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# Strategies to Achieve a Successful Business Exit

## Transition Readiness in the SME Sector

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*"You can check out any time you like  
but you can never leave"*

Hotel California,  
The Eagles 1979



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## Executive Summary

Many business owners are facing an unprecedented demographic challenge as they contemplate the best way to depart or transition from a business that they founded and built many years ago to a financially rewarding exit with a proper succession structure in place.

Based on extensive primary and secondary research, this paper introduces a three-step process that will allow the enterprise owner to develop an effective transition 'road map' which will add valuable clarity and direction.

» The first step involves the completion of a comprehensive situation assessment commencing with a review of key advisory resources, both internal and external, which will be required to assess and plan the transition process.

An in-depth personal financial review and business 'size up' will also be necessary to gain an accurate fix on the owners' individual wealth accumulation success and objectives along with attainment of corporate key performance indicators.

This is followed by a change readiness review to assess the organization's appetite and tolerance for the significant change that will accompany an enterprise transition strategy.

» The second step involves an in-depth review of the five primary transition pathways which may be available to the business owner. These are summarized as follows:

- 1) Do nothing and pray**
- 2) Sell Internally**
- 3) Sell externally**
- 4) Grow – and then sell (either internally or externally)**
- 5) Harvest – maximize cash withdrawals**

Each pathway has various sub sections which are presented in detail along with the relative benefits and constraints of each.

In this section, an important research finding is addressed – invariably, it is recommended that business owners select two or more transition pathways which would then be implemented either in tandem or in sequence.

» The third and final step presents a transition plan which would be completed in conjunction with the business owner's advisory team.

Our extensive research has resulted in the development of a unique Enterprise Transition Strategy (three-step) model which provides a highly pragmatic focus on the different transition pathway options available to business owners and their professional advisors.

## Introduction

The objective of this paper is to present an approach that will allow SME (Small and Medium sized Enterprise) owners attain personal and organizational readiness to implement succession planning and transition strategies.

For the purposes of this paper, a SME would typically have revenues in the \$5 – 30M range, be profitable, have single or multiple shareholders and may have a board of directors/ advisory board in place. The company would be at the 'mature' stage of its life cycle with a seasoned management team in place and proven products or services sold into well established markets.

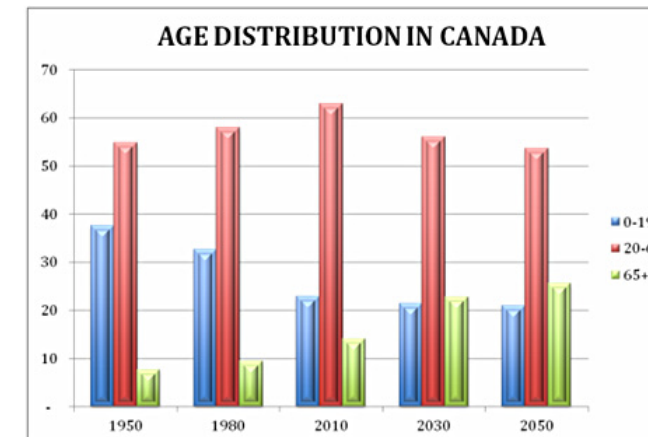
Many SME owners require objective and pragmatic guidance in navigating the chasm of poor succession and exit planning.

The research within this paper highlights the importance of the SME sector in Canada in terms of job creation and as a driver of economic growth – which is now threatened by an unprecedented demographic shift.

There appears to be a critical window of time where the next generation of leaders/managers in the SME sector have to be identified and placed in order to succeed the wave of retiring business owners of the boomer generational cohort.

In Canada, the Baby Boomer generation spans the birth years from 1946 to 1965 – in 2011, the first wave of baby boomers turned 65 with the last wave reaching 65 in 2030. This generational tidal wave is expected to set off a chain reaction of slower growth, weaker investment returns, government budget pressures and the prospect of inter-generational tensions.<sup>1</sup>

As indicated in the following graphic, there will be a progressive increase in the >65 year old population between 2010 and 2030 as the boomer cohort enters its retirement years.<sup>2</sup>



It is interesting to note that on the international stage, Canada has a more profound generational challenge with the retiring boomer cohort comprising 42% of the population at final retirement age in contrast to the UK where 21% is the corresponding figure.

This raises a key question; current market conditions appear to favour sellers due to strong buy side activity generated by an increasing wave of private equity firms, a shortage of quality companies for sale and increasing competition from Canadian and international buyers with a resultant increasing trend in valuation multiples. A recent M&A update from CIBC indicates that North American Private Equity transactions for companies with enterprise values in the \$10 – 50M range have averaged 6x EBITDA.<sup>3</sup>

Yet, could this trend be reversed with a progressive decrease in valuations (and earnings multiples) over time as the supply of companies for sale starts to exceed demand from potential buyers?

A recent PWC report indicates that 'a highly competitive buyers' market will prevail between 2018 and 2025' suggesting that many business owners will not sell their business for the price that they had hoped for.<sup>4</sup>

A study by CIBC World Markets (Globe and Mail November 2013) indicates that \$1.9 trillion in business assets are poised to change hands over the next five years within Canada. Those companies employ 2 million people and account for a least 15% share of GDP. Yet, based on the CIBC survey, close to 60% of business owners, aged 55 to 64 have yet to discuss exit or succession plans.

A more recent survey by BDC (Business Development of Canada) in October 2017 indicates that 40% entrepreneurs in Canada plan to exit their business within the next five years. Of this group, over 50% intend to sell or transfer to parties outside their family.

The survey further revealed that 40% of those anticipating an external sale had accomplished little in terms of sprucing up their financial reporting or maximizing their cash flows.



## Research Methodology

Specific research undertaken so far includes:

- » A comprehensive Literature Review which confirmed extensive applied research on the family owned firm and their succession related challenges. However, little work appears to have been completed on the types of transition/exit options that a business owner should consider before embarking on a formal succession planning process.
- » Primary research via interviews with SME owners/professional advisors in Victoria and the Lower Mainland to review prevailing attitudes around the need for effective transition planning and implementation.

This research included an assessment of the benefits and constraints impacting the development of effective transition strategies.

A key element in meeting with research respondents was to review and validate a unique 'Transition Pathways' model which defines five discrete exit options that would be available to enterprise owners.

Some of the key research questions included:

- » What are your present thoughts on a prospective exit from the business and time horizon? Is there a defined exit strategy – a succession or transition plan?
- » What type of exit options appear to be available? What are the relative pros and cons?
- » What are the benefits of an 'exit readiness' roadmap? Which Transition Pathways might be applicable and why?
- » How will you adapt to 'not being in-

involved' any longer in the business that you founded?

- » Once pathways are defined and rationalized, what succession issues need to be resolved?
- » How would the business be positioned for sale – would buyers be internal or external?
- » What resources are required to achieve a successful exit?
- » How important is a company valuation, when should this be done and by whom?
- » How will the issues of senior management 'bench strength' and employee buy in to the exit decision be addressed?
- » What will be the impact on clients and other stakeholders?

## Some Definitions

There are many different phrases currently used to capture the challenges facing business owners at this mature stage of the business cycle – the following definitions will hopefully add some clarity.

**Succession Planning** – tends to have a focus on the reality that all SME owners eventually have to confront the need to 'move onto new pastures'. The succession process will typically involve either internal (family, management, employees) or external (new owners or hires) individuals who will replace the departing business owner.

**Exit Strategies** – often applies to early stage companies (seeking exit via share sales to external parties, IPO, Private Equity funds etc.)

or less frequently, more mature entities which involve owner retirement.

**Transition** – is more of an umbrella concept where there is clearly defined evolving process at play where a SME owner will move through discrete stages towards an eventual exit, having considered issues like readiness, professional resources, preferences, succession, and financial viability.

This paper will use the Transition phraseology as it best captures the current reality of the demographic challenges facing enterprise owners today.

## The Enterprise Transition Strategy Model

A three stage model has been developed based upon the writer's commercial banking and management consulting experience allied with extensive primary research in the form of interviews with SME owners and their professional advisors.

A detailed listing of the research respondents is included in Appendix 1.

The model structure is summarized below followed by detailed insights and research findings as they apply to each of the three sections:

- » **Stage One**  
Situation Assessment
- » **Stage Two**  
Transition Pathway Review & Selection
- » **Stage Three**  
Transition Plan & Implementation



## Stage One – The Situation Assessment

Before embarking on a challenging journey, travellers need to review their resources and capabilities to assure successful completion of their planned itinerary. Likewise, today's business owners, facing the potential for retirement and/or new opportunities, will need to critically assess their current resources including personal financial, corporate health and change readiness.

This assessment process will involve the following four action steps:

### 1) Detail Key Advisory Resources

The business owner will need to document both his/her internal and external advisor resources.

Internal advisors would include the company's senior management team, board and if applicable, family members.

External resources would include trusted professional advisors such as accountants, corporate lawyers, management consultants, personal financial advisors and commercial bankers.

At this stage, both sets of advisors will need to be apprised of the planned journey – a transition to retirement and/or new ventures – and will play a key role in the formulation and execution of the resultant strategy.

