HOW IMPROVING THE FOUR INTANGIBLE CAPITALS CAN BUILD VALUE IN YOUR BUSINESS

Dan Paxton, Principal at ExitSmarts, Inc. and CEPA since 2021, shared the story of one of his client engagements dealing with weaknesses in the business's intangible capital. He states, "One of the first responsibilities of an advisor relative to helping a business increase in value is to explain the difference between tangible and intangible capitals and their effect on business value. Most all business owners are shocked to learn that intangible capitals carry more value determination than tangible capital."

Exit Planning Institute

COMPANY

Design Elegance

FOUNDED

1995 by Susan Day

NUMBER OF EMPLOYEES

2

Design Elegance is a Los Angeles, CA company in the (very) high-end design/build remodeling business. Most work centered around kitchens and bathrooms. It is 100% owned by Susan Day and operated as a sole proprietorship. The business was started in 1995 and 2020 revenues were slightly over $2,000,000 with Seller's Discretionary Earnings of $600,000. There was just one other employee who was an administrative assistant to Susan. There were two sub-contractors who have worked with Susan for a number of years, and the working relationship was very close – to the point that Susan almost considered them as employees.

Jobs averaged in the hundreds of thousands of dollars, with Susan reporting one job that was an $800,000 bathroom remodel! Susan did not advertise, with business coming exclusively through referrals. For the three years prior to Paxton's engagement, the business had steadily rising revenue. Over the years Design Elegance provided a comfortable lifestyle for Susan.

Susan was 72 when she and Dan Paxton began to work together. She had been running her business for over 20 years, her husband's health was failing, and exiting seemed like the thing to do.

The Situation

Susan did not have an inclination about any specific exit option. None of her five children had any interest in being involved with Design Elegance. She had assumed that one or both of her two primary sub-contractors would buy the business from her. In the end, neither had any desire to buy the business from Susan.

The Goal

Susan's driving objectives were to exit in 3-5 years with enough money to continue her current lifestyle. (She wanted to use a 15–20-year life expectancy in the planning.) Susan really did not have an after-exit plan. Her statement was that she just wanted to take it a day at a time. She wanted to take care of her husband, be with grandchildren, and play tennis. As is the case with most entrepreneurs, Susan did vacillate about finding a sales arrangement where she would still be needed and could work perhaps 10 hours a week. She did not have any concerns about her legacy.

Design Elegance Intangible Capitals

Human Capital:

Susan was the business. She had only one employee, a clerical assistant. There were two sub-contractors who had been with Susan for a long time to the point where Susan almost considered them employees. However, they were not employees, so they were really not a transferable component of the company.

Customer Capital:

Almost all of Design Elegance's business came from customer referrals so there was Customer Capital. However, all this capital was about Susan herself and her personal ability to visualize makeovers, so this capital was not transfetrable.

Social Capital:

Susan has only one employee and the work environment appeared to be stressful. The culture at Design Elegance was not anything positive that could carry over value to a new owner.

Structural Capital:

Susan had not documented any part of how she operated Design Elegance. She relied on project drawings and developed a great relationship with her subs which enabled the work to get done in the absence of any documented process. The result was that there was no transferable Structural Capital.

The bottom line about Design Elegance was that it was a company producing net Seller's Discretionary Earnings of $600,000, but the company really had no value because there was no transferable intangible capital.

The Strategy

Dan Paxton began his transition plan development with the establishment of Susan's transition objectives: business exit in 3-5 years, $1.6 MM to $2.5 MM needed to fund post-transition life (see below), Design Elegance could be sold to anyone willing to meet Susan's selling price.

He calculated Susan's post-transition financial needs. The high-level summary of that work was:

15-Year Life Expectancy

Post-Transition Total Annual Income	$38,400
Total Post-Transition Essential & Discretionary Expenses	$161,700
Net Annual Cash Need	$123,300
Lifetime need 15 Year Live Expectancy	$1,849,500
Subtract NET USABLE FUNDS	$700,000
Asset Gap (pre-tax)	$1,149,500
Asset Gap (post-tax) 30% tax rate	$1,642,143

20-Year Life Expectancy

Post-Transition Total Annual Income	$38,400
Total Post-Transition Essential & Discretionary Expenses	$161,700
Net Annual Cash Need	$123,300
Lifetime need 20 Year Live Expectancy	$2,466,000
Subtract NET USABLE FUNDS	$700,000
Asset Gap (pre-tax)	$1,766,000
Asset Gap (post-tax) 30% tax rate	$2,522,857

Design Elegance needed to sell for between $1,642,143 (15-year life expectancy) and $2,522,857 (20-year expectancy).

