Exit Routes for Business Owners White Paper

When business owners start to think about exiting their companies, the number of exit routes available may seem unending. In fact, there are only eight:

- Transfer the company to a family member
- Sell the business to one or more key employees
- Sell to employees using an Employee Stock Ownership Plan (ESOP)
- Sell to one or more co-owners
- Sell to an outside third party
- Engage in an Initial Public Offering
- Retain ownership but become a passive owner; and
- Liquidate

Which of these exits do owners, in fact, intend to use? A January 31, 2005, survey by PriceWaterhouse Coopers indicates that:

- About one-half anticipate a third-party sale;
- Nearly one-fifth anticipate a transfer to the next generation;
- Fourteen percent anticipate a management buyout;
- Seven percent expect to sell to an ESOP; and
- Ten percent anticipate an IPO or other option.

This White Paper examines the advantages and disadvantages of each before it describes a process that enables owners to choose the best exit path for them.

Let's begin with a fictional company case study.

Ben (55), Tom (45), and Larry (35) purchased Front Range Powder Coating from its former owner in 1998. They paid "book value" - about $1 million. Now, seven years later, they faced a crossroads: Ben, the oldest, was interested in reducing his role in the company and had approached Tom and Larry about purchasing his one-third interest.

But there was a kicker. Ben was not interested in selling his interest on the same basis as he had acquired it - book value. Instead, he wanted one-third of the fair market value of the company. Since the company had increased its book value to $2.5 million and its annual cash flow from $200,000 in 1998 to over $2 million today, Tom and Larry knew they faced a major cash crisis. Should they proceed with the buyout?

As these owners discussed their objectives, it became clear to them, as it does to all owners, that business succession planning had little to do with the characteristics of the business and *everything to do with each particular owner's personal exit objectives.*

- *Ben was interested in exiting now for fair market value.*
- *Tom was interested in continuing to work for a number of years but wasn't keen on the idea of Front Range Powder Coating's cash flow being exclusively used for several years to purchase Ben's stock. Tom believed that using all available cash flow to acquire another owner's stock created risk and stunted the continued growth of the company because future cash flow would be used to pay off Ben rather than to fuel further growth. Further, Tom figured that at just about the time Ben was paid off it would be his turn to retire (hopefully at an even greater value).*
- *Larry, the youngest, had the same cash flow concerns as Tom, but also had a close relationship with the non-owner management in the company – the next generation of ownership. Several of those key employees were beginning to quietly, but rather insistently, clamor for ownership or similar ownership-based incentives. Larry wanted to remain active in the company for the next 15 to 20 years as its principal owner and he knew he could not tarry long before providing meaningful incentives to the new key employee group.*

SETTING THE STAGE FOR EXIT PLANNING

Front Range Powder Coating was one company with three very different viewpoints on the best way of exiting the business. When the owners decided to meet with their advisors to determine the best exit path for Ben, or perhaps all three of them, the first question was: How do the owners of Front Range Powder Coating agree on an exit strategy?

The decision-making steps can be relatively straightforward. First, the ownership needs to find an exit path that best meets the needs of *each* owner. Second, they need to value the company and determine its marketability. This, by itself, may provide sufficient direction and eliminate some of the potential exit paths. For example, if the value of the company and its marketability are high, then ownership may decide to sell the business to an outside party. Finally, the tax consequences of each exit path need to be evaluated.

While this evaluation takes place, owners need to continue to increase the value of the company and will likely need to revise their existing buy-sell agreement to reflect the true value of the company.

When owners look at each exit path, they can thoroughly evaluate each option, have frank discussions based on realistic possibilities (rather than conjecture or wishful thinking) of what each owner wishes to do and of what the company value can support. In short, owners ultimately decide what path to take and when. Let's examine each exit path available to business owners.

TRANSFER TO FAMILY MEMBER

Since one of every three owners wishes (at least initially) to transfer the business to a family member, let's look first at the advantages and disadvantages of that choice.

Owners who consider transferring their businesses to family members usually do so for non-financial reasons. Leaving the business in the hands of someone they know, trust, and whom they believe will continue to run the company as it has been run for years is of paramount importance to these owners. Further, this route appeals to owners who want to throttle back on their activity but who wish to remain involved. Advantages to this route are that it achieves several non-financial owner objectives:

- Transfers the company to a known entity - in particular, one's own flesh and blood;
- Provides for the well-being of the owner's family;
- Perpetuates the company's mission or culture; and
- Allows the owner to remain involved in the company.

What then are the disadvantages? There are several . . . not the least of which is the increased financial risk the owner who chooses this route will incur. In almost all of these transfers, family members are not financially capable of paying an owner cash for the company. This means that the owner remains tied (usually via a promissory note) to the company's future financial performance. For this reason, most owners choose to stay active with the company to ensure its (and their own) financial success.

Similarly, owners often receive little or no cash at closing — an obvious disadvantage to the owner who must convert his largest, and illiquid, asset (the company) into cash for retirement.

Let's not forget that every owner is not blessed with a child (or children) able and willing to assume ownership of a company — a company that is much larger and more complex than when the owner was the child's age. Even children who have been active (and successful) in managerial roles, may not be equipped to assume the responsibility of ownership.

The disadvantages to an owner of a family transfer are:

- Little or no cash from closing available for retirement;
- Increased (and continued) financial risk;
- Required owner involvement in company post-closing;
- Children's inability or unwillingness to assume the ownership role; and
- Family issues that surround treating all children fairly or equally.

TRANSFER TO KEY EMPLOYEE(S)

In terms of advantages and disadvantages, the transfer to key employees is remarkably similar to the transfer to family members. (Recall that this exit strategy is Larry's rather vague strategy.) Simply substitute "