### 2) Complete a Personal Financial Review

The business owner(s) will have likely built a significant personal net worth as they steadily grew their enterprise from the start up stage to its current mature and hopefully established position. To get an accurate fix on the owner's

personal financial situation, the following areas would need to be reviewed with their personal financial advisor and accountant:

- » Completion of a current and detailed personal financial statement, recording all personal assets, liabilities, income, taxes etc. This would provide a snapshot of asset diversity and investment portfolio performance.
- » A comprehensive review of all insurance coverage including key person business insurance.
- » Family needs and preferences will have to be reviewed with a frank assessment of the next generation's capacity and capability to assume managerial leadership and share ownership.

- » A review of the company's shareholding and governance structure will also be required along with any estate planning/trust initiatives in place or under consideration. The services of an experienced tax lawyer/accountant may be required to fully understand all the legal and fiduciary issues.

This can be a critical issue as many SMEs have minority shareholders (employees, past employees or business associates, family members, etc.). Prior to embarking on a business transition, such interests need to be cleaned up (bought out when the share price is low or moved to a different share class that is frozen). Otherwise, problems may arise later manifested either by discomfort in providing growth capital when needed or potentially complicating or stalling a share purchase by an outside buyer.

It should be noted that with a family business, as part of the planning process, an estate 'freeze' may need to be established to optimize tax deferrals where the older generation fix or freeze the current value of the business via preferred shares with new common shares issued to a family trust or next generation to allow future growth to be attributed to the next generation..

Planning may require that real estate assets be removed from the operating company to purify the company, while also providing an additional future income source. <sup>iii</sup>

### 3) Conduct an Organizational Size Up

The business will also need to undergo a rigorous 'health check-up' which can be accomplished by using the Business Diagnostics 'size up' methodology. <sup>5</sup>

The following areas would be reviewed:

The **External Size Up** – commences with a review of high level influences and/or trends, current or anticipated which can have a profound, game changing impact on a business. These are known as 'Disruptive Forces' and are akin to strategic jet-streams, high in the atmosphere, broad in scope, and often difficult to anticipate and define. Today's business owner is facing an unprecedented array of such forces such as Technology Acceleration (Moore's Law) and Geo-Political trade implosions (Brexit and NAFTA concerns).

Awareness of such forces and their far reaching impact is a critical element in a business owner's transition planning. In Appendix 2, we detail three Disruptive Forces which need to be carefully understood and assessed by today's business owner.



The next step is to conduct a current review of PEST factors (Political, Economic, Socio-Cultural, and Technological) that might impact the business along with an analysis of the industry sector's competitive conditions (Porter's Five Forces).

The **Internal Size Up** – a review of the company's performance within the key functional areas of Finance, Marketing, HR, and Operations. Also a key consideration here is to detail what actual impact the company founder and owner, has had on the business (sales, innovation, leadership etc.) A critical evaluation of existing management strengths and abilities would be required with a view to upgrade if required.

**Strategic Direction** – entails documenting the organization's current strategic pathway (status quo) along with an assessment of other potential directions including one that involves the owner's eventual planned departure.

The Organizational Size Up model is summarized in Appendix 3.

Strategic Planning is a crucial element in charting a company's growth direction and trajectory, yet many SMEs have no Strategic Plans, preferring to work 'in' as opposed to 'on' the enterprise. In Appendix 4 we present a short and effective planning approach, the Strategic Team Review, which would be an essential prelude to commencing a transition process.

**Preliminary Valuation** – at this stage in the transition process, company accountants should be engaged to complete an informal valuation which would be based on the historical and projected income statements. This valuation process will determine the desired sale price range of the business.

This would be a 'broad strokes' determination of a value range to ensure that the owner does not have unrealistic expectations as to the company's expected sale price to either internal or external buyers.

A typical valuation approach would involve averaging the business historical EBITDA (less maintenance capital expenditures) over the past 3-4 years + a one/two year forward projection. Such projections could be completed using a sensitivity analysis – Worst case (sky falling in), Expected case (business as usual) and Best case (accelerated growth) basis. The EBITDA would be 'normalized' or 're-casted' with an adjustment made for excess/deficient owner salaries, non-recurring items, above/below normal rents etc.

For a typical SME, a multiple in a range of 4x to 6x would be applied reflecting industry growth rates, potential acquisition synergies, growth expectations, capital expenditure requirements, intellectual property protection and recent sales comparables, if available.

It should be noted that such multiples could be higher depending on the type of industry, geographical location and the deal size, especially if the buyer is a publically traded company.

Once a defined buyer has been identified (see Stage 3) and negotiations commence, the specialized services of a Chartered Business Valuator (CBV) will invariably be required to justify the sale price. The business owner (vendor) should also evaluate what short term changes can be made to enhance EBITDA performance, both from a revenue generation, gross margin enhancement and expense control standpoint. The existence of long term contracts (which provide consistent recurring cash flows) will mitigate fluctuations in historical EBITDA.

#### 4) Initiate a Change Readiness Review

With the company's leadership transition in play, the final component of the Situation Assessment is to assess the organization's appetite for significant change and transformation.

To evaluate the company's 'change readiness', we have adapted the Drivers for Change model (Anderson and Ackerman)<sup>6</sup> into the two following areas of focus: **External and Internal**



#### External Focus

» Marketplace Requirements – what will be the impact of the planned transition on the aggregate set of customer requirements that determine what it takes for a business to succeed in its marketplace and meet its customers' needs? Does the CEO have deep and enduring client relationships which may wind down upon the departure of the company leader?

» Business Imperatives – what must the company do strategically to be successful post transition, given its customers' changing requirements? Are there any risks associated with the potential for disruptive change within the industry sector that could influence client buying preferences?

» Organizational Initiatives – what changes will take place in the organization's structure, systems, processes, skill base, and staffing to implement an eventual transition action plan.

#### Internal Focus

» Cultural Imperatives – denote how the norms, or collective way of being, working, and relating in the company, must change to support and drive the organization's new design, operations, and strategy.

» Leader and Employee Behaviour – collective behaviour creates and expresses an organization's culture. Therefore, as part of the transition process, the new leaders and existing employees will behave differently as they work to re-cast the organization's culture and organizational design successfully.



**Two key observations:**

1. Today's work force is dominated by demographic considerations with Boomer, Gen X and Gen Y (Millennial) generations working side by side. In formulating a defined Business Transition strategy, these discrete groups' preferences and characteristics have to be carefully understood and assessed.

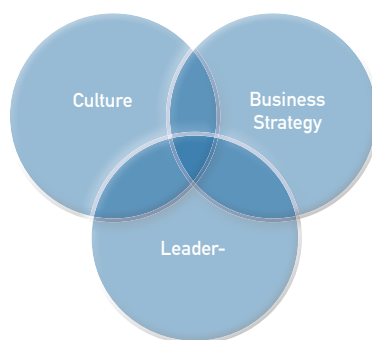
The table below summarizes some of the key distinguishing features of the three generations<sup>7</sup>:

2. In preparation for a Business Transition event, a useful best practice is to establish a formal transition team which operates separately from regular managerial operations. As part of this process, it is also important to acknowledge the 'forming, storming, norming and performing' stages of change will doubtless emerge with a commensurate need to ensure that these are moved through constructively and as quickly as possible<sup>8</sup>.

The following key questions may arise in assessing the leadership and cultural implications of business transition<sup>9</sup>:

- » Will the new leadership team be capable of leading the organization?
- » Is the company's current culture aligned with the new leadership's objectives to sustain or evolve the business?
- » Noting the sober warning that 'culture eats strategy for breakfast', are the strategic goals of the business aligned with its culture?

Culture, leadership and strategic goals are intrinsically intertwined. Every change initiative is a unique opportunity to align the organization for optimal effectiveness and employee support.



**Key Differentiators**

Boomers (1945-64)	Generation X (1965-79)	Generation Y (1980-99)
<ul style="list-style-type: none"> <li>• Top of most organizational hierarchies</li> <li>• Retain most of corporate memory</li> <li>• Technology laggards</li> <li>• Competitive</li> <li>• Face to face communication style</li> <li>• Participatory decisions</li> <li>• Strong work ethic</li> <li>• Tend to be self centered and judgemental</li> </ul>	<ul style="list-style-type: none"> <li>• Usually Middle Managers</li> <li>• Tend to be skeptical/cynical</li> <li>• Like short and direct communication via email</li> <li>• See selves as 'intrepreneurs' within the organization</li> <li>• Able to process high volumes of information</li> <li>• Prefer to live in present</li> <li>• Loyal to individuals versus the organization</li> <li>• Technologically literate</li> </ul>	<ul style="list-style-type: none"> <li>• First line managers</li> <li>• Technology innovators</li> <li>• Focus on internet based social relationships</li> <li>• Large goals with short term horizons</li> <li>• Goal oriented and desire inclusivity</li> <li>• Impatient with routine, yet overconfident</li> <li>• See careers as a series of project assignments</li> </ul>

**Steps towards assessing the viability of this mix, pre and post, transition include:**

1. Performing a cultural assessment to identify the current and preferred future organizational culture type. Culture may or may not have to change depending on the leadership coming in and the defined strategic business goals moving forward.
2. An assessment of the current leadership team style as well as that of the incoming incumbent(s).