There were three primary factors that affected the deal structure that Dan Paxton proposed to Susan:

1. There was no transferable intellectual property
2. The financial records of Design Elegance were suspect
3. Uncovered an accounting irregularity that could have caused Susan trouble if exposed in a traditional 3rd party sale

Because of these factors, Paxton deemed a 3rd party sale as highly, perhaps totally, unlikely. The lack of intellectual property alone drove this conclusion. The financial records added to the non-salability of Design Elegance. The accounting irregularity made a 3rd party sale dangerous to Susan.

For these reasons the structure that Dan Paxton finally proposed was to find an outsider in the design/build industry who would like the opportunity to ultimately purchase the company. The underlying assumption of this approach was that there would certainly be someone out there who would love to own their own business but may otherwise be prohibited from this because of a lack of investment capital. Specifically, the proposal was to find a new employee with the desire and talent to eventually buy the company from Susan. This person would earn sweat equity to the point where the sales transaction could be eligible for SBA financing. Susan would "tuck the new employee under her wing" teaching and introducing this person so they would transition over time to be the face of Design Elegance. The plan would likely take 3-5 years to develop, but so long as the revenue and cash flow continued to grow, the plan was very realistic:

- The deal would be structured at the outset so that both buyer and seller were aware of how the process would unfold.
- A selling price formula could be developed that protected Susan's required cash need from the transaction, while at the same time giving her an upside based on the future cash flow of the business.
- Susan would "teach the ropes" to the new employee, thus overcoming the lack of documented processes. The new employee could document the processes as fitting.
- Susan would aggressively include the new employee in customer interactions – "pushing" an ever-increasing relationship of the new employee with customers.
- Design Elegance would have time to clean up its bookkeeping to conform with GAAP standards.

The Potential Results

Should Susan follow through with the plan laid out by Dan Paxton, she would be able to meet the following transition objectives:

- First and foremost, she would have an ultimate sale – a situation which, if not for Paxton's proposal, might not have been realistic.
- Susan would be the one to set the (minimum) price – thus getting the cash she needed for her post-transition life.
- Susan would remain in control of majority ownership until the conditions were right to transfer the majority to the new employee.
- Assuming the new employee worked out (need to do serious due diligence in picking the person to take over), Susan would have a deal set now instead of trying to prepare Design Elegance for sale hoping to find a buyer and meet her ideal price.
- Susan had told Paxton's team that she would be willing to finance a sale. Paxton's approach, where he was working toward an SBA-financed deal would render Susan's financing unnecessary. (Note that if the SBA financing did not come to fruition, Susan could still finance the deal in a way that she still would be able to draw enough annual cash to meet her needs.)

Paxton's proposal was an illustration of how an inside transfer can "overcome" a deficit of the 4Cs that would otherwise prohibit a third-party sale.

Dan Paxton was concerned with the accounting irregularities that he had uncovered in their work and was desirous of ending their relationship with Susan and Design Elegance. Accordingly, Dan Paxton included David Lebarger in his report to Susan and suggested that he work with her to execute Paxton's plan.

However, if Susan did not follow through on Dan Paxton's plans, she was at great risk of failing to successfully exit her business. If she deemed the strategy as too expensive and time-consuming of an endeavor, she would not have made the necessary improvements to her intangible capital. Without improving the intangibles in her business or preparing a key employee to serve as her successor, her business would not have the value needed to secure a third-party buyer.

What's Next?

Depending on what path Susan takes in her exit, her life after her business can be vastly different. By spending the time and resources needed to improve her business value through the four intangible capitals, Susan will open her business up to a wider selection of potential third-party buyers. As she decentralizes herself from her business by hiring a key employee to learn the ins and outs of the business, she prepares Design Elegance for the future. Currently, Susan is the only person working full-time in the business. By hiring another full-time employee to slowly gain more responsibility in the company, Susan allows herself the opportunity to slowly exit the business over time as she intended.

However, if she fails to follow through with Dan Paxton's plan, her business will have no value as Susan effectively is the business. If she chooses to exit without planning, her business will not be valuable to potential buyers or have a successor in place to run the business after she leaves. What could have resulted in a $1.6 - $2.5 million transaction with proper planning could end up with the businesses simply closing and leaving Susan with nothing.