ARIZONA

2017

Exit Planning Institute™

THE LOCAL MARKET STUDY:

The State of Owner Readiness

BENCHMARKING LOWER MIDDLE MARKET BUSINESSES AND EDUCATING OWNERS ON THE DIFFERENCES OF "ATTRACTIVENESS" VERSUS "READINESS"

WWW.OWNERREADINESS.COM

THE STATE OF OWNER READINESS
2017 ARIZONA REPORT

SURVEYED BY: The Exit Planning Institute
SPONSORED BY: The Arizona Owners Forum Council
AUTHORED BY: Christopher M. Snider, CEPA

Table of Contents

Survey Overview

The Exit Planning Institute (EPI) and its local Arizona chapter, located in Phoenix, conducted a survey of business owners in the Arizona region to determine their state of readiness to transition their businesses and unlock the wealth accumulated within them. We also compared the Arizona results to EPI's national survey and other regional surveys that EPI has conducted over the previous four years. Finally, we noted specific facets that both successful and unsuccessful business owners do and offer suggestions to business owners and business advisors regarding how they can improve the probability of a successful transition and unlock this vast amount of wealth.

Roughly six million operating companies are privately held in the United States, representing approximately $30 trillion in sales. According to US census data, baby boomers aged 53–71 own 63 percent of these companies. Although baby boomers are holding on to their businesses for a longer period, all boomers will reach the age of 70 or older within 17 years. That represents nearly four million baby boomer businesses poised to transition. Assuming a business valuation of 50 percent of sales, which is reasonable by most standards, that number further represents $10 trillion of wealth poised to transition.

Unlocking this wealth should be of paramount importance to all business owners if for no other reason than that **most owners have 80–90 percent of their financial assets located in their businesses themselves**. Given the significance of these assets in owners' wealth portfolios, the ability to monetize this wealth at some point will have a significant impact on owners' financial security and lifestyles once they exit their businesses.

The significance of the business asset transition is of great importance beyond the owners and their family. Failure to provide for the continuity of the business affects not only owners' personal wealth and that of their family but also the future of all other stakeholders who depend on the businesses' successful transition. "The business owner is the giver of life," wrote Leon Danco, a legendary expert on family businesses, in his book *Beyond Survival, a Guide for Business Owners and Their Families*. With roughly six million operating privately held companies in the United States, representing around $30 trillion in sales and $15 trillion in wealth, the continuity of owners' businesses matter not just to their family but also to their employees, vendors, customers, charities, and the surrounding communities, for whom the owner provides jobs and economic and social well-being.

What happens if the business does not successfully transition? The alternative is that the business shuts down. People lose their jobs. Families suffer. Communities suffer. In addition, in many cases, an owner's life's work is liquidated for pennies on the dollar.

Previous surveys conducted by the Exit Planning Institute, PricewaterhouseCoopers, the Alliance of Mergers and Acquisitions, Business Broker Press, and the Family Firm Institute have determined that **historical transition success rates are in the range nationally of only 20–30 percent**.

Changing this outcome is the mission of the EPI and all Certified Exit Planning Advisors (CEPAs) worldwide. The beauty is that we have models (20–30 percent of business owners do successfully transition) that many business owners can emulate when they decide that a successful business transition is in their future.

The need to increase the number of successful transitions is becoming more urgent, as baby boomers, who own nearly two-thirds of all privately held businesses, face the inevitable fact of aging. Boomer-owned businesses alone represent roughly $20 trillion in sales and $10 trillion of wealth in the United States. As of 2017, boomers' ages ranged from 53 to 71, with an average of 62 years. Although boomers are holding onto their businesses longer than previous generations, they must face the reality that **preparing for their business transition is now an urgent imperative**.

The community of owners must realize that transitioning a business is a high-stakes—and for many, a once-in-a-lifetime—endeavor that takes significant focus, action, and time to do properly.

How do business owners benefit from transition planning?

Transition planning and value acceleration addresses several potential problems that prevent owners from achieving better transition succession rates and improving growth sustainability. These are four typical issues we see:

- **First,** when owners do decide to exit, they realize they have not allowed themselves enough time to position their businesses for transition, minimize taxes, or maximize net proceeds. Thus, they achieve significantly lower net proceeds.
- **Second,** they are unprepared when an unplanned event affects them and forces them into an exit that is not on their terms or timeline. Alternatively, they are fortunate to receive an unsolicited offer from a buyer. However, their lack of readiness prevents them from harvesting the value of their business in either situation.
- **Third,** when the time comes, owners can't sell. Private equity and strategic buyers are very seasoned and selective. And if owners decide to get out but have not planned for a transition to a family member, employee or management group, or partner, they are unable to achieve a sale—even a partial sale—to a third party.
- **Fourth,** they may also be unaware that they have eliminated their inside options, including transitioning to a family member, because their business cannot operate without them and is potentially undercapitalized or has insufficient cash flow to succeed with an inside option.

Doing a business transition right has significant benefits. For many owners, their businesses represent the vast majority of their wealth. With the average middle-market business, which we define as a business with sales between $5 million and $100 million that holds an average market value of $8.5 million, successfully transitioning represents the difference between having $10.6 million in pre-tax wealth at transition and having $2.1 million in pre-tax wealth. Even at an aggressive rate of return of 6 percent per year, the difference in pre-tax income is $510,000 ($637,000 vs. $127,000) per year.

For the micro market, the consequences are even more significant. The micro market, which we define as those businesses that do less than $5 million in sales per year, the average business value is just over $300,000. Most of these businesses are owner-operated, so owners derive almost all of their income from their businesses. Moreover, roughly 5.7 million (94 percent) of the six million privately held businesses fall into this category. Assuming again that, for many, 80 percent of their wealth is locked into their businesses, successfully monetizing the business asset is the difference between having $400,000 and $100,000 at transition.

To successfully transition, owners must accomplish three things: (1) focus on maximizing transferable business value for as long as they own the business while positioning it to successfully transfer upon exit so that they can harvest the wealth locked in the business; (2) prepare financially for a lifestyle without the income from the business; and (3) plan personally for what they will do (as a "third act") after exiting the business.

The State of Owner Readiness research.

Since 2013, to understand business owners' present levels of readiness to harvest this wealth and their current financial preparedness outside the business, as well as to understand how well owners have prepared personally, EPI has been conducting surveys of business owners with the help of its many strategic partners. EPI completed national surveys in 2013 and 2014 and has already released four regional surveys in 2017. Additional EPI regional surveys, also scheduled for release in 2017, are underway in New York, Los Angeles, Indianapolis, and the Greater Atlanta area.

The survey results continue to demonstrate many business owners' lack of readiness to transition, which explains why most transitions fail. The reports also demonstrate the need for massive education of business owners and business advisors regarding the successful transition of privately held businesses.

The reader should note that **the survey answers reflect the owners' *perceptions***. Although the owners' answers may be factual, they are not based on proven fact. The only way this can be accomplished is to complete a thorough personal, financial, and business assessment conducted by an independent credentialed advisor such as a CEPA.

Nevertheless, the data is useful for at least assessing a given owner's *state of mind* as it relates to readiness to transition from a business, personal, and financial standpoint.

Owners would be wise to consider obtaining a personal, financial, and business assessment to support their current perceptions and their business valuation to avoid surprises when the time comes for executing the business transition. This is also necessary for proper estate and personal financial planning.

What we do know from past studies is that success rates in the United States are in the range of 20–30 percent—far below what they should be from an economic and social standpoint. Some of the owners' responses reflect good reasons for this. Others may reflect an owner's misunderstanding or underestimation of what a successful transition requires. In other words, it may be a situation in which business **owners don't know what they don't know**. Although business owners do many things right, exiting one's business is, for many, a once-in-a-lifetime event that they have never undertaken. Certainly, their lack of formal education demonstrates that they have not received enough information on how to transition successfully.

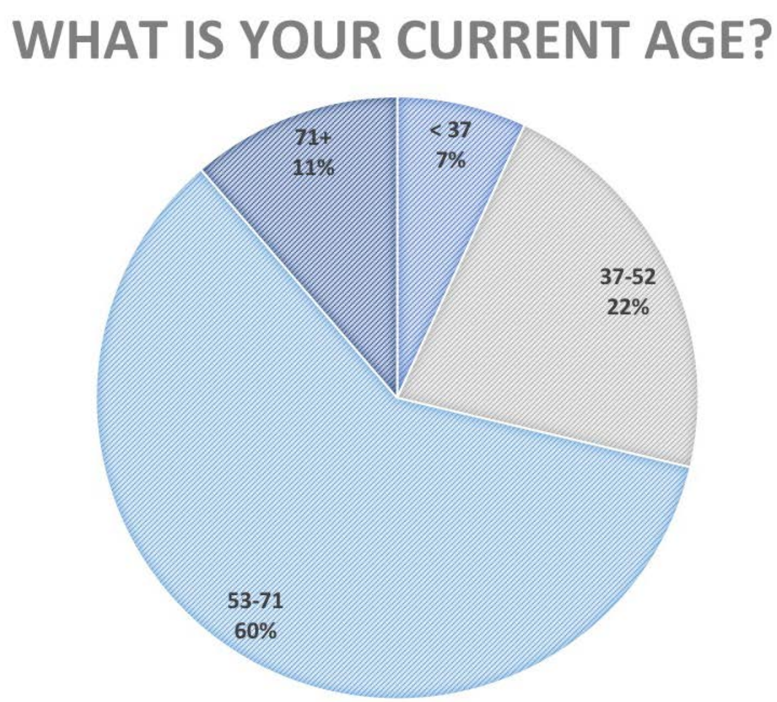
This data should be used as a business tool for discussing transition and identifying areas where education and assistance are necessary. At a minimum, the results should be reviewed with business owners to begin the process of validating their particular situation, educating them on critical success factors, examining their options, and determining the probability of a successful transition.

This report is divided into three sections: In Section 1, we make general observations about the data collected from the Arizona survey and how the data compares to the national surveys that EPI conducted in 2013 and 2014. In Section 2, we provide our analysis of the data and make observations regarding the data's implications for the business owner. In Section 3, we provide recommended actions business owners and business advisors should take to improve the probability of a successful transition and capture this hard-earned wealth.

In September 2017, the first phase of the Arizona State of Owner Readiness report was drafted based on the 118 responses collected. The survey included 53 questions, organized as follows:

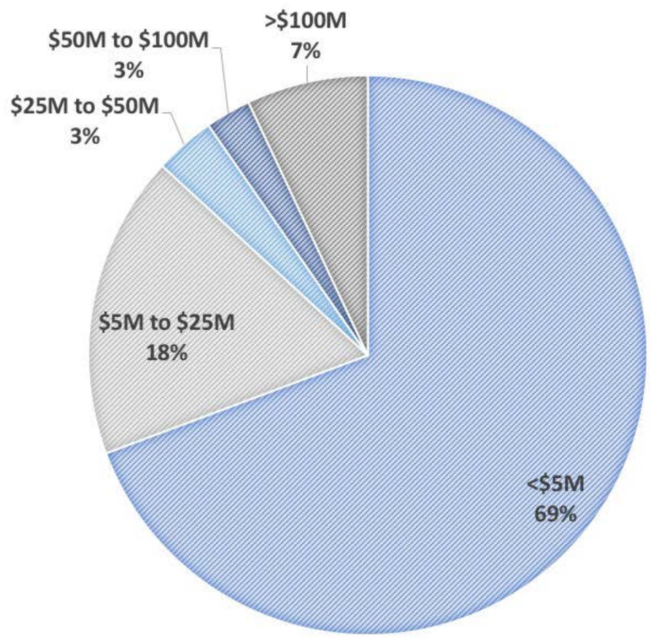
- Demographic information (age, gender, annual revenue, legal structure, industry, most trusted advisor, etc.)
- Current transition plans and thoughts
- Owner, shareholder, family, and company readiness to transition

Section 1 – Demographic Data



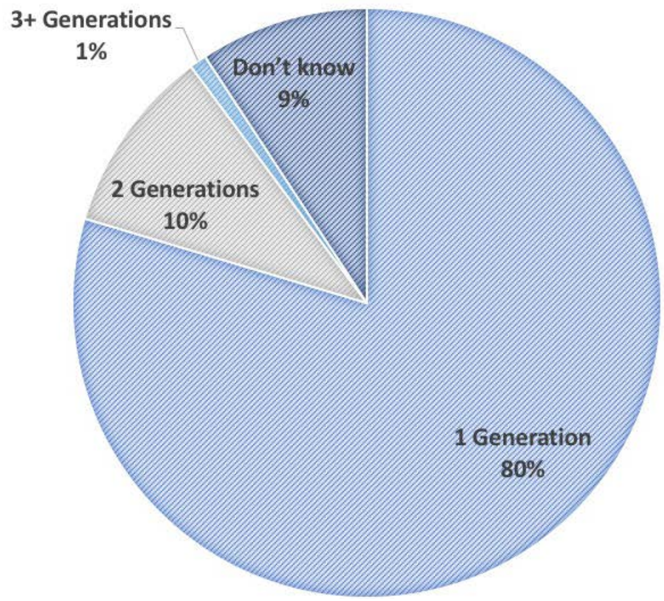
OWNER AGE: 68 percent of the respondents were baby boomers. This aligns with US census data indicating that baby boomers own 63 percent of privately held businesses. *71 percent of the Arizona sample were 53 years of age or older*. The importance of transitioning rises significantly as the owner ages, meaning that it is likely that the importance of a successful conversion of the owner's most valuable asset, the business, will be a priority for at least 71 percent of the owners surveyed.

WHAT IS YOUR COMPANY'S ANNUAL REVENUE?

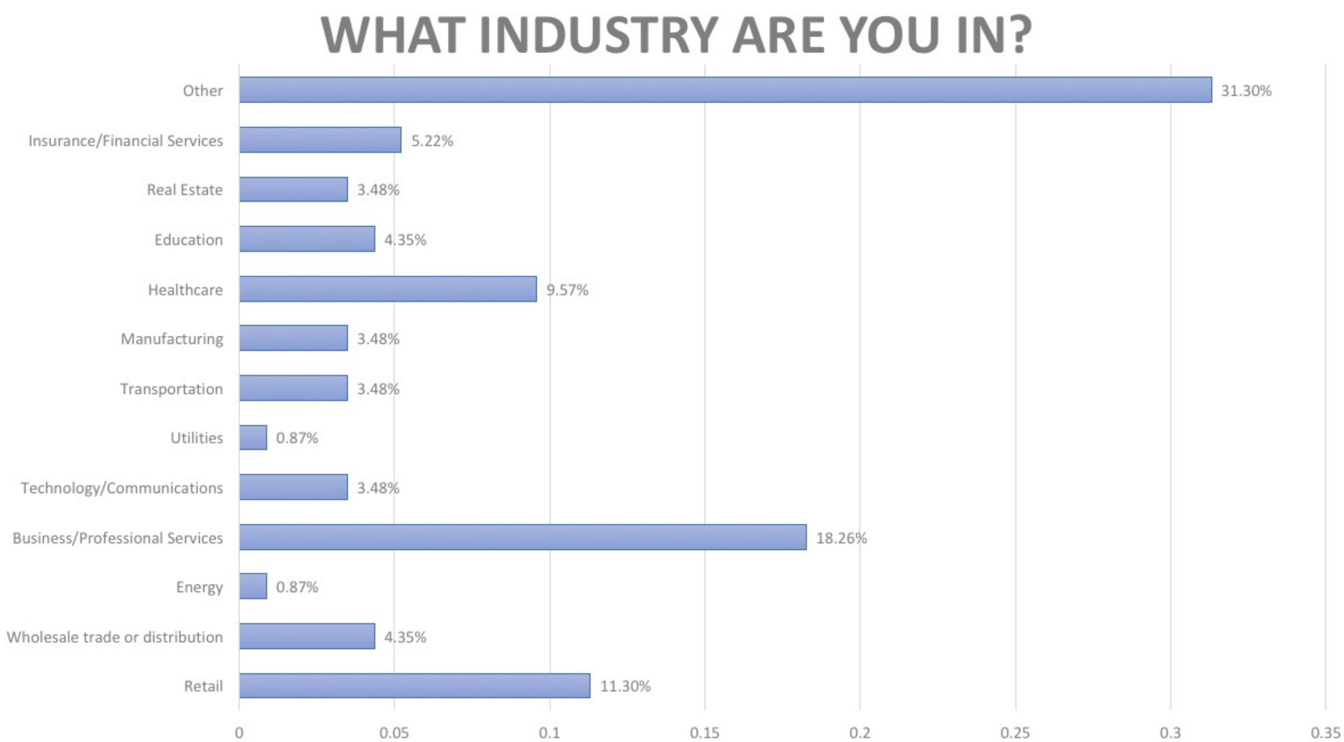


BUSINESS SIZE: Sixty-nine percent had business sales of less than $5 million, 24 percent had sales in the range of $5–100 million, and 7 percent had sales of $100 million or more. The Arizona data shows a strong middle-market focus representing a greater share of businesses over $5 million in sales than that in the national US Census data, which indicates that, of the six million privately held operating companies, 94 percent do $5 million in sales or less, 5.8 percent do between $5 million to $100 million, and only 0.2 percent do over $100 million in sales.

IF FAMILY OWNED, HOW LONG HAS YOUR BUSINESS BEEN OWNED BY THE FAMILY?



OWNERSHIP STRUCTURE: 81 percent of businesses were family owned, and 86 percent were at least family controlled, with *80 percent of the businesses being first-generation businesses, primarily started "from scratch" by the owner*. In fact, 83 percent of respondents reported that they were the founder of their business, while the remaining participants reported the following when asked, "How was your business started?": five percent purchased from a third party, five percent received from family, 3 percent purchased from family, with the remaining 4 percent reporting "other." Most of the businesses in the sample were LLCs (40 percent), followed by S-Corps (19 percent) and C-Corps (17 percent).



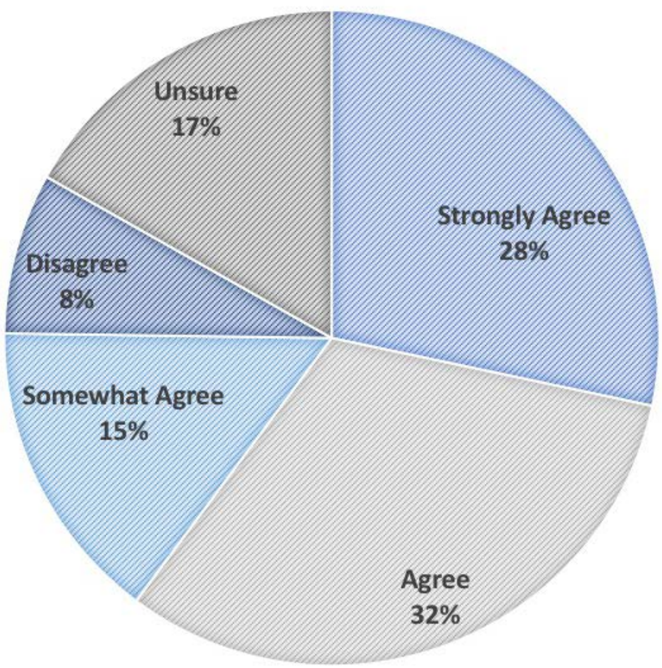
INDUSTRY BREAKDOWN: The surveyed business owner sample included a diverse cross-section of more than two dozen industries, the largest being business/professional services (18 percent), retail (11 percent), and health care (10 percent).

Section 2 – Analysis and Relevant Observations

Given the general lack of family and business transition readiness evidenced in the survey results, it is not surprising that 70–80 percent of transitions fail.

As you read through the rest of this report, bear in mind the following statement: *Seventy-five percent* of the business owners who completed the survey in the state of Arizona indicated that they *agreed* with this statement:

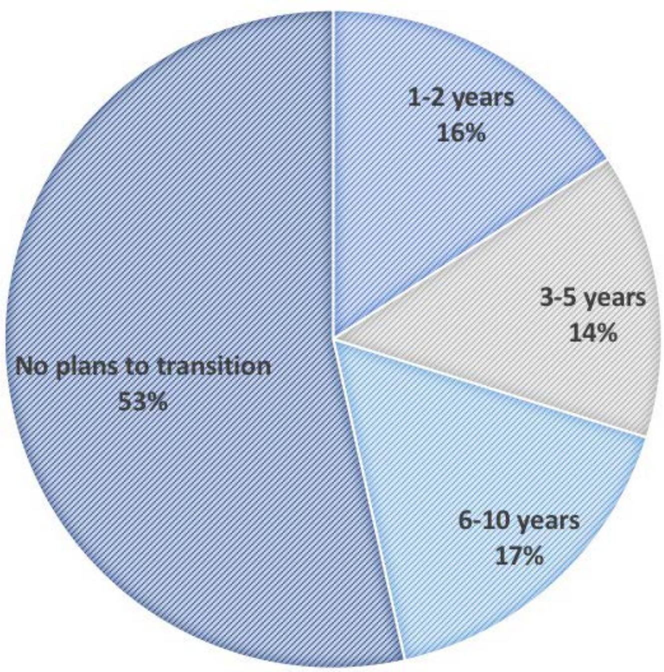
"Having a transition strategy is important both for *my* future and for the future of the business."



However, although 75 percent of the business owners indicated agreement with this statement and 28 percent indicated strong agreement,

- 85 percent had **no written business transition plan**
- **60 percent had done "no planning at all"**
- 95 percent had **no written personal plan** for what they would do after transitioning their business (*35 percent had not even thought about it*)
- 84 percent had not established a formal transition team, 75 percent had not sought any outside advice, and 77 percent had not accomplished any formal transition education.

The state of transition planning is very weak despite a large segment of business owners indicating that they would like to transition their businesses within 5–10 years.



The previous statistics are alarming, considering that **almost one-third (30 percent) of the people in the sample indicated that they wanted to transition in 5 years or less,** and almost half (47 percent) in 10 years or less. In fact, 53 percent indicated that they had **no plans** to transition.

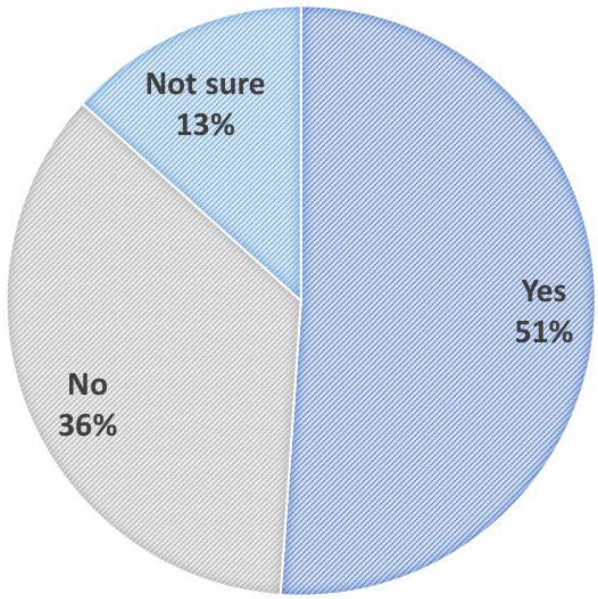
Owners must realize that to transition properly, they must start transition planning well in advance of their exit to maximize the value of the business and leave an appropriate amount of time to prepare financially and personally for it.

The biggest regrets many owners face include the following:

1. They realize that they should have integrated a value acceleration process to prepare themselves and their business much earlier.
2. They realize after the fact that they left money on the table by not maximizing the value of the business at the time of exit.
3. They are miserable because they did not prepare a personal plan to fill their time and develop a fulfilling experience post transition.

Ironically, although 95 percent of business owners surveyed indicated that they had no written personal plan and **60 percent indicated they had done "no planning at all,"** over 90 percent of the owners responded to the question of what they were planning to do post transition. The most popular answer was "retire" or "semi-retire" (59 percent). Other popular answers included "consulting" (24 percent), investing in or sitting on a board (18 percent), and philanthropy (15 percent).

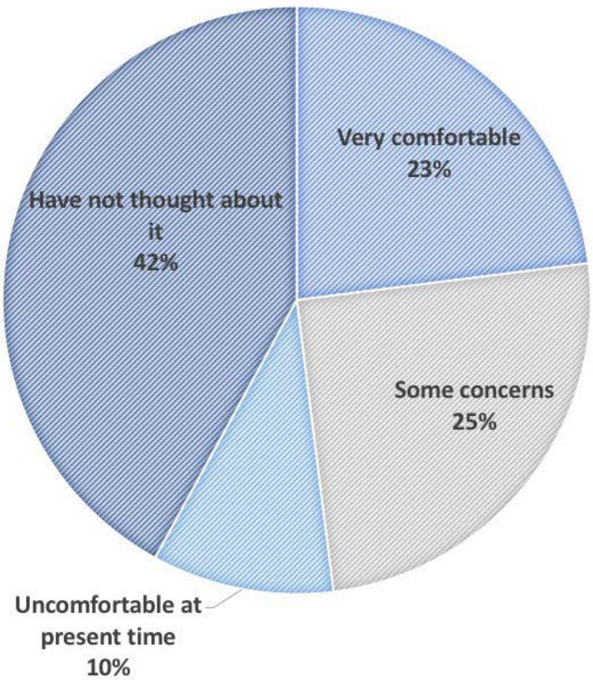
DO YOU NEED THE INCOME PRODUCED BY THE BUSINESS TO SUPPORT YOUR PRESENT LIFESTYLE?



To execute their transition plans properly, **most business owners need their companies to *remain* profitable.**

Of the owners who said they had a plan, 63 percent indicated that it was at least "helpful" that the **company remain profitable for their transition plan to be properly executed**; 42 percent said that it was "critical." Many owners need the business to remain profitable because they will not get all their money out until many years after the actual transition because of seller financing, holdbacks, and earn-outs.

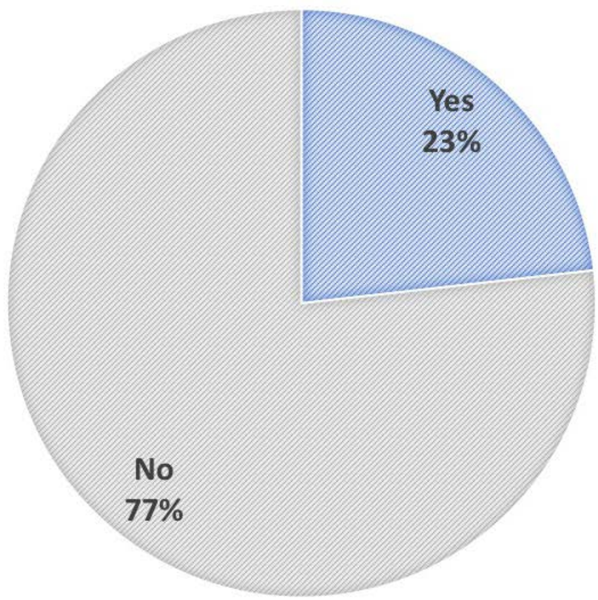
This is especially important for inside exit options such as ESOPs, family transitions, and management and partner buyouts. Usually, the owner does not achieve a windfall at close. Rather, the owner is required to finance the inside buyout and depend on the next generation of management to carry the day without the owner at the helm.



HOW COMFORTABLE ARE YOU THAT YOUR MANAGERIAL TEAM WILL BE SUCCESSFUL WITH NEW OWNERSHIP?

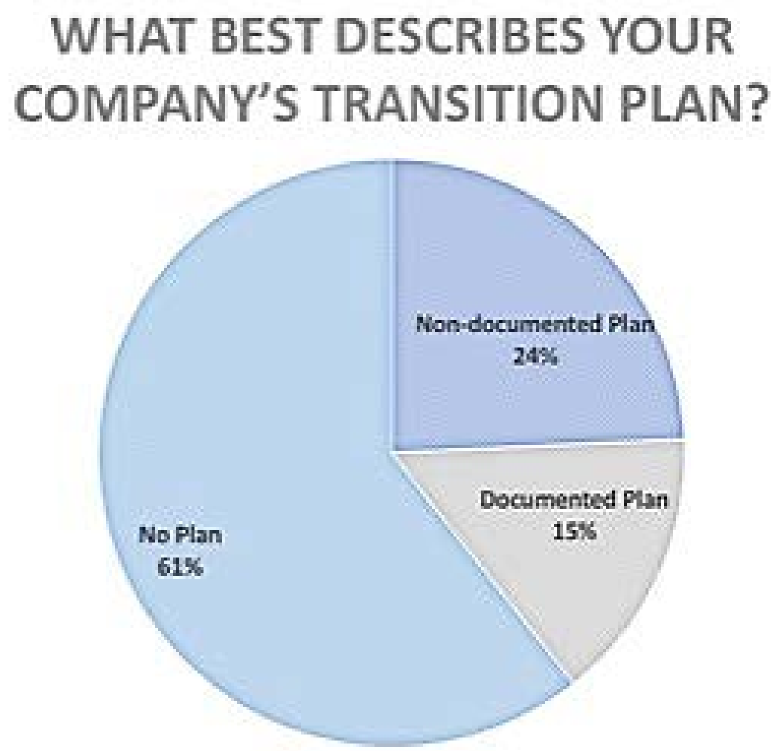
Another answer demonstrating a high degree of **misguided confidence** was that **only 48 percent of owners surveyed indicated that they had at least some comfort that the managerial team** would be successful if the owners were not involved with the business post-transition; only 23 percent said that they were very comfortable, and 42 percent indicated that they had not even thought about it. This would be critical in a situation where the owners depended on the company remaining profitable after they are gone.

HAVE YOU COMPLETED AND FORMAL EDUCATION RELATED TO TRANSITIONING A BUSINESS?



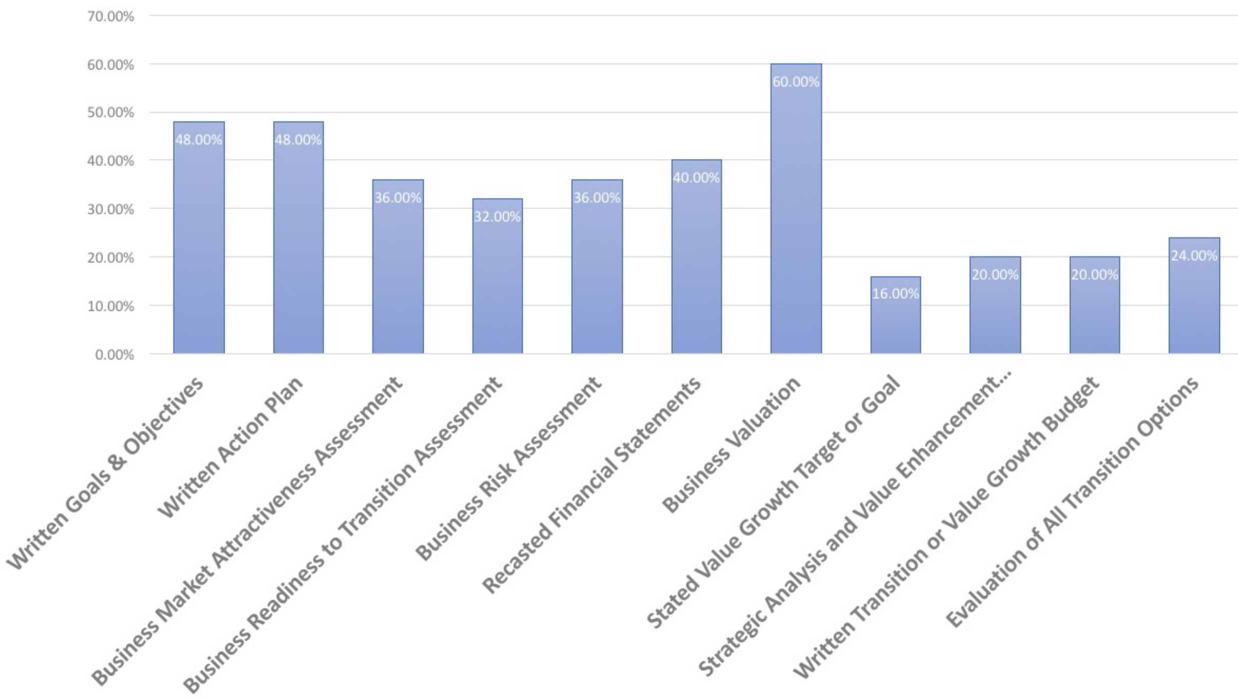
That owners **don't know what they don't know** is concerning. This lack of education is further evident in that **65 percent of the owners who completed the survey indicated that they had not completed <u>any</u> formal transition planning education**.

The danger here is that business owners significantly underestimate what exiting successfully requires. This Arizona statistic is lower than the national survey average and below averages compared to other regional EPI market studies. As educators, we feel a correlation between this data point and transition success odds.



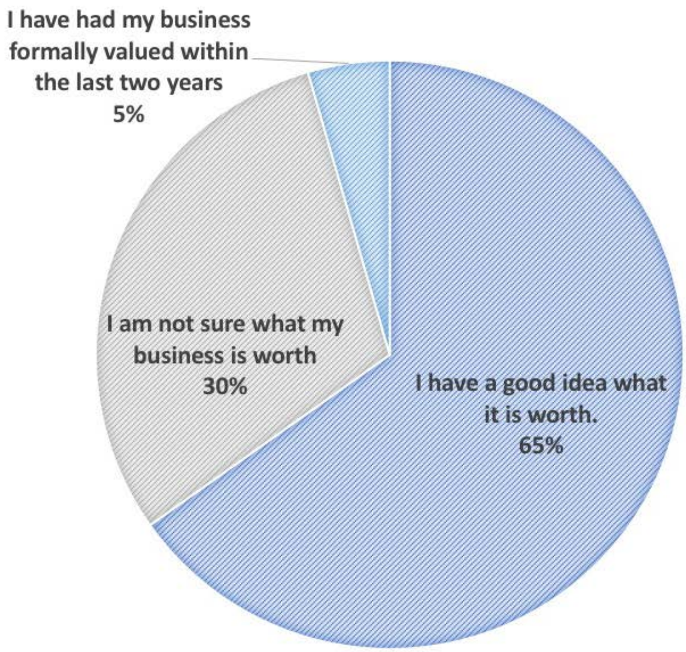
The 1979 Harvard Business School study made a correlation between written goals for the future and likelihood of achieving them, tying the results directly back to financial key performance indicators.

In Arizona when asked, "What best describes your company's transition plan?" the responses did not reflect an embrace of the Harvard goal-setting mentality. Thirty-nine percent reported having a plan, though only 15 percent of business owners said they had a documented company transition plan.



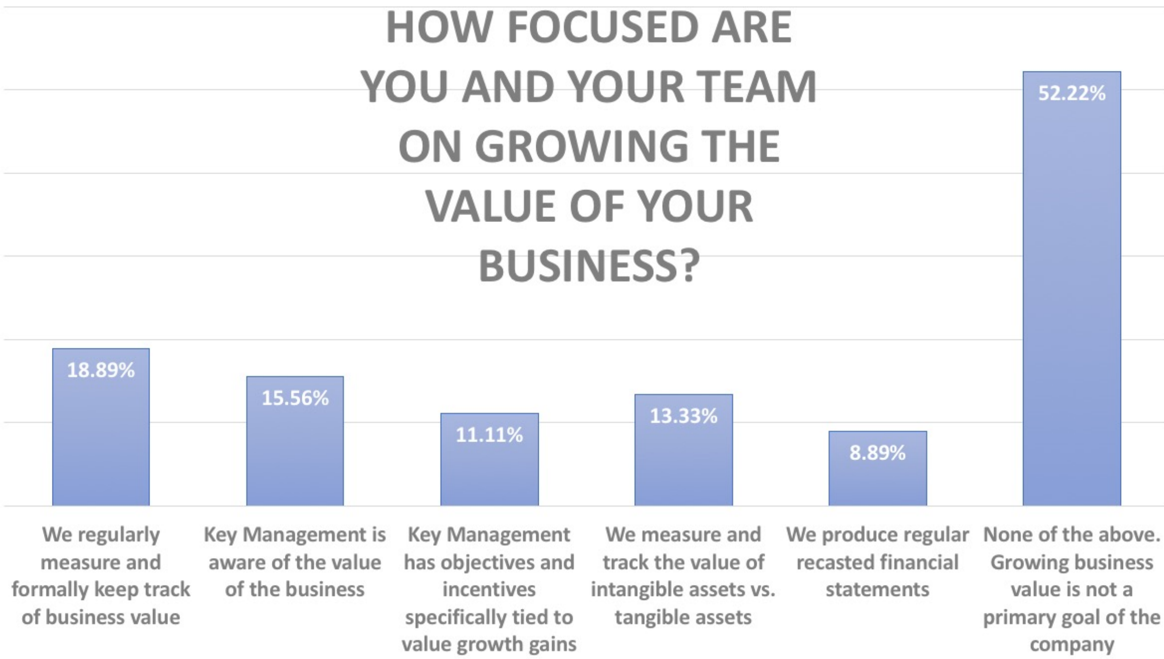
Diving deeper into the makeup of the owners reporting having plans, we asked, **"What do your plans include?"**

- Only 60 percent indicated that their plans included a business valuation; Only 40 percent included recast financials.
- Less than half included written goals and objectives (48 percent) and a written action plan (48 percent).
- Less than 40 percent included a business risk assessment (36 percent), a business market attractiveness assessment (36 percent), and a business readiness assessment (32 percent).
- Less than 25 percent said that their transition plans included an evaluation of exit options (24 percent), a strategic analysis and value-enhancement plan (20 percent), a value growth budget (20 percent), or a stated value growth target or goal (16 percent), **taking maximizing value off the table.**



WHAT BEST DESCRIBES YOUR CURRENT UNDERSTANDING OF THE VALUE OF YOUR COMPANY?

Overall, **only 5 percent of the business owners responding to the survey indicated that they had had their business formally valued in the last two years**. However, 65 percent said that they "had a good idea what it was worth." How would owners know that if the business had not been valued by an independent professional? One conclusion could be that owners must be relying on hearsay and not on the kind of facts that a formal business valuation produces. This is a major reason why only 20 percent of businesses that go to market actually sell. In an Alliance of Mergers and Acquisitions study, 95 percent of mergers and acquisitions professionals indicated that the owners' overestimation of value was the number-one factor in failed deals.



Owners tend to focus on sales and income without giving appropriate attention to business value. **Maximizing business value, not business income, should be the primary goal.** Although this sounds like a subtle play on words, it is a major paradigm shift. Income alone does not necessarily mean that the business has value if the asset is also not ready to transfer. Focusing on value first is the only way the owner can achieve both business value and an increase in business income.

When asked, “How focused are you and your management team on growing the value of your business?” 52 percent answered, “Growing business value is not a primary goal of the company.” In fact, 89 percent of the business owners indicated that they had not taken on a value enhancement or de-risking project within the last two years.

- Only 19 percent said that they regularly measured and formally kept track of business value.
- Only 15 percent said that key management was aware of the value of the business.
- Only 11 percent said that key management had objectives and incentives specifically tied to value growth gains.
- Only 13 percent said that they measured and tracked the value of intangible assets vs. tangible assets.
- Only 9 percent said they regularly produced recast financial statements.

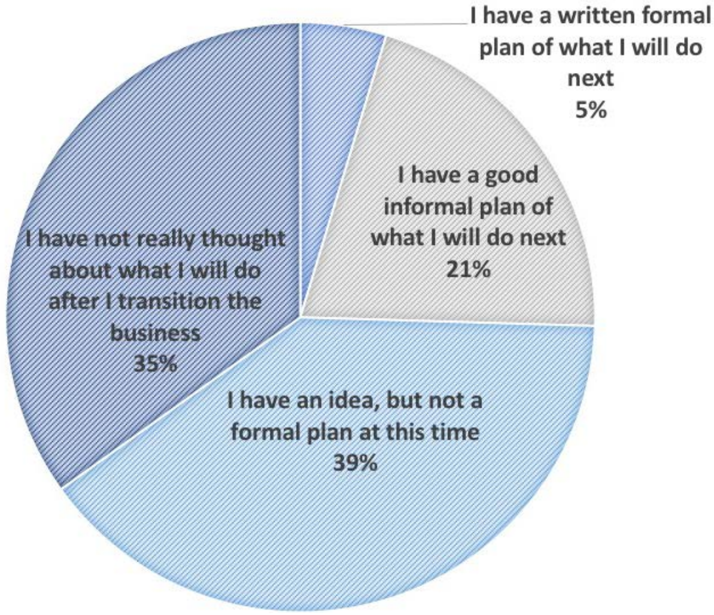
Thus, if many of the owners' transition plans do not include business valuation, goals, or objectives; written action plans; exit options analysis; a risk assessment; or a strategic value analysis, budget, and value enhancement, **what *do* they include?**

To us, these responses are clear proof that owners **don't know what they don't know.** This lack of education is further supported by the **77 percent of owners completing the survey who indicated that they had not accomplished *any* formal transition planning education**.

The danger in that response is that business owners are significantly underestimating what a successful exit requires. Owners *think* (i.e., have the perception) that both they and the business are prepared because they have given some attention to their transition. However, successful transitions require much more than thought. They require solid, long-term business, personal, and financial plans grounded in action, with specific deliverables completed along the journey.

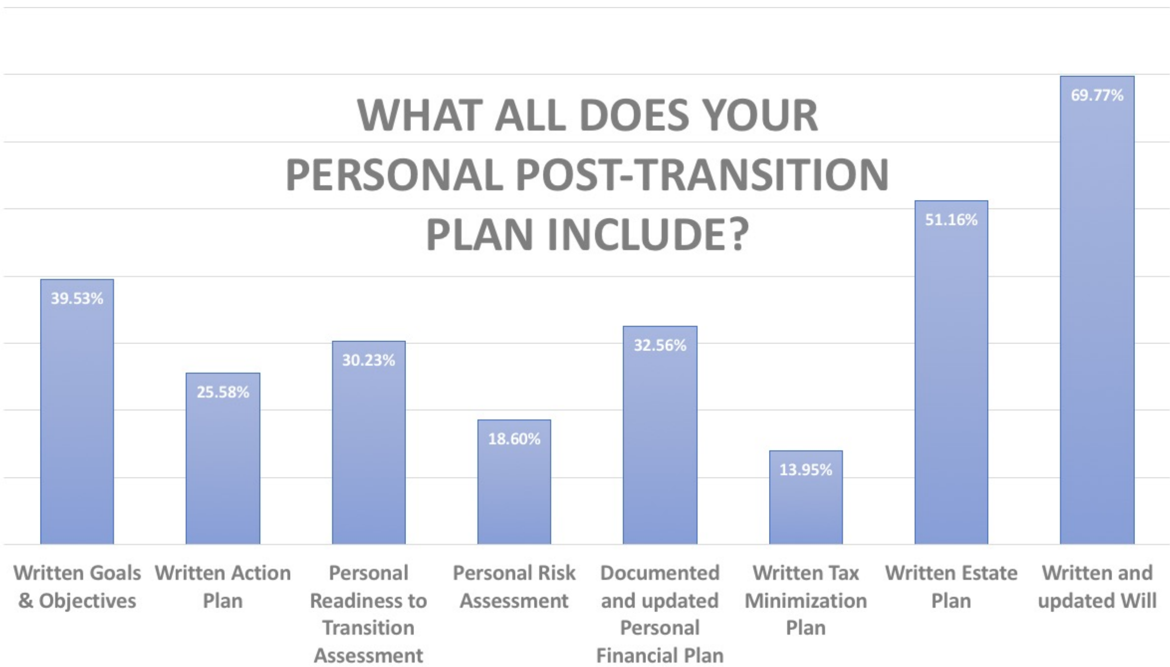
The owner planning and actions required to build a growing and transferrable business are clearly lacking. That transition rates are very low and only 20 percent of businesses that go to market sell is not surprising. All the actions noted above are essential to sustaining growth and building transferability.

WHAT BEST DESCRIBES YOUR PERSONAL POST-TRANSITION PLAN?



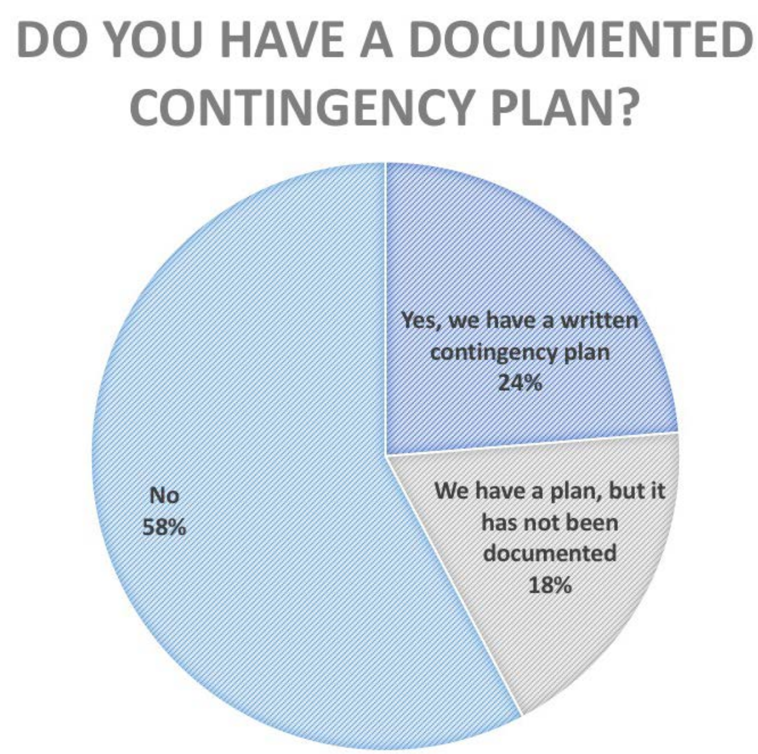
Personal planning and personal financial planning (both which establish independence from the business) are **essential to a successful transition** and living a fulfilled and financially secure life post-exit.

Owner responses to the state of their personal plans regarding what they would do after the exit demonstrate that owners underestimate the importance of both personal planning and personal financial planning. **Less than 5 percent of business owners (4.72 percent) indicated that they had a written plan for what they would do post-exit, and only 33 percent had a documented and updated personal financial plan.**



From a personal financial planning standpoint, 51 percent said that they had a written estate plan, and 70 percent at least had a written and updated will. However, only 19 percent indicated that their estate plans had incorporated the business transition into their personal financial and estate plans, and only 14 percent had a written tax minimization plan.

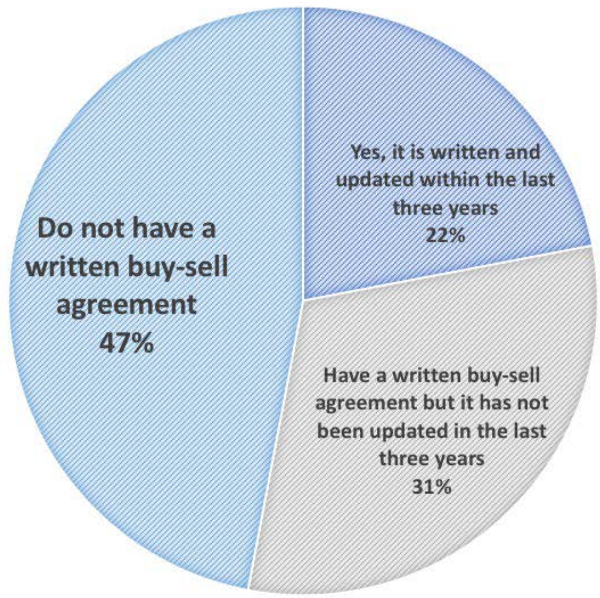
How can estate plans be accurate if they do not provide for the transition of business value? That most financial planners and many owners have 80–90 percent of their net worth invested in their businesses is well recognized. Estate and financial plans, therefore, are likely missing 80 percent of the owner's net worth, which is clearly important for one's personal financial strategy and mitigation of personal financial risk.



The transition planning process does not appropriately address **business risk.**

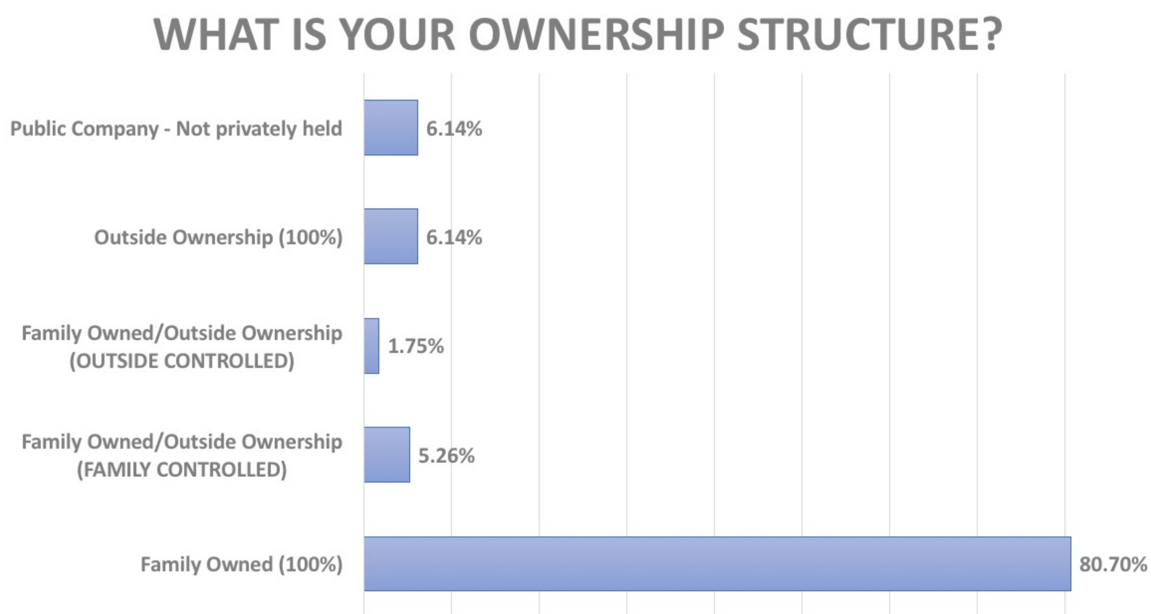
In our study, 58 percent of the owners indicated that, should they be forced into an exit, they had no contingency plan. Of the 42 percent who said they had a contingency plan, **only 56 percent had documented it,** and only 31 percent said it was funded by life and disability insurance.

IF THERE ARE MULTIPLE OWNERS/PARTNERS IN YOUR BUSINESS, DO YOU HAVE A WRITTEN BUY-SELL AGREEMENT THAT HAS BEEN UPDATED IN THE LAST THREE YEARS?



Current buy–sell agreements are **lacking and outdated.**

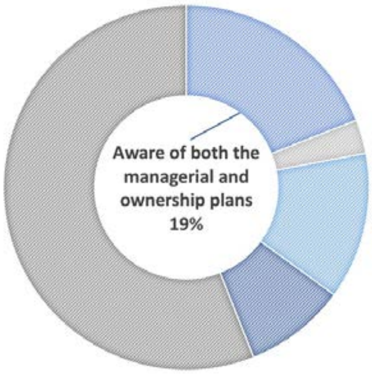
Approximately one-third of the business owners surveyed indicated they had multiple partners invested in their businesses. Of those businesses that had multiple investment partners, **47 percent did *not* have a written buy–sell agreement**. Of those who did have a buy–sell agreement, only 22 percent had had it reviewed and updated within the last three years, and only 33 percent had funded it through life and disability insurance. A buy–sell is like a business valuation. It should be revisited annually, even if it requires no changes. Moreover, ensuring that the buy–sell is funded is key to ensuring that the terms can be met if the buy–sell must be invoked.



Family is still important, but is the family ready for the transition of the business and the potential lifestyle changes?

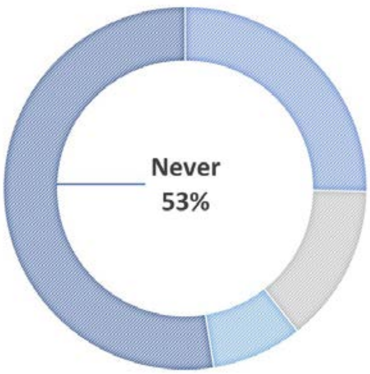
81 percent of the sample included businesses that were 100-percent family-owned, and **86 percent were at least family controlled**. Transitioning to family was the #1 inside transition choice. However, the survey results indicate that better family communication is necessary.

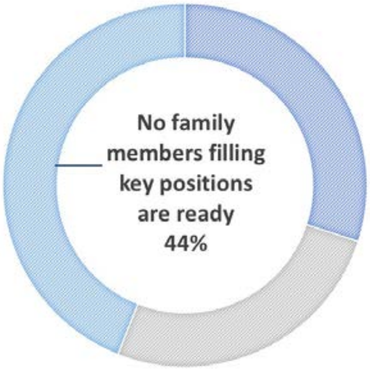
The dangerous aspect of family transitions is that business owners tend to do less transition planning when they have decided to transfer the business to family. **The family should approach the transition with the same vigor as they would if they were selling to a third party,** especially if the family has decided on an intergenerational transfer. The characteristics that make a business valuable to a third party are the same ones that make it valuable to the next generation. And families that treat it as a "gift" to the next generation versus a "sale" tend to transfer a much less healthy, valuable business.



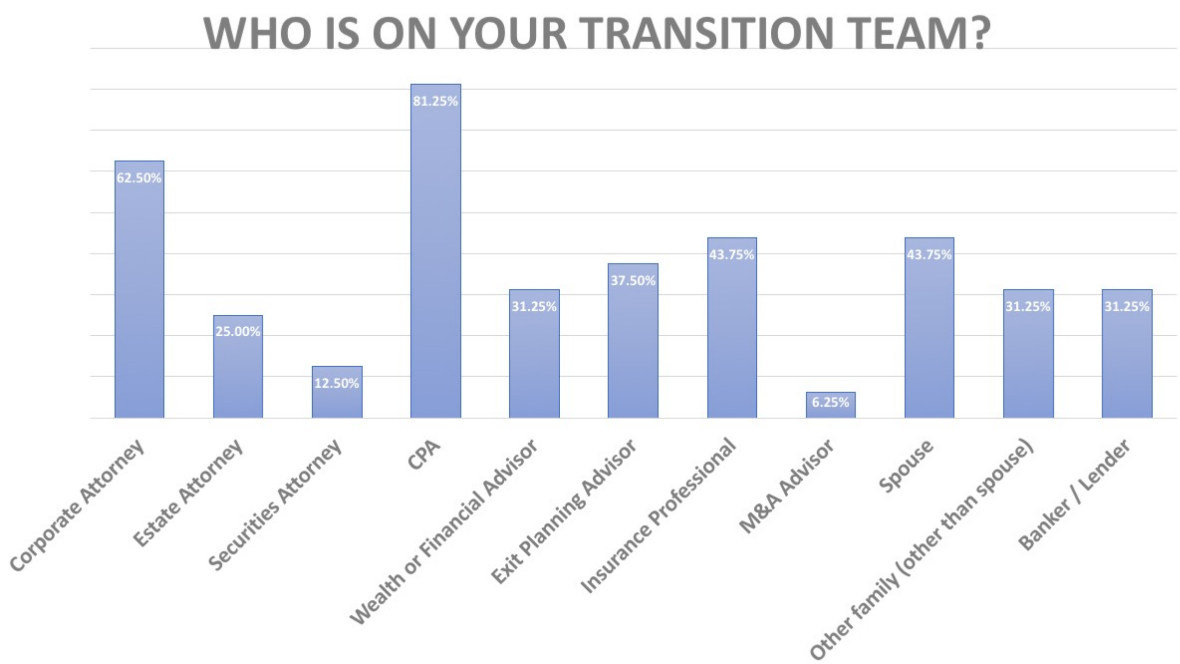
Only one in five (19 percent) said that the family was aware of both the owner's management and transition plans.

More than half (53 percent) indicated they had never had a family meeting about the business. Of those who did, less than half (47 percent) met at least once a year.



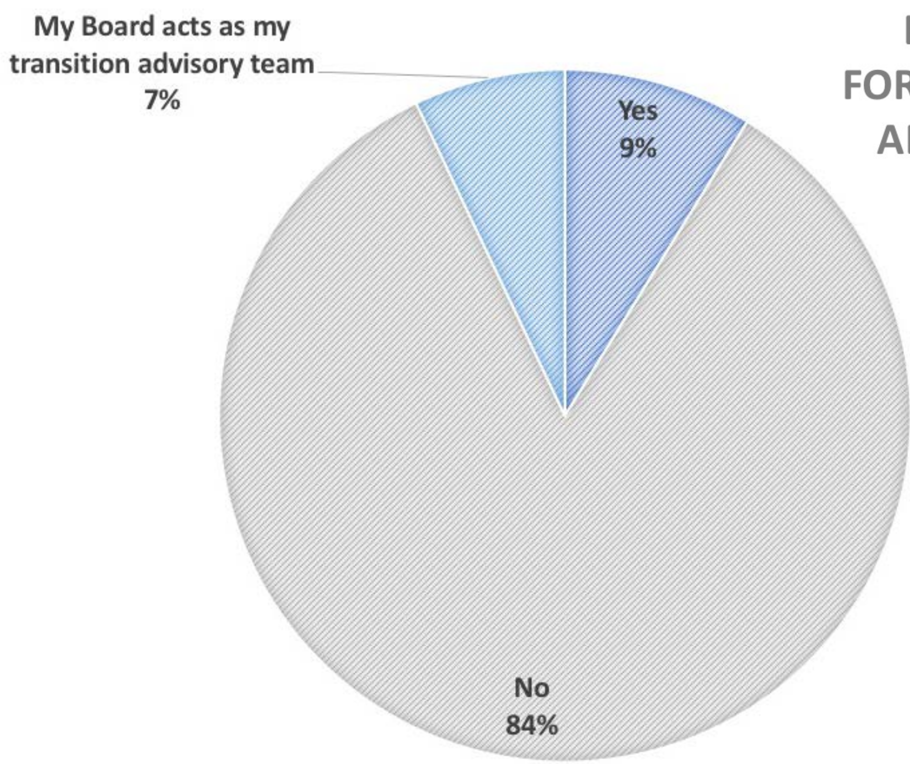


Almost half (44 percent) of business owners who said their plans included filling key positions with family members said that no family members were ready. In this same group, 45 percent indicated that these family members had no training.



On a positive note, although only 15 percent of the business owners surveyed had an established transition team; those owners who had one recognized the need to include family in this team. **75 percent of business owners indicated that spouses or other family members were members of their transition teams**.

HAVE YOU ESTABLISHED A FORMAL TRANSITION ADVISORY TEAM?



Improving the use of outside resources would likely result in an increase in **successful transitions and higher valuations.**

From previous surveys, we have observed that using outside resources and having an active board of advisors with nonfamily members on the board are two characteristics correlated with better planning and preparation and a greater focus on maximizing value. The Arizona business owners scored low in both categories.

Noteworthy, 7 percent indicated that they used their board of advisors as their transition team—usually a mistake. Most advisors and many owners should realize that the skillsets needed to transition a business can be much different from the existing advisory board acumen. Both are necessary and have distinct roles in supporting the business owner.

Key players missing from the team.

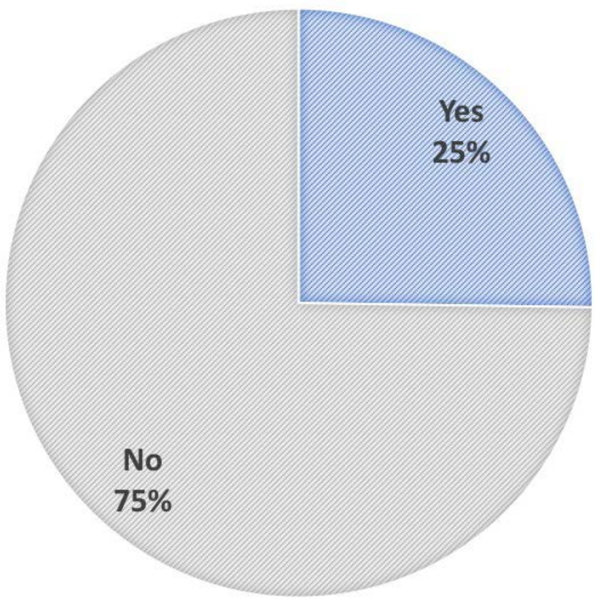
Even for the 16 percent of the owners who said that they had transition teams, we found that these teams were missing key advisors. The core transition team for the owner should comprise, at minimum, an attorney (typically a business attorney), a CPA, a wealth manager/financial planner, and an exit planner such as a CEPA.

However, most owners did recognize the need for a CPA: Eight-one percent of those owners who had defined a transition team had a CPA as a member. This is much better than we have seen in other regional survey results. However, several other key advisors were missing:

- Only 2 out of 3 (62 percent) teams included an attorney.
- Only 4 in 10 included an insurance professional (44 percent) or exit-planning advisor (38 percent).
- Only 3 in 10 included a wealth manager (31 percent) and a commercial banker (31 percent).
- Considering the lack of transition planning, that only 6 percent of those who had established a transition team included an M&A advisor was unsurprising.

Commercial bankers and insurance advisors are additional key roles that can help produce a successful transition to new owners, whether they are family or outside ownership. For example, the commercial bank currently supporting the business is likely to be the first to step up to provide financing, given that they already know the business and would benefit from the present relationship's transition to the new owners, assuming that the owners and banker have already developed a strong business relationship.

HAVE YOU SOUGHT OUTSIDE ADVICE REGARDING YOUR TRANSITION PLAN?

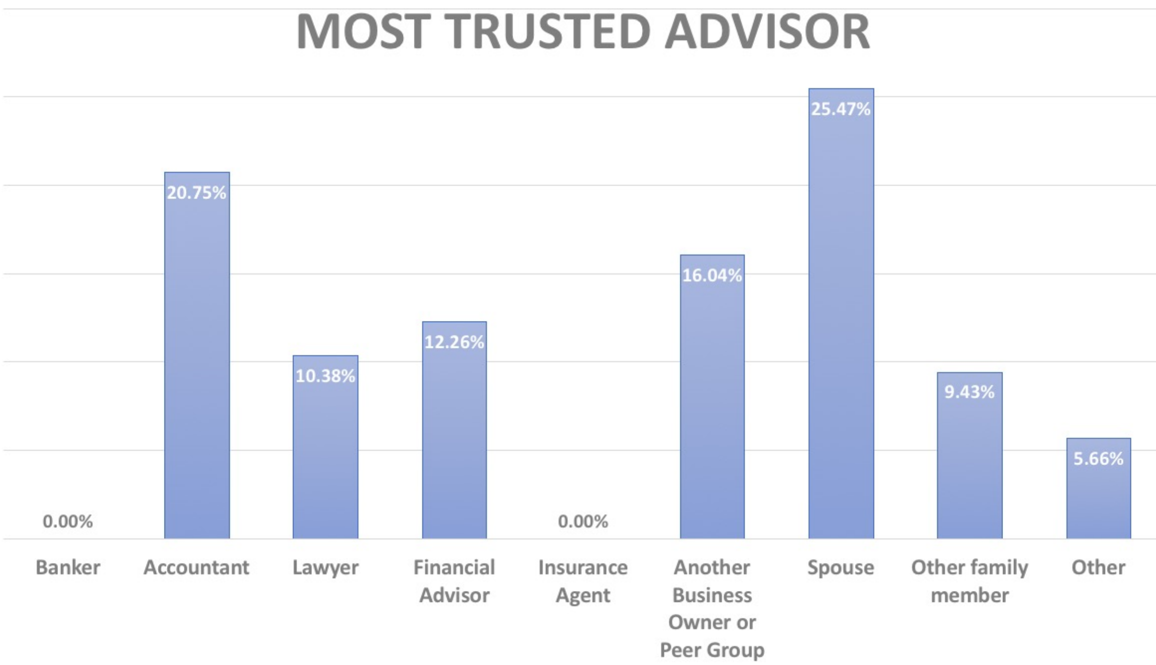


75 percent of Arizona business owners have not sought outside advice related to their individual transition goals. This is clearly tied to the poor overall planning demonstrated in this survey. In other words, why would owners seek outside transition advice if they were not planning a business transition?

However, business owners should note that a common critical success factor we have heard from those who have successfully transitioned their businesses is the need to bring in the "right people," who have the necessary expertise to help them transition successfully.

What’s more, 68 percent of the respondents in the Arizona region had an outside board of advisors, compared with 20–28 percent in previous surveys, with the exception of the Nashville area. **This is the best response we have seen in all the regions we have surveyed.**

However, few respondents had nonfamily members active on their boards. For example, only 25 percent in the Arizona region had nonfamily members on their advisory boards, compared with 50 percent in the Greater Nashville region.



For the first time, **the spouse is the most trusted advisor.**

For the first time in EPI's State of Owner Readiness research history, in 2017, the status of most trusted advisor has been awarded to the owner's spouse, beating out the role usually voted as the number one: CPA.

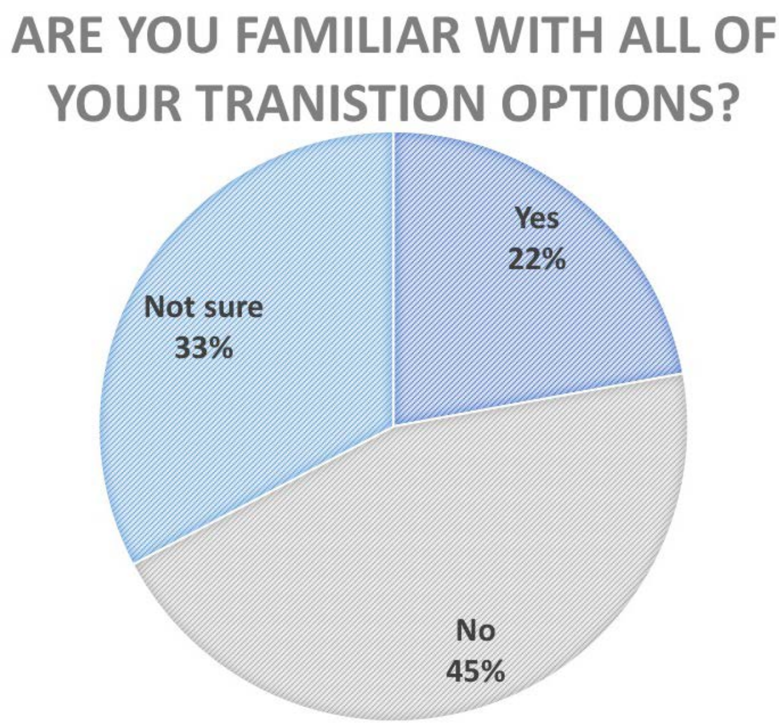
The spouse was shortly followed by the owner's CPA; next, peer groups or frankly, another business owner. Although this is the first time the spouse has been the most trusted advisor, these three people are usually rank in the top three most trusted advisors year over year, region by region.

A few concerns should be noted:

Although 31 percent of the owners indicated that the wealth manager/financial planner should be or is on the transition team, **only 12 percent considered the wealth manager/financial planner to be the most trusted advisor**.

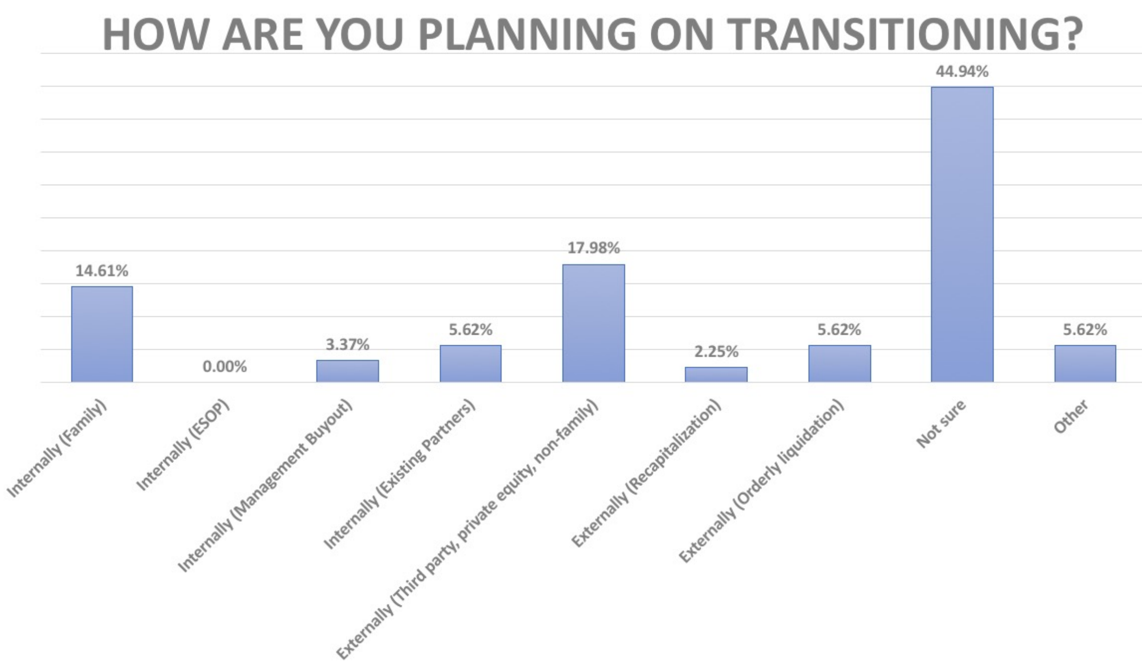
This is surprising and, I believe, a huge opportunity for the financial planning industry. It is clearly a best practice to have a wealth manager or financial planner involved in the transition process as early as possible. I don't even know how it's possible to design a transition strategy without involving the financial planner, who plays a critical role in determining the owner's financial needs before, during, and after the exit. The planner's role in evaluating options to optimize the owner's post-business lifestyle is vital and often dictates the available exit options and the structure of the exit transaction, whether that be an internal or external option. The financial planning industry and the owners themselves would benefit tremendously if the financial planning industry did a better job of educating owners on the roles of financial planners and wealth managers in the transition process.

Additionally, ***none*** **of the owners considered their banker to be their most trusted advisor**. With the exception of the CPA, no other advisor *should be* as familiar with the business as the commercial banker. We have consistently observed opportunities for improvement in this relationship; it certainly is a two-way street. However, given the potential significant role the banker plays in the growth and transition process, both owners and commercial bankers would benefit from an improved relationship.



The evidence is clear that more education on exit strategy is necessary and that Arizona owners are not spending ample time analyzing their exit options.

In fact, 78 percent of the business owners surveyed said "no" or "not sure" (which effectively means no) when asked if they were aware of all their exit options. Compared with previous surveys, **this is the largest segment of owners who indicated that they were not aware of all their exit options**, which clearly points to a need for education. In the national survey, 63 percent of business owners answered "no" or "not sure." In other regional surveys, the percentage of respondents who answered "no" or "not sure" ranged from 46 to 68 percent. Not being aware of all their exit options means that owners risk leaving money on the table when they exit or structuring exits that are not ideal for their situations.



When asked, “What best describes how you are planning on transitioning your ownership?” 45 percent indicated they were “not sure.” As mentioned above, this was the **highest score of all previous research surveys,** in which respondents giving this answer ranged from 20 to 30 percent. Nationally, 33 percent of business owners indicated that they were “not sure” how to transition their businesses.

The most popular choices for the 55 percent who indicated they had considered exit options were a third-party sale (18 percent) followed by a family transition (15 percent). Both choices are consistent with other surveys. Third-party sales and family are the most popular transition options.

Overall, for the more than half of respondents who had considered their exit options, about half (48 percent) preferred an inside and half (52 percent) preferred an outside option. Again, this is consistent with previous research.

It is safe to conclude that half of all business owners would like to transition to family, employees, management, or partners, with family as their first choice, whereas half prefer an option to transition to a third-party, recap, or orderly liquidation, with a third-party sale as their top choice.

NOTE: Only 2 percent of the sample indicated that they were considering a recap option, which is disappointing. Recap is an excellent way for the owner to take some money off the table while bringing in capital and talent to accelerate growth.

So, at the end of the day, are you ready?

We asked owners to rate their readiness to transition their businesses and transition personally. Only 30 percent rated their business readiness as above average, and only 38 percent rated their personal readiness to transition as above average. Apparently, the majority of business owners recognize that neither they nor their businesses are ready to transition, as this survey's data points confirm.

In addition, almost half (45 percent) of the business owners surveyed rated the strength of their personal financial position (strength of financial assets not including the business) below average, and 73 percent said ownership transition plans requiring that the company remain profitable would be helpful for the proper execution of their plans; 42 percent said it was critical.

Recall our opening statement in this section: **75 percent of the business owners in the Arizona region who completed the survey indicated their agreement that "having a transition strategy is important for my future as well as the future of the business."**

If that is true, why are Arizona owners so unprepared?

Section 3 – Recommended Actions

Owners of businesses of all sizes must become much more proactive to improve successful transition rates and harvest their most significant financial asset. Success rates are not likely to improve if business owners view exit planning as "something I can do down the road" rather than an imperative integrated into the way they currently operate their businesses.

Advice to Business Owners

Owners must realize that they must redefine their present exit planning paradigm: until they do, their progress will be limited.

An effective exit plan is a strategic business tool that will create more income today, empower the owner's management team or children to take the business to the next level, create owner independence, and potentially increase the owner's wealth by 400–500 percent. In other words, exit planning is simply good business strategy. With $10 trillion of wealth at stake from an aging generation of business owners (remember, 71 percent of our survey respondents were aged 53 or older) and a new generation of business owners at hand, a greater sense of urgency is required.

> "Exit planning is simply *good* business strategy."

Business owners must realize that exit planning is present tense. For owners, the best practice is for them to integrate the actions of a successful transition into the way they run the business every day. Owners can accomplish this by following the principles of the Five Stages of Value Maturity: identifying what they have now, taking risk-mitigating actions to protect their wealth, building value consistently over time using 90-day sprints, positioning the business to have multiple exit options—and, perhaps, multiple exit events—and always actively managing their wealth (including the business wealth) before, during, and after the exit event.

Clearly, this is not being accomplished today.

As previously pointed out, 80–90 percent of the owner's net worth is likely to be in the business. Moreover, 70–80 percent of that business wealth is tied to intangible assets. To check this, owners need only look at their present income statements and balance sheets. Does the income recorded on the income statement (for tax purposes) really reflect the true cash flow benefit assumed by the owner or future owner? Often, the answer is no when the owner considers normalized income and expenses, discretionary expenses charged to the business, and one-time, nonrecurring charges. Does the owner's present balance sheet reflect the business's true "market value"? Again, not often.

The balance sheet (again for tax purposes) reflects the book value of the owner's recorded business assets—not the true market value, which would include the value of the business' intangible assets.

"Most accounting and management systems today do not provide feedback on the value of the business."

Management systems must be adapted to give the owner strategy and feedback on the value of intangible assets—human capital, customer capital, structural capital, and social capital (the 4Cs)—on a regular basis. Most accounting and management systems today do not provide feedback on the value of the business. Focusing on value first drives all other positive outcomes, including increases in sales and profits. Integrating personal and financial goals and plans with business planning prepares the business owner for all possible events from a personal, financial, and business standpoint (a concept called the "Three Legs" or "Master Planning"). Owners must realize that 50 percent of all exits do not occur on the owner's terms or timeline because of one of the five Ds: death, disability, divorce, distress, or disagreement.

By focusing on regular and relentless execution of actions to protect, build, and harvest business value (which, again, is likely 80–90 percent of the owner's net worth), owners position themselves to be able to harvest that wealth in good times or bad.

Despite 75 percent of the respondents' indicating that a transition strategy was important to their futures and the future of their businesses, the survey results clearly indicate the vast education that business owners need. Owners can start by taking control of their own business and transition plan by educating themselves. Today, a vast number of resources are available to them, including their peer groups, their advisors, local universities, economic development organizations, books, and current research on the subject.

"Owners can start by educating themselves. "

Advice to Advisors

The "most trusted advisor" spot in this survey went to the owner's spouse. However, the CPA continues to be a key trusted advisor. In fact, the CPA has received the "most trusted" status in four out of the six surveys completed since 2013. Of all of the owners' possible advisors, the CPA most likely has the best insight of all outside advisors into the business's financials and operations. Going beyond self-imposed boundaries and becoming more consultative with the owner with regard to managing the value of the business and exit options is an opportunity that would benefit the CPA as well as the business owner.

Only 12 percent of the business owners surveyed indicated that their wealth advisors were their most trusted advisors. Although the percentage for this response is much higher than in previous surveys, we feel that wealth managers have a significant opportunity to improve their status with business owners, given that the wealth manager is—or at least should be—the one advisor (other than the business's attorney) who is with the owner throughout the entire process, not only leading up to the transition event but thereafter, charged with managing the owner's windfall after the exit event. The wealth manager is also vital for helping the owner select and structure the appropriate exit option. This is another indication of how owners often lack the necessary information regarding all their exit options and underestimate the value that their wealth advisors provide before, during, and after the exit event.

The exit advisor community is growing, but it is a blue ocean—a new profession driven by the wave of four million baby-boomer business owners who will be exiting their businesses over the next decade and beyond. Many owners are not even aware of the existence of a group of professional advisors who focus on helping them rapidly increase the value of and unlock the wealth trapped in their businesses. In this survey, 38 percent of the business owners who had designated a transition team had an exit advisor on that team. Although that number is still lower than it should be, it is a significant step up in recognition of the role of the exit advisor from previous research reports. We have had dozens of owners who have exited tell me that they wished they had known about exit advisory services before they exited.

Other key advisors, including attorneys, insurance professionals, and commercial bankers, are all necessary to fill out a transition team. All three of these groups already have existing clients who likely match the demographics of this survey. For example, 71 percent of their existing client base are likely to be aged 53 or older. It would thus be wise and financially beneficial for these professionals to go outside their subject matter expertise and attempt to develop a deeper, more personal, and more business-consultative role with their business owner clients. To accomplish this requires they reach out to other professionals involved in the transition and become more collaborative.

Thank you to our contributors.

This report was prepared and written Christopher Snider and the Exit Planning Institute. The author wishes to thank and recognize the work of Kimberle Dyer, the President of the EPI Arizona Chapter and the Cofounder of Keystone Capital Management Group, and the Arizona Owner Forum Council, including Joseph Evers of Evers Robinson LTD, Norman Lemus of UBS Financial Services, David Noosinow and Anthony Tanner of BNY Mellon Wealth Management, and Rick Wilcox of Point North Group LLC.

This research was a collaborative effort of many partners and organizations in the Metro Phoenix and Northern Arizona market. Thank you to the Arizona Community Foundation, the Phoenix Business Journal, and the many supporting firms in the EPI Arizona Chapter.

Moreover, thank you to the survey respondents in the Arizona market for their willing contribution to this study. Your participation has created an opportunity to educate and empower middle market business owners nationwide.

About the Exit Planning Institute

The Exit Planning Institute (EPI) delivers innovative learning experiences, performance-enhancing resources and strategic tools designed to enhance the exit planning profession. Formed in 2005 to serve the needs of CPAs, financial planners and wealth managers, attorneys, commercial bankers, management consultants, M&A advisors, ESOP and family business advisors, the Exit Planning Institute is considered the standard trendsetter in the field of exit planning across the globe. It is the only organization that offers the Certified Exit Planning Advisor (CEPA) Program and qualifies for continuing educational credits with eleven major professional associations, making it the most widely accepted and endorsed professional exit planning program in the world. For more information, please visit www.exit-planning-instutute.org.

For more information regarding the key stakeholders and individual partners of the State of Owner Readiness Survey conducted in this region, visit **www.OwnerReadiness.com**.

IN COLLABORATION WITH LEADING FIRMS AND ORGANIZATIONS:

UBS

EVERS ROBINSON LTD
ACCOUNTING 4 GROWTH
CERTIFIED PUBLIC ACCOUNTANTS

BNY MELLON
WEALTH MANAGEMENT

POINT NORTH

Exit Planning Institute
Arizona Chapter

AS SEEN IN:

PHOENIX BUSINESS JOURNAL