 million. Tom was eager to sell and retire. The owners were approached by a strategic buyer that offered a strong price of \$8 million. Tom was glad to accept, but Jerry refused to sell because he would have netted far less than his number. The obvious solution of Jerry buying out Tom was not agreeable either, because Tom would only accept an all-cash deal, and Jerry was unwilling to assume that much risk. The potential strategic buyer eventually went away, and the two owners were stuck.

Reducing the Exit Magic Number™ requires using the business to create wealth for the owner *outside of the business prior to exit*. Ideally, the mechanisms used to reduce the number offer some amount of tax efficiency—simply raising the owner’s wages, paying ordinary income taxes and putting the after-tax surplus into a personal checking account may not be the most tax efficient way to create wealth outside the business.

In the author’s experience, the two biggest obstacles to lowering the Exit Magic Number™ calculation are the owner’s memory and discipline. Business owners, like most working people, struggle to save or invest unless they remember to and have sufficient personal discipline. In some ways however, business owners have a more difficult time than the average employee. Owners are in a constant, unspoken tug-of-war with their businesses for dollars. Rare is the day when a business owner can look at his or her business and say, “My business has no need for any new investment or spending. Everything is absolutely perfect as is.” Until this day comes, owners perpetually struggle with their businesses’ endless clamor for resources. All too often the entrepreneurial voice inside them carries the day and the business gets the discretionary dollars. The paradox is, as the owner constantly reinvests back into the growing business, the Exit Magic Number™ calculation is getting higher and higher.

An in-depth study of mechanisms to reduce the Exit Magic Number™ calculation is beyond the scope of this paper. Briefly, some of the most commonly used methods include retirement plans, asset-lease backs (for example, purchasing an office building and leasing it back to the business to create rental income and equity) and other tactics designed to systematically build wealth for the owner outside the business prior to exit. Consult your business, financial and tax advisors on tactics to systematically reduce your number. Or, read the author’s book *Dance in the End Zone: The Business Owner’s Exit Planning Playbook* for a detailed presentation of tactics to reduce your name, available at www.danceintheendzone.com.

TRACKING THE EXIT MAGIC NUMBER™ CALCULATION OVER TIME

An owner’s Exit Magic Number™ calculation likely changes over time. Given the number quantifies the owner’s financial dependency on the business, as business, personal, financial and economic circumstances change, the number will change. In general, the number is influenced in the following manner:

The Exit Magic Number™ will increase If:	The Exit Magic Number™ will decrease If:
The owner accelerates the exit timetable	The owner delays the exit timetable
The desired income level at exit increases	The desired income level at exit decreases
The owner's debt increases	The owner's debt decreases at a faster rate than previously assumed
The assets or income sources held outside the business decrease or grow at a slower rate than previously assumed	The assets or income sources held outside the business increase or grow at a faster rate than previously planned
Inflation is greater than previously assumed	Inflation is lower than previously assumed

Given the changing nature of the number, owners should consider tracking the figure over time, updating it annually. It bears repeating that the number states how much an owner needs to achieve personal financial freedom. Given that financial freedom is most closely-held business owner's primary objective in exit planning, it makes little sense to build a business year after year without knowing if today's decisions and results put the owner on a path to success.

WHAT IS NAVIX®?

NAVIX® is a proprietary process that helps business owners plan for and achieve successful exits.

NAVIX® helps owners of closely held businesses plan for and execute successful exits: achieving financial freedom, creating a sustainable legacy, and exiting on their own terms.

NAVIX® was designed out of experience seeing business owners struggle to achieve financial freedom, create a sustainable business legacy, and exit on their own terms. NAVIX® is a dual track process, that prepares both the business and its owner(s) for exit. NAVIX® is not just about planning; we also help clients execute the strategies and tactics needed to achieve a successful exit.

To review your score with someone from the NAVIX® team, or to learn about the NAVIX® program, please