Such a change management plan is created and implemented that identifies steps to be taken to ensure alignment between the organizational culture and new leader/leadership team, to meet the strategic business needs.

A popular Change Management approach that captures the above objectives is the Competing Values Framework, developed by Cameron and Quinn in 2006.<sup>10</sup>

**Six Dimensions to the framework are identified:**

1. Dominant Characteristics – what kind of work place exists – personal or entrepreneurial or results oriented or structured?
2. Organizational Leadership – leadership exemplifies mentoring or risk taking or no nonsense or co-ordination?
3. Management of Employees – style is characterized by consensus, or innovation or high demands or conformity?
4. Organizational Glue – that holds the organization together is loyalty or being cutting edge or the need to win or formal rules and policies?
5. Strategic Focus – the organization emphasizes high trust or creating new challenges or winning in the marketplace or

stability and efficiency?

6. Definition of Success – concern for people or unique and new products or out-pacing the competition or dependable delivery?

Respondents (management and employees) are invited to select the best definition for each of the six dimensions and score for both the current and required culture.

From this process, four different types of organizations emerge, one of which will map closely to the organization that is being reviewed:

- » **Clan** – an organization with a focus on internal maintenance and exhibits flexibility, concern for people and sensitivity to customers. This would be described as Collaborative.
- » **Adhocracy** – an organization with a focus on external positioning and exhibiting a high degree of flexibility and individuality. This would be described as Creative.
- » **Market** – an organization with a focus on external positioning with a need for stability and control. This would be described as Competing.
- » **Hierarchy** – an organization with a focus on internal maintenance + a need for control and stability. This would be described as Controlling.

Such a complex engagement process would be managed by an experienced management consultant (CMC) with a proven track record in such change management interventions.



## Stage Two – Transition Pathway Review and Selection

Having completed a comprehensive situation assessment, the next stage in the Enterprise Transition Strategy model involves the review and selection of the best 'transition pathways' which may be available to the business owner.

One key outcome of the extensive dialogue with research respondents has been the realization that there are a number of finite options or pathways open to business owners as they consider their transition to retirement and/or new ventures.

The five separate pathways, with their component options are summarized below:

### Do nothing – and pray

1. Wind down – voluntary.
2. Wind down – forced.

### Sell Internally

3. Family – same/next generation.
4. Management buy-out (MBO).
5. Employee buy – out (EBO).

### Sell Externally

6. Strategic buyer.
7. Financial buyer.
8. Merger/Strategic partnership.

### Grow – and then sell

9. Board chair – redefined C-Suite (some external hires).
10. Board chair – refreshed C-Suite (internal promotions).

### Harvest – maximize cash withdrawals

11. Sell non-core assets.
12. Review cost structure + a defined program of dividend withdrawals.

We will now review each transition pathway in more detail examining the relative benefits and constraints of each.

### 1. Do nothing and pray



#### Overview

It is a sad reality that many business owners will do nothing except hope for a serendipitous event whereupon their business is unexpectedly sold and their journey on to new pastures is assured. The potential for such an 'unexpected buyer' materializing is remote at best.

This is known as the 'Hail Mary Strategy' which inevitably culminates in either a voluntary or forced wind down of the business operations rather than a miracle sale.

#### Voluntary Wind Down

In terms of potential benefits, this is the simplest exit strategy to implement; all assets are liquidated, cash proceeds are used to pay off liabilities, with the residual proceeds distributed to the shareholders.

It is interesting to note that the October 2017 BDC survey revealed that while only 3% of companies with >20 employees had plans to liquidate their company, the percentage grew dramatically to 24% for companies with less than 20 employees.

In such liquidation scenarios, there is a large and growing market for assets sold through business closeouts and liquidations, known as the 'remarketing' industry. Such industry players include inventory liquidators, discount retailers, auctioneers and web marketers.<sup>11</sup>

In most instances, there should be no complex or difficult negotiations and no challenges with transfers of control.

There are however, a number of key concerns arising from such a voluntary wind down decision:

- » While deciding to wind down the business by a defined date may have some merit in terms of expediency and simplicity, such a process will invariably be demanding and involve the liquidation of fixed and current assets along with the settlement of any outstanding liabilities.
- » The resultant cash represents the net equity of the enterprise but there may be significant foregone proceeds due the company not being sold as 'a going concern' with an independent buyer paying market value for the enterprise.<sup>12</sup>
- » There may also be various non-financial assets such as client relationships, company brand and reputation, suppliers and customer lists that have significant enterprise value. A decision to liquidate the business will remove such intangible value which will likely have been created over a long period of time.<sup>13</sup>

There may also be other (minority) share-

holders seeking the maximum return on their equity share which could also lead to conflict and resistance.

There is one positive variant of this approach where a defined strategy to 'harvest cash flow' over a set time frame, is established. This approach is covered in more detail later in this paper as a separate transition pathway.

### The Forced Wind Down

Clearly there are no positives here with this stage being more of a consequence than an action. The brutal reality is that if the company is neither solvent nor viable, company creditors will commence formal liquidation and wind-down will take place through Receivership or Bankruptcy proceedings.

The forced wind down is the most demanding and stressful transition scenario and takes place when a company finds itself assailed by creditors who have the legal right to exercise remedies which may lead to the business closing down.

Causes of such business difficulties are usually attributable to one or a combination of the following factors:

The business owner checks out either physically and/or mentally leading to:

- » Managerial or key employee problems.
- » Financial difficulties.
- » Product and/or market related challenges.
- » Poorly recognized external factors such as industry consolidations, adverse regulatory changes to name a few.

In some instances, such a decline in corporate health can be arrested, by considering two key

questions:

#### Is the company solvent?

In most cases, a company is said to be insolvent if it is unable to meet its obligations as they become due and the net realization value of its assets does not cover its liabilities.

To return the company to a solvent state, some form of urgent external capital injection will need to take place.

#### Are company operations viable?

A viable company is one that is able to carry on profitable operations now and into the medium term. If the company is not viable, it is not worth expending valuable resources in an attempt to save it.

In assessing the viability of a distressed business, some key questions must be considered:

- » Is there a sufficient depth of market (awareness) for the company products or services?
- » Is there still a viable management team in place?
- » Is there an effective sales force in place to market the product or service?
- » Are reasonable gross margins being obtained?
- » Does the business model now make sense – remember the dot com era?

Many business owners are caught in the 'activity trap' (Steven Covey – The Seven Habits of Highly Effective People) where their 'busyness' results in constant preoccupation with no thoughts as to the ultimate destination. In effect, their exit strategy is death.<sup>14</sup>

## 2. Sell internally



### Overview

There may be someone in the owner's family or current staff team (management or employees) who are well positioned to carry on and run the business. Sale proceeds may be lower and/or deferred but knowing the buyer well can often minimize unexpected surprises.

### Family – Same/Next Generation

There are many attractions in 'keeping the business in the family' with the all-important caveat that the successor generation has the inclination and ability to take over the 'reigns':

- » Assuming the interests of family members are aligned, the timeframe on this type of succession transaction can be quite short, relatively efficient and carry low legal, accounting and intermediary fees.<sup>15</sup>
- » The risk of the underlying deal structure collapsing tends to be low in family business transactions, especially as there is typically less due diligence completed. Also a family owned enterprise will tend to focus on longer term investment decisions, experience greater employee engagement

(extension of the family) and make more decisive strategic decisions due to the closer links between shareholders and management.<sup>16</sup>

» Family successors usually have many years to be groomed and prepared for the eventual taking the helm of the business; preparatory measures such as external and internal training, education and years of progressive experience working within the business should ensure a comfortable transition.<sup>17</sup> In some circumstances, the hiring of a 'Second in Charge' executive, with appropriate industry and managerial experience, can serve to bridge between the generations.<sup>18</sup> This appointment lessens reliance on the owner-manager by the next generation. The hiring of such 'non family professionals' is increasingly seen as critical for the long term health of the business along with the need to incent with an appropriate equity stake.<sup>19</sup>

» Family business issues are often highlighted in the press, while organizations like CAFÉ – The Canadian Association of Family Enterprises – provide highly professional mentoring services and consulting resources.

» A recent survey by PWC Company Services highlights some best practices for family business governance and transition:

Establish a family council to discuss and resolve key issues, including succession planning.

Appoint an external advisory board (comprising of non-relatives) to provide objective and independent advice and insight. Benefits include taking a more strategic approach in assessing the industry sector/vertical, continuity in light of unexpected management changes, provision of external expertise and resources

along with a platform to ensure enhanced inter-family communication. It is important to ensure that these members have the time, expertise and commitment to discharge this critical function.<sup>20</sup>

Ensure that the next generation gains experience outside the family business or, at a minimum, take on different roles within the company.

Develop a contingency plan for unexpected events, including family health and mortality issues.

Engage a third-party, unrelated mediator or facilitator to handle complex family dynamics.<sup>21</sup>

There will be instances where family business succession may be disadvantageous and lead the owners to explore other transition options:

» A recent Family Firm Institute study indicates that only 30% family owned businesses make it to the 2nd generation, only 12% making it to the 3rd and a dismal 4% making it through to 4th generation and beyond.<sup>22</sup>

» Inter-familial sales tend to have lower values due to the 'non-arm's length' of such transactions – as a result, the exiting senior family member(s) will typically receive lower cash proceeds as opposed to a sale transaction with external, unrelated parties. Such transactions are often funded by vendor take-back funding – the family business owner retains share ownership but transfers management responsibilities to the next generation. Such ownership transfers can be delayed until the death of the vendor.

This reduction in potential extracted value is often mitigated by the owner-manager harvesting annual dividends and investing the proceeds in separate assets, such as commer-

cial real estate, which are controlled through a family holding company, unrelated to the core business.

» Also, such proceeds may be deferred or delayed to meet the successor family members' priorities. This 'slow cash out' processes, often involving an estate freeze and the take back of preferred shares that are redeemed over time, can be problematic if the next generation does not perform.<sup>23</sup>

» Often, there may be complex inter-personal and emotional relationships at play which conflict with the strategic goals and operational tactics of the business. Also, older generations are experiencing increasing concerns with 'transliquification', a phrase coined by the banking sector where wealth is transferred to the next generation and then 'liquefied'.<sup>24</sup>

» There might be differing personal goals and aspirations of individual family members, including variable liquidity and wealth accumulation priorities which could lead to miss-alignment with the goals of the business.

» The complexity of family business succession and the inherent communication challenges can be nicely framed using the Three Circle Model of the Family Business System that was developed at the Harvard Business School by Taguiri and Davis in the 1970s.

The Family Business System consists of three interdependent groups, which have their own unique communication issues:

**Family** – this group recognizes that there are three separate, time defined stages of family development – First, Second Generation and Third Generation.

In the First generation, there may be role ambiguity and lack of boundaries between the family and the business operations. In the Second generation, sibling rivalry and potential over parenting may lead to communication challenges, while the Third generation may see conflict arising between active and non-active family members.

**Business** – this grouping identifies the three separate life cycle stages of an enterprise – Start Up, Growth and Maturity/Divestment.

At the Start Up stage, co-mingling of family and business financial resources can lead to communications challenges, while during the Growth stage, weak managerial capability and capacity of family members can pose challenges. At the Maturity/Divestment stage, lack of family consensus around valuation issues and the best exit strategy can emerge.

**Ownership** – defines three different generational ownership stages – Founder Owner, The Sibling Team and The Cousin Consortium, again, each with their own unique communication challenges

The Founder Owner stage may involve a poorly structured share ownership while the Sibling Team may experience conflict from founder demands for share buyout. The Cousin Consortium often experiences lack of clarity around governance and accountability.

» As noted in the Ownership grouping above, if a family business has reached the Cousin Consortium stage, there may be less confidence that the management team can execute effectively given the disparate personalities and talents at play and/or the cousin's desire to exit the business. In such circumstances, an externally appointed (hired gun) CEO may be brought into run the company, reporting to a family shareholder board.<sup>25</sup>

» Another concern with a family business transaction is that there is not the same degree of 'corporate house cleaning' that would be completed if the business was being sold to an external buyer – such complacency can have adverse long term implications.

#### Management Buy-Out (MBO)

Another internal transition pathway to consider is the sale of the business to a team of senior management who have the determination and resources to continue growing the business. This strategy may be attractive for the following reasons:

» A sale to the management team will typically carry lower legal, accounting fees and may be completed in a relatively short time-frame. The services of a business broker or M&A firm will not usually be required with resultant commission savings in the 3-5% range. That said, using a seasoned M&A may not always result in a higher sale price.

» Management, having had experience in the business and a close working relationship with the outgoing ownership will be more likely to preserve the intangibles like branding, culture, along with enduring client and supplier relationships than an outside buyer.

» To meet the transaction financing requirements, many banks and credit unions, along with organizations like the BDC (Business Development Bank of Canada) can structure loan facilities which can provide a significant portion of the funding required to cash out the existing shareholders and owners. Please refer to Appendix 5 for further details.

This will essentially be a 'leveraged buy-out' whereby some of the company assets can be leveraged or collateralized to generate a portion of the share buyout transaction.

It should be noted that the MBO team may not have the financial (cash) resources to generate the equity requirements of the deal – in such circumstances, a vendor take back and/or potential participation by a Private Equity firm can bridge such a funding requirement.

One interesting element of the lender's risk assessment process would be the reassurance that the company still remains 'saleable' to an external (strategic or financial) buyer – another reason to consider the engagement of a M&A specialist firm, even on a retainer basis.

Such a buy-out structure can also have significant downsides, which need to be clearly recognized by both the outgoing owner and the incoming management team:

- » The corporate strategic vision of the succeeding management team versus the departing shareholder(s) may not be aligned with the potential for conflicts and disputes, especially if some form of 'earn out' or deferred payment structure has been negotiated.
- » Due to the sometimes limited financial resources of the MBO team, the funding assistance of commercial lenders/financing may be required to facilitate the transaction. By leveraging company assets, the resultant debt load may impede the ability to raise future working capital financing (operating lines of credit) and therefore constrain future growth. In most cases, the lenders will require the MBO team to 'have skin in the game' and contribute a realistic equity contribution from their own resources.

» Sometimes, the company does not qualify for MBO financing due to concerns around the company achieving sustainable EBITDA and/or lack of supporting collateral from the management team. This leaves the owner with the option of structuring vendor (take-back) financing and perhaps liquidating surplus assets and/or withdrawing surplus cash resources (ensuring that the company's working capital position is not adversely impacted).

» The longstanding relationship between exiting ownership and the incoming management team may have the potential to impede negotiations and the attainment of a fair market price for the enterprise.

### Employee Buy-Out (EBO)

A similar structure to the MBO but involving a broader employee based group, this can be an attractive option where employees may retain their jobs. An employee buy-out, conceptually, by its very nature, guarantees a high level of stakeholder involvement from employees themselves.

However, in reality, this type of transition pathway is typically difficult to achieve as it will usually have involved some form of past financial distress which may have made other exit structuring options unavailable.

This might be the 'last resort' with employees involved to preserve their jobs. Such an em-

ployee group will also likely require financing to achieve what will essentially be a leveraged buyout. Potential lenders may be deterred by the complexity in dealing with a larger, more disparate group of borrowers with uneven personal financial resources.

Given there will be more individual stakeholders involved, a host of complex governance issues will emerge, especially the demarcation between the employee leadership (who will perform a quasi-managerial function) and the rest of the workforce.

There may also be significant roadblocks to successful deal structuring if there are union negotiations in progress.

One recent and emerging trend is that of employee owned co-ops which are established as an interim step and allow the company owner(s) to share ownership on a co-operative basis. Credit Unions in Canada (which themselves are co-operatively owned) are able to provide financing to employees to buy shares in the company.

In the USA, such 'worker cooperatives' are attracting interest of the boomer generation where worker-owners control the business and are able to avoid local employment layoffs which otherwise might occur with the retirement of a business owner.

The business sale is usually funded by a combination of vendor financing, local community development financial institutions loans and 'first loss money' in the form of employee contributions (\$5-10K range) which can also be structured via payroll deductions.<sup>26</sup>



### 3. Sell Externally



#### Overview

Having looked within the organization, it would also be prudent to examine opportunities to locate an external buyer who may be interested in acquiring the company for their own strategic or financial reasons. There may also be opportunities for a mergers or a strategic partnership.

#### The Strategic Buyer

There are a number of compelling reasons to consider the sale of the enterprise to a strategic buyer who may be a competitor, supplier or a conglomerate seeking to add to its portfolio of diversified companies:

- » This option opens up a landscape populated by a wide variety of potential suitors to choose from and rank order in terms of attractiveness and strategic fit.

In seeking such acquirers, it is essential that the company owner and advisors really understand their unique industry competitive conditions, especially the feasibility and practicality in making an initial connection with one's closest competitors. If

the industry sector has few competitors, there may be more risk and danger in disclosing an intention to sell the business.

- » Strategic buyers seeking synergies with the target business may find their product/service portfolio to be unique or may be seeking vertical or horizontal integration opportunities within their industry sector.

A recent example is the acquisition of Daniel's Electronics, a Victoria based radio Electronics Company, by Codan Limited, a large Australian radio communications distributor. Benefits to Codan included access to new North American markets, a hedge against the US dollar and avoidance of restrictive US government ITAR regulations.<sup>27</sup>

- » Large multi-nationals and public companies may often seek smaller entities in order to close strategic gaps in product development and market segment penetration. Some recent examples in the Victoria, BC technology sector include:

- **Power Measurement – purchased by France based Schneider Electric (2005)**
- **Abebooks – acquired by Amazon (2008)**
- **Custom House Currency – bought by Western Union (2009)<sup>28</sup>**

- » In some instances, the Strategic buyer may be an individual, either a (retired) CEO or executive in a larger (often, public) company, who is seeking more independence from regulatory, governance and executive team issues. Such an individual would have significant financial resources and/or access to private capital, to effect a successful purchase.<sup>29</sup> The challenge here is to successfully identify and access such individuals.

- » There is also the emergence of 'Boomer syndicates' (who created wealth selling their own companies) and 'Family Offices' (wealthy families building diversified investment portfolios) who have also entered the Strategic Buyer domain.

- » If the business has strategic value to the acquirer, there will usually be a 'goodwill' premium on the price paid for the business, which is typically the highest of all the transition pathway options. In the current business climate, financial buyers (P/E firms) are typically paying more than strategic buyers.

- » In some cases, depending on the sophistication of the sales support selected (C.A firm, M & A specialists), there may be the potential for a bidding war between rival strategic/financial buyers with a consequent enhanced selling price.

- » There may also be a potential buyer which is a company that needs to hit top line revenue growth targets and seeks to achieve this by acquisition versus organic growth.

There are also some important cautions to consider with a strategic buyer identification and selection strategy:

- » As sale negotiations commence, the buyer may endeavor to structure the deal where the seller is bound by an 'earn out', a process where a significant portion of the sales proceeds are tied to future annual financial performance (usually pre-tax earnings). This entails the exiting shareholder(s) being tied to the management of the business and their proverbial 'feet being held to the fire' for a contractual period (three to ten years).
- » There may also be a 'vendor take back' or deferred payment negotiated by the

buyer (without financial performance earn out targets) which often involves the exiting shareholders and executive team 'staying on board' until the final payments are made. For example, 50% purchase price paid at closing, followed by 25% payable over the next two years.

#### The Financial Buyer

Financial buyers are also known as Private Equity Groups (PEGs) who administer funds which invest in various geographic areas and industry sectors. It is estimated that there are 5,000 or so such funds in North America with a focus retiring baby boomer business owners. Minimum EBITDA requirements are typically \$5M with PEGs often executing a 'roll up' strategy where they acquire a number of smaller companies in an industry vertical and then consolidate into one larger entity – also known as accretive bolt-on acquisitions.<sup>30</sup>

PEGs will finance their acquisitions with various debt instruments from banks and subordinated debt lenders, with typical transactions underpinned with rigorous financial test covenants including a Total Debt: EBITDA ratio

The attractions in dealing with a financial buyer are detailed as follows:

- » Financial buyers are rarely direct competitors or industry participants – they have a 'strategic disinterest' with a primary focus in seeking superior returns on their investment.
- » Financial buyers may be more inclined to move the transaction forward quickly offering a cash deal, in contrast with strategic buyers who may endeavour to structure an earn out or a deferred payment.
- » In some cases, such buyers may be content to acquire less than 100% of the busi-

ness (holding either a minority or majority interest) which may yield a potential upside for the exiting business owners as they retain a residual shareholding. Such transactions will also often entail the retention of existing management thereby minimizing the risk of cultural and organizational change issues.

Such 'Leveraged Recapitalizations' can facilitate the buyout of selected shareholders and provide wealth diversification to a business owner who has the opportunity to still share in the future success of the company. The Private Investors would usually seek majority ownership and finance the transaction with a combination of bank term debt and mezzanine (subordinated debt) financing.<sup>31</sup>

There are also some inherent risks in commencing negotiations with financial buyers:

- » They may not share the long-term vision of the (exiting) business owners as they focus on a short-term return on investment and their own financially driven exit strategy (perhaps an IPO or sale to larger strategic buyer). While this may not impact the departing shareholder(s) who will have safely 'cashed out', the remaining employees may face greater risks to their future employment stability.
- » To optimize their cash investment into the deal, the financial buyer may place a higher emphasis on debt financing to grow the business with resultant increased pressure on the remaining management team and employees.
- » Financial investors will likely impose a stricter governance structure and higher levels of financial reporting requirements and control measure that may be a shock to the extant management team and overall organizational culture of the company.<sup>32</sup>



### The Essence of the Deal

With external sale transactions (involving Strategic or Financial buyers), there are many issues that need to be considered in structuring a successful transaction:

- » A key question is – how do you find the right Strategic or Financial buyer?

Financial Buyers (PEGs) often make a direct acquisition after direct contact is made by either the buyer or the seller. In some instances, an M&A firm will act as an intermediary to make the connection.

- » In selecting an M&A advisor, key considerations include their track record in successfully closing a sale (duration and ultimate sale price) along with their compensation structure (work fees and success fees).<sup>33</sup>
- » The sale process involving such external buyers will typically involve a long time-frame, often nine to eighteen months, or longer if there is a high level of complexity which entails a greater degree of due diligence. There is certainly potential for the selling executive team to burn out, especially as M&A practitioners state 'it is not a deal until it has failed at least three times'.<sup>34</sup>
- » It is also interesting to note that some transactions will be 'accidental exits' which involve serendipitous or unplanned meetings with potential buyers and are completed more by chance than by careful and strategic planning.<sup>35</sup>
- » Legal, consulting, accounting and intermediary fees will tend to be higher while the potential for the deal structure to fall through will be greater with an external strategic buyer (who will have their own team of professional advisors, keen to safeguard their client's interests).
- » Disclosure of sensitive or confidential material is also a key issue – Non-disclosure agreements (NDAs) provide some protection but extreme caution must be exercised in maintaining confidentiality, especially with employees and other key stakeholders like clients and suppliers.

Strategic Buyers are usually found by using facilitators (fee for service) like Business brokers, typically small deal size <\$5M and M&A firms with deal size over \$5M.

M&A firms will be either Boutique (based on location and/or industry sector) or Institutional (Banks or large Accounting firms).

» Care also needs to be exercised in negotiations around the sale price especially conditions that relate to the company being sold on a 'debt free and cash free' basis. The latter clause implies that surplus cash (over and above normal working capital requirements) can be withdrawn by way of dividends to the business owner, in addition to the agreed upon cash proceeds at closing.

» Current economic conditions, notably the low interest rate environment, point to a sellers' market although there would be some exceptions in the extractive resource sector. With a strong seller's market come higher valuations and a commensurate increase in buyer's due diligence as they evaluate the quantum of post deal cost savings and acquisition synergies.<sup>36</sup>

» The services of a seasoned corporate lawyer will be critical to ensure a properly structured LOI (Letter of Intent) or HOT (Heads of Terms) is completed, which will guide ongoing negotiations through the due diligence process, which can often be arduous and lengthy.

» It is important that the business is properly positioned for a successful sale to a strategic or financial buyer. This would involve the following:

- Demonstration of professional business planning and forecasting.
- Identification of the primary attributes and value of the enterprise, for example intellectual property protection or unique sales channels or partnerships.
- Focus on increasing revenues along with maximized profitability.
- Cleaning up the Balance Sheet via surplus asset disposal and liability write offs if warranted.

- Documenting all important contracts with clients, supplier's management and employees.
- Ensuring that management succession and continuity has been addressed so that the buyer has the reassurance that key capabilities and relationships are retained in the business.<sup>37</sup>

It is also instructive to 'stand in the shoes' of a potential buyer to understand how they view their potential acquisition. The following factors would be considered based upon a recent article by Share Vault and Centaur Partners (The Art and Science of High M&A Valuation):

1. Market/Sales Strength – first mover and/or fast innovator advantage need to be demonstrated.
2. Management & Team strength – compatibility with each other and demonstrable leadership skills.
3. Ideas – defensible IP allied with a focus on clearly defined, customer-centric goals.
4. Customer base – understanding the depth and breadth, transaction size, and potential for authentic testimonials.
5. Competition – barriers to entry need to be in place providing a 'strategic moat' and strong market advantage.

A final key insight is that trust between the buyer and the seller is absolutely critical if the transaction is to succeed – if there is no transparency and commitment to reach a mutually agreeable deal, then the negotiation process will either stall or fail.

To allow the reader to more fully understand the External Buyer landscape and its key players, we have completed a marketplace scan and review which is detailed within a companion publication titled 'Merger & Acquisition (M&A) Resource Guide' – Western Canada. This guide documents:

Facilitators who locate Strategic Buyers – consisting of Business Brokers and M&A firms based in B.C and Alberta – 28 separate company profiles for review.

Financial Buyers – consisting of various Private Equity firms based in B.C and Alberta – 11 separate company profiles for review.

#### Merger/Strategic Partnership



In terms of achieving a successful exit, the company owner may elect to merge or craft a strategic alliance with an outside entity as a potential interim step towards a formalized strategic sale. Such a move would confer the following benefits:

- » A potential merger partner may pay a premium on merging with or partnering with the company if there are perceived strategic values and synergies.
- » Depending on the deal structure, the exiting shareholder may be able to sell 50% of the company and enjoy the upside of the enhanced growth performance of the newly merged entity.
- » Even if the merger were to consist of a share swap between each entity (with no cash consideration), the resultant synergies (1+1=3) could position the entity for successful sale down the road to another external player along with an enhanced valuation due to improved pre-tax earnings performance.

Best practices in embarking on a potential merger or strategic alliance include:

- » Assess cultural fit.
- » Obtain a formal and independent valuation and verify with scenario planning with a focus on market trends.
- » Assess product/service offerings + administration/supply chains to ensure tangible synergies.
- » Review each organization's reputation, client base, and growth prospects.
- » Evaluate each company's corporate governance and managerial capacity and capability.
- » Assess historical revenue generation, margin performance, cost control and cash driver performance for each potential partner.
- » Review marketing, business development and sales strategies.<sup>38</sup>

There are also challenges associated with such merging or alliance opportunities, specifically cultural and organizational challenges as the two merged management teams strive to reach consensus on strategic and operational direction. Incompatible cultures are cited as the principal cause of failed mergers.

Post-merger integration often will see weakened profit and productivity as valued employees leave the organization as they struggle to cope with new job roles, new reporting relationships and uncertainty as to the future.<sup>39</sup>

The harsh reality is that there are rarely 'mergers of equals' (one side wins and takes over) and thus, significant change management issues will need to be recognized and addressed.



#### 4. Grow – and then Sell (Externally or Internally)



##### Overview

The October 2017 BDC survey of business owners revealed that almost 50% had intentions to continue growing the enterprise yet the other 50% did not want to grow or were indifferent. This disconcerting finding points to a ‘bailing out’ strategy whereby many business owners appear to want a quick exit (and retirement) rather than grow and maximize enterprise value.

Thus, this transition pathway (Grow – and then sell) emphasizes the importance of the business owner in taking a ‘strategic pause’ and developing either **incoming** (external) or **upcoming** (internal) talent to lead the business while continuing to grow the enterprise and its business value.

Building ‘bench strength’ through new hires or internal promotions will ensure there is a logical succession process in place along with continued revenue growth before eventual sale of the business to either internal or external parties.

In essence, the business owner ‘moves up-stairs’ into a board, oversight role and either

redefines the executive team (C suite) via external hires or refreshes the team via internal promotions.

##### Board Chair – Redefined C-Suite (External Hires)

The business owner/shareholder makes a carefully defined decision to set up a new governance structure by taking a board seat (providing strategic and operational oversight) and hires a replacement CEO and potentially other new members of the executive team.

This ‘hired gun’ approach is an interim step to eventual sale of the company and shareholder exit and can often result in a refreshed corporate strategic direction and enhance revenue/earnings performance, along with potentially higher valuation multiples.

As with any transition pathway opportunity, there are some downside issues to consider:

- » This option does not provide cash liquidity that the business owner would receive by selling the business or winding down the assets of the business. Also, the business owner may need to invest additional personal funds and/or take on new liabilities in order to meet the future growth requirements.
- » A new leader, who will likely want to make executive team changes, will face cultural and organizational challenges in attempting to ensure that the ‘right people are in the right seats on the right bus’.
- » The governance and reporting structure will need to be clearly defined to avoid any tendencies of the board to micro manage the new CEO and executive team. Executive compensation, including annual bonus and share ownership incentives will need to be carefully managed.

##### Board Chair – Refreshed C-Suite (Internal Promotions)

In this scenario, the company owner builds bench strength from within by developing a younger generation management team that will progress to the C suite and allow the older executive team, including the business owner, to take on board oversight responsibilities.

The benefits of this transition pathway include the business owner continuing to work with management he or she is familiar with from the boardroom. There would be few continuity problems with regard to strategic vision as the management team (internally promoted) would already know the strengths and weaknesses of the business.

The writer was recently involved in the creation of such a bench strength development

program that was structured to ensure that a staged and customized approach was implemented, detailed in the ‘4 C model’ diagram below.

In terms of challenges with this particular option, again, the business owner will not enjoy immediate cash liquidity from sale of the business.

It is also interesting to note that the boomer generation occupy many senior management positions in companies as well as the company owner(s). This outflow of retiring talent will have serious macro-economic repercussions both from the standpoint of consumer demand and also business continuity. While Canada continues to enjoy immigration of 250,000 people each year along with employees often electing to take later retirement, these factors

may still be unable to offset the demographic impact of the boomer cohort moving through their retirement years.

There may also be inter-generational and cultural challenges as the ‘old guard’ are supplanted by the younger internally promoted CEO and executive team. This can usually be addressed by an external management consultancy engagement which would use focus groups and surveys to build common ground.

##### Growth Funding

Regardless of an internal promotion or external hire, a key element of any growth strategy is to ensure that adequate funding is in place to cover increased working-capital requirements.

‘4 C Model’ Diagram

<b>CONTEXT</b>	<ul style="list-style-type: none"> <li>• Organizational Size Up</li> <li>• Leadership &amp; Management Development Review</li> <li>• Key Position Analysis</li> </ul>
<b>COHORT SELECTION</b>	<ul style="list-style-type: none"> <li>• Nomination Process</li> <li>• Candidate Selection</li> <li>• Program Design Document</li> </ul>
<b>CUSTOM PROGRAM DELIVERY</b>	<ul style="list-style-type: none"> <li>• Full Custom Training or</li> <li>• Workshop Series</li> </ul>
<b>CHANGE IMPLEMENTATION</b>	<ul style="list-style-type: none"> <li>• Quarterly Round Tables</li> <li>• Debriefs and Best Practices</li> </ul>

The following sources need to be considered:

- » Internally generated cash flows – if the company has delivered strong revenue, gross margin and earnings performance on a consistent basis, there may be adequate cash resources to fund further growth.
- » Chartered Bank financing – provided adequate financial health (working capital and debt: equity) and performance is demonstrated, an increase in Operating lines of credit can be a useful means to cover funding requirements.
- » Subordinated Debt – for larger funding amounts (and more aggressive growth ambitions), Sub Debt or Mezzanine Financing, similar in structure to the MBO financing described earlier, is another attractive funding option which does not usually involve dilution of share ownership.
- » Venture Capital (VC) – if the above options are not feasible, recourse can be made to 'patient capital' made available by VC firms who prefer to fund more mature companies with attractive growth and ultimate sale prospects.

Also, as discussed in the Financial Buyer section above, there may be occasions where a Private Equity firm will take a minority share interest in order to catalyse growth ahead of an eventual decision to take a majority interest or sell to an outside party.

To allow the reader to more fully understand the role that VCs play in the provision of growth capital, we have completed a marketplace scan and review which is detailed within a companion publication titled 'Sources of Growth Capital – Western Canada'.

This resource guide documents providers of early stage growth capital (Angel Investors) and mature stage growth capital (VC firms)

with 11 separate company profiles for review.

In conclusion, a Grow then Sell strategy, either with a replaced or refreshed c-suite, and supported by growth funding, should result in maximized cash flows and enhanced enterprise value.

## 5) Harvest – Maximize Cash Withdrawals

### Overview

If attempts to sell the business are problematic or protracted, it may be expedient to maximize cash generation by 'harvesting' cash through the sale of non-core assets (such as real estate) or a defined program of cash dividend withdrawals prior to an orderly liquidation. The intent here is to maximize cash withdrawals, avoid long term contractual commitments and minimize cash injections.



### Sale of Non-Core Assets

This pathway would see the streamlining of the business with a sole focus on its core cash generation capabilities supported by lean and concise decision-making and financial reporting. Any non-core assets, such as investments in subsidiaries, a redundant division (which may be attractive to an outside buyer) or real estate holdings would then be sold to generate an infusion of cash. Other assets that could be divested include low margin products and services, high maintenance and low return customers or complete product lines where significant but non-viable development efforts are required.

These proceeds could then be withdrawn by the business owner (mindful of any adverse personal tax implications) or reinvested in the core areas of the business to enhance further revenue/earnings growth as a prelude to an attempted sale.

### Optimize Cost structure + Defined Dividend Withdrawals

Another harvesting option is to craft a plan to critically examine the organization's cost structure, reduce operating and margin costs where appropriate and then dividend out surplus proceeds at each year end.

Such a process often takes place when the search for an internal or external buyer has been unsuccessful despite the business having a demonstrated capability in generating attractive surplus cash flows.

There are however some drawbacks which need to be considered:

- » The dividend withdrawals which are extracted from the company may have negative tax implications for the business owner given those salaries and/or dividends are taxed more highly than capital gains.
- » There is also the risk that dividends, which are 'foregone' retained earnings, will leave the business 'capital starved' and unable to react to any future operational cash flow challenges.
- » Overzealous cost cutting and controls could have a very negative impact on managerial and employee morale.
- » It needs to be clearly recognized that this option limits potential growth (and therefore attractiveness to future potential buyers) and will lead to the business slowly and inevitably winding down. There may perhaps be a last minute sale to key employees (resulting in far lower than expected sales proceeds) but in most cases the doors will ultimately close.

## Which Transition Pathway?

During this stage, the business owner will have reviewed and assessed the various Transition Pathways that may be feasible and available. One key finding from our primary research and interviews with SME business owners and their supporting professionals, is that often two Transition Pathways will be selected, either implemented in tandem or in sequence.

This 'coupling' process can be demonstrated by way of the following brief scenarios, based upon the writer's own management consulting experience and feedback from selected research respondents.

### Scenario 1

**Strategic Sale → Board Chair (in tandem with an Internal Promotion)**

An engineering company, based in the EU, pursued strategic buyers (without success) and at the same time, cultivated a new Managing Director from its existing senior management team, as a potential successor. Given the absence of a suitable external buyer, a new MD was appointed from the senior management ranks as part of an MBO transaction with the business owner assuming a board chair role.

### Scenario 2

**Board Chair (in tandem with an External Hire) → Strategic Sale**

The shareholders of a B.C. Canada based manufacturing company decided to assume board positions and hired a new CEO to protect existing market share and develop new product offerings. This 'hired gun' appointment has resulted in strong revenue growth and expansion into the EU. Eventually, a strategic



alliance or sale may be sought, reaping the benefits of enhanced earnings that have been achieved through the hire of the new executive.

### Scenario 3

**Family sale → Strategic Sale**

A Canadian based family company planned to pass on ownership and management to the next (third) generation. As they became operationally involved, it was apparent that the younger family members did not have the requisite skills to run the business, so the older generation (who had retained voting and shareholder control) elected to seek an external strategic buyer and sold the business.

### Scenario 4

**Harvest (minimize costs, maximize dividends) → Voluntary Wind Down**

A second generation internet marketing company (with no apparent third generation successors) elected to harvest surplus cash flow in the face of mounting competitive threats from US based competitors. After three years, a reluctant decision was made to wind down company operations, although a new scaled back entity emerged, owned by a key employee.

Thus, at Stage 2, in consultation with their professional advisors, the business owners will likely have determined to 'couple' the most feasible and advantageous transition pathways.

To achieve the best planning and implementation steps, it is critical that the business owner work closely with their trusted professional advisors, who would normally have been engaged at the commencement of Stage 1 (see the Key Advisory Resources step).

In the writer's experience, to support the business owner, the most logical 'leadership' role would be assumed by either a C.P.A firm, ideally with a CBV (Chartered Business Valuator) on staff or an experienced M&A firm. Various supporting professionals would then be added to the team.

At Stage 1, a financial planning firm could assist with the personal financial review, while a management consultant could assist with the business size up and the change readiness steps.

Depending on the size and complexity of the deal, a tax lawyer would be engaged to assist with estate freeze transactions, while an M&A firm – with appropriate sector experience, could be hired to assist with the search for suitable strategic or financial buyers if those transition pathways were selected.

### Stage Three – Transition Plan and Implementation

Having completed a detailed Situation Assessment (Stage 1) and Transition Pathway Review (Stage 2) the business owner now commences the all-important Transition Planning and Implementation process (Stage 3).

Based on feedback from our primary research respondents, a suggested Transition Plan outline (with implementation steps) follows:

#### Transition Plan for ABC Company

- » Assemble a Business Transition team – external and internal advisors.
- » Complete a Preliminary Situation Assessment – getting a fix on the health of the business/individuals.
- » Determine Value/Price – via a preliminary valuation based on historical and projected data.

» Set Exit Objectives – understanding the owner's personal/business/family priorities.

» Review and select Transition Pathway – best options (2) and supporting rationale For example:

#### **Internal buyers (Family/MBO/EBO)**

- Readiness assessment and key successors
- Planned ownership and management structure

#### **External buyers (Strategic/ Financial/ Merger)**

- Strategic positioning plan – to identify potential candidates

#### **Grow and Sell (Refresh or Replace C-suite)**

- Planned ownership and management structure

#### **Harvest and optimize cash withdrawals**

- Cost optimization initiatives
- Tax efficient cash withdrawals

Based on Transition Pathways selected – next steps would be:

- » Review the best way to market and position the business with internal or external buyers.
- » Optimize the sale transaction structure – assess the need for vendor take-back financing.
- » Assess required post-sale staff training and development initiatives.
- » Develop a post-sale communication plan (internal and external).

This process would also be accompanied by a rigorous sell side 'Preparatory Due Diligence' process by 'stepping into the shoes of future potential buyers'. This allows the seller to identify critical operational issues and concerns in advance of negotiations thereby inspiring buyer confidence and the avoidance of any unexpected surprises.<sup>40</sup>



## Conclusion

We hope that a positive outcome of this paper will be increased dialogue and awareness around SME succession challenges.

Our intent has been to position the Enterprise Transition Strategy model as a useful 'road map' for business owners to use and navigate with more confidence and professional support. The various insights will also resonate with families, external advisors and internal management teams.

It is also anticipated that many useful best practices arising from this paper will be communicated within the business community to enhance SME capacity building and performance.

To assist with the self assessment process, we have created two unique self-evaluation tools which will assist business owners enhance their transition readiness:

**The Corporate MRI** provides best case scenarios which would impact the key elements of an enterprise (Appendix 6).

**The Transition Assessment Tool** poses ten important questions to consider as part of the transition/succession process (Appendix 7).



## Appendix 1: Primary Research Respondents

### SME Owners:

Name	Position and Company
Jack Stepler	Former CEO, Telcom Training
David Fissel	Board Chair, ASL Environmental Sciences
David Lemon	CEO, ASL Environmental Sciences
Kate Lord	MD, QKL Ltd. London, UK.
Rob Bateman	CEO, Western Oil Services
John Baron, Gareth Fry	MD, Statiflo Inc., Manchester, U.K
Debra Else	CEO, Whippletree Furniture
Jennifer Mitchell	Titan Boats Ltd
Deidre Campbell	CEO, Tartan Communications
Trevor Tasker	CEO, EMCS Industries
Terry Tarle	CEO, Axys Technologies
Darcy Kray	CEO, Durwest Construction Management

### Professional Advisors:

Name	Position and Company
Lisa Collins QC	Principal, Lisa Collins Law Corporation
Vernon Fischer CFP	CEO, Fischer Financial
David Fraser MBA	Senior Manager, BMO Commercial Banking
Kyman Chan C.A	Partner, Grant Thornton
Chuck Chandler C.A C.B.V	Partner, Grant Thornton
Richard Mimick CPA	PPM Professional Practice Management
Bill Cooke B.Sc.	Former CEO, VIATeC
Robert Williamson P. Eng.	Principal, Prismoid Consulting
Mike Stubbing C.A	Partner, Grant Thornton
Gerry Humphries FCMC	Principal, Western Management Consultants
Victoria Williams CMC	B.C Provincial Government
Mark Grey Dreaper C.A C.B.V	Partner, XPS Consulting
Bill Hartley LLB	EKB Law Group, Vancouver
Catherine Holt	CEO Chamber of Commerce, Victoria
Mike Shannon	VIATeC, Victoria
Bob Murray	People First Solutions, Vancouver
Carolin Rekar-Munro	Faculty. School of Business, Royal Roads
Ernest Bednarz	Malahat Valuation Group
David Stevenson	Faculty. School of Business, Royal Roads
Humaira Ahmad	CEO Spice Marketing

## Appendix 2: The importance of Disruptive Forces

In a current review of business literature and periodicals we have identified three broad disruptive forces which exert a significant influence on today's business environment:

### 1. Geo-political shifts

#### China's ascendancy?

- » International trade and supply chain initiatives (One Belt, One Road)
- » A 250 million-strong emerging middle class with significant wealth generation aspirations.
- » Yet high domestic debt levels (which financed infrastructure growth) and IMF warnings.

#### Global trade uncertainty:

- » The potential for NAFTA breakup (Fortress America)
- » The prospect of a hard BREXIT with resultant negative impacts on the UK and EU.

#### Unstable states/regions:

- » North Korea – developing ICBMs threatening Japan and potentially the USA
- » Iran – continued oppression combined with deteriorating relations with Saudi Arabia and USA
- » Venezuela – economy imploding with extensive social unrest.
- » Spain – the potential for a Catalonia separation.
- » Italy – out of control Debt:GDP ratio (165%) and a pervasive banking crisis

### 2. Technology Acceleration

The impact of Moore's Law (microchip processing speed/capacity doubling every two years) with resultant technology acceleration and the following key developments:

**Artificial Intelligence (AI)** - can be defined as a broad field of science where computers are able to complete tasks which would normally require human intelligence.<sup>41</sup> Applications in use today include Siri (Apple), Alexa (Amazon), Cogito (call centre interactions), Watson (IBM).

**Machine Learning (ML)** - is a sub set of AI and is based upon 'neural networks' which classify information the same way as a human brain does.

**Deep Learning (DL)** - is a sub set of ML, 'goes deeper' and can be applied to any form of data to produce conclusions that appear to have been deduced by humans.

**Quantum Computing** - uses 'qubits' instead of bits to represent data. Google is currently developing the first Quantum computer and expects to see machine learning take place exponentially faster and artificial intelligence progress much more rapidly.

Based on these dramatic technological advances, the following sectors will experience significant change:

#### Manufacturing:

- » Advanced Robotics with increased use of Deep Learning, Knowledge sharing and Drone applications.
- » 3D printing – polymer production (replacing additive printing), print welding and bio-medicine applications like 3D implants/prosthetics and Bio-printing.<sup>42</sup>
- » Internet of Things (IoT) – a network of devices that are connected to the internet to provide a range of new and innovative services via sensors and actuators. Increased applications observed in Automotive, Consumer Electronics and Utility sectors.<sup>43</sup>
- » Nanotechnologies – used for atomic precise manufacturing (APM).

#### Retailing:

- » Ecommerce (on-line purchases) impact on conventional retail sectors resulting in 'over-stored' suburbs and high profile bankruptcies.
- » Advent of Drone deliveries (Amazon).
- » Social media influence on consumer buying decisions and communication of value.
- » The Sharing Economy – UBER ride sharing, AirBnb shared accommodations.

#### Biotech:

- » Genetic analysis/diagnostics (the intersection of Information and Biology), gene editing and drug discovery.
- » Genetic Engineering – cancer killing nano-particles, smart contact lenses, DNA electrical based circuits.

#### Education:

- » The advent of Augmented Reality (classroom learning) and MOOCs (Massive Open On-line Courses)

**Financial technology (Fintech):**

- » Crowdfunding - offering a less stringent way of accessing capital (versus approaching a discrete group of investors) is a new method of sourcing investment – usually through a digital platform – through small amounts of money from a large number of people.<sup>44</sup>
- » Big Data - using structured and unstructured data in innovative ways to promote efficiency, productivity and to develop new product offerings in a more meaningful way, especially in the financial services sector.
- » Robo-advisors – has been called the Uber of the professional investment advisory world, eliminating intermediate roles and thus reducing fees for the end-user.
- » Blockchain – Bitcoin and Ethereum which are open-source Distributed Ledger Technologies (DLT).

**3. Population & Climate Change Imperatives**

**Global population change** – the current world population is 7.2 billion and is forecast to rise to 9.7 billion by 2050. This translates to another 2+ billion people on the planet in just over 30 years with dramatic impact on urban populations. India will have the largest population, followed by China and Nigeria.

**Global warming** – temperatures are at the highest level since the Industrial Revolution with Paris accord target of < 2 degrees C problematic given USA disinclination to participate. Carbon levels in the atmosphere are at 400 parts per million CO2 well over the 350 parts per million consensus threshold.

**Ocean acidification** – scientific data points to increasing CO2 levels in the oceans with negative impact on coral reefs.

**Deforestation** – less rain, boreal and temperate forests (now at 62% down from maintenance target of 75% of Earth’s original forests).

It is interesting to note that Thomas Friedman, in his new book ‘Thank You for Being Late’ highlights the need to watch out for ‘**Black Elephants**’ – a cross between the ‘elephant in the room’ (a problem widely visible to everyone that no one wants to address) and a ‘black swan event’ (a rare unanticipated event with significant consequences).<sup>45</sup>

**Appendix 3: Organizational Size Up Diagram**





### Appendix 4: The Strategic Team Review

In completing annual strategic planning sessions with business owners, we have developed a Strategic Team Review (STR) that involves the use of a Strategy Scan™ template which is presented below:

PRESENT POSITION	STRATEGIC DIRECTION	REQUIRED RESOURCES	RISKS (MITIGATION)	SUCCESS INDICATORS
<ul style="list-style-type: none"> <li>• External:</li> <li>• Internal:</li> <li>• What business are we in?</li> <li>• What's working well?</li> <li>• What's not?</li> <li>• What is our competitive advantage?</li> </ul>	<ul style="list-style-type: none"> <li>• Present course?</li> <li>• Impact on stakeholders?</li> <li>• Alternative avenues?</li> <li>• Blue ocean potential?</li> <li>• Best direction &amp; rationale</li> <li>• Goals &amp; objectives</li> </ul>	<ul style="list-style-type: none"> <li>• Key functional areas</li> <li>• Best practices to adopt?</li> <li>• Key action items</li> <li>• Implementation steps</li> <li>• Key performance indicators</li> </ul>	<ul style="list-style-type: none"> <li>• External – uncontrollable?</li> <li>• Internal – controllable?</li> <li>• Financial:</li> <li>• Products/marketing:</li> <li>• Key management and employees:</li> </ul>	<ul style="list-style-type: none"> <li>• Management?</li> <li>• Employees?</li> <li>• Financial position?</li> <li>• Product development?</li> <li>• Market positioning?</li> <li>• Reputation/brand?</li> <li>• Company valuation?</li> <li>• Owner's aspirations?</li> </ul>

This process allows the company owner and his/her senior management team to craft a 'living' strategic plan, which can be reviewed and up-dated on a regular basis to anticipate changes in key organizational variables, such as a company expansion, a new product line or development of new market segments.

The team members benefit from their inclusion as part of the planning process which is flexible enough to leave room for innovation and new ideas. Participants are also exposed to a readily understandable model which delivers pragmatic and tactical action plans.

### Appendix 5: Financing Vehicles for MBO/EBO

With MBO or EBO internal sales, financing will be a critical consideration for both the exiting business owner and the aspiring new owners.

Often the business owner will be required to offer vendor (take-back) financing which will be combined with subordinate or mezzanine debt financing from a financial institution BDC – the Business Development Bank of Canada, which specializes in shareholder buyout financing.

A typical deal would have the following characteristics and structure:

Financing amount: \$250K to \$20 million

**Purposes:**

- » Acquisitions (competitors, suppliers or clients)
- » Shareholder buyouts
- » Intergeneration transfer
- » Buyout by existing management/new team
- » Financing of intangible assets – goodwill

**Security:**

Subordinated to secured lenders

**Pricing:**

Variable yield, partially based on the company's success, specifically:

- » Royalty on sales or profits or EBITDA (Earnings before interest, taxes, depreciation and amortization)
- » Bonus interest: may be fixed or tied to performance and/or the value of the business
- » Warrants: option to purchase an ownership position in the business

Limited requirements for shareholder agreements, board of directors representatives.

**Term:** 3 to 7 years

**Payments:** Balloon and/or cash flow sweeps and/or regular monthly payments.

## Appendix 6: Corporate MRI Tool

PERFORMANCE INDICATOR	OPTIMAL SCENARIO	RATING [1-5]
1. <b>External Environment</b>	There are no adverse political, economic, socio-cultural or technological 'storm clouds' at present or anticipated, which might impact your company operations.	
2. <b>Competitive Conditions</b>	A strong competitive advantage is maintained within your industry sector with high barriers to entry, manageable buyer/supply power, few substitutes and moderate intensity of competition.	
3. <b>Financial Sustainability</b>	Strong historical revenue and cash flow performance has been achieved and is anticipated in the future. Comfortable working capital and debt: equity positions will allow you to meet current growth plans.	
4. <b>Market Positioning</b>	Your products/services are carefully positioned within appropriate market segments. You have well-developed pricing, product migration, distribution, promotional and partnering tactics.	
5. <b>Customer Retention/Attraction</b>	You have developed a successful CRM (customer relationship management) system, have built a successful ('guard the back door') client retention culture and have launched a specific business development function.	
6. <b>Operational Efficiency</b>	You have developed an effective and consistent production/service delivery process underpinned by specific project, quality, facilities and risk management functional areas.	
7. <b>Employee Engagement</b>	A specific HR function has been established with a focus on effective hiring, ongoing training/ development with appropriate industry-leading compensation and incentives in place.	
8. <b>Technology Potential</b>	You have a comprehensive understanding of intellectual property (IP) issues that may impact your company and have the ability to assess new technology opportunities, including Internet based marketing initiatives.	
9. <b>Strategic Awareness</b>	Annual strategic planning reviews are completed with senior management – all employees understand the strategic direction that has been charted. Realistic and pragmatic key performance indicators are in place. Societal commitment is understood and demonstrated.	
10. <b>Leadership Capability</b>	The company CEO inspires confidence to take on demanding/challenging tasks and has crafted an understandable and compelling vision for the company. Professional mentoring and coaching opportunities are fully exploited.	
11. <b>Stakeholder Sensitivity</b>	The company has established close and trusting relationships with key stakeholders (employees, clients, suppliers, shareholders, bankers) and completes a regular stakeholder mapping process based upon in their relative power and interest. There is an effective governance system in place.	
12. <b>Innovation</b>	An enduring culture of creativity and innovation exists with ongoing R&D committed to key product/service offerings. Collective knowledge and skills are applied to process improvement linked to a formal Knowledge Management system.	

## Appendix 7: Transition Assessment Tool

PERFORMANCE INDICATOR	OPTIMAL SCENARIO	RATING [1-5]
1. <b>Exit Readiness</b>	You are ready to commence the transition to exit process and have clearly defined retirement goals, a key advisory team in place along with a preliminary valuation completed (by a CPA or CBV).	
2. <b>Personal Financial Review</b>	A detailed personal financial review, including a review of the company's shareholding and governance structure, has been completed with family wealth protection established as a key priority.	
3. <b>Organizational Size Up</b>	A comprehensive assessment of the corporate external business environment and internal functional areas has been completed as part of an annual strategic planning process.	
4. <b>Change Readiness</b>	The organization is 'change ready' with cultural implications of a leadership change carefully considered, including the impact on employee security and future employment.	
5. <b>Internal Sale Opportunities</b>	You have reviewed the potential for sale to internal buyers, including family members (if applicable) and MBO/EBO opportunities.	
6. <b>External Sale Options</b>	You have carefully evaluated external sale options including potential strategic and financial buyers and how they might be identified and approached.	
7. <b>Ongoing Growth then Sell</b>	As a prelude to an eventual sale, you have assessed the potential to replace yourself as CEO through either refreshment (external hire) or refinement (internal bench strength building) process.	
8. <b>Harvesting Potential</b>	You understand the potential to engage in a 'harvesting process' – to maximize cash withdrawals – which could include the sale of non-core assets and/or a cost structure review	
9. <b>Retaining Business Integrity</b>	In anticipation of the post exit stage, the issues of company brand retention, reputation and integrity have been reviewed.	
10. <b>Post Sale Wealth Preservation</b>	Scenarios have been developed to address the most tax efficient post-sale wealth preservation and estate planning strategies.	

## Endnotes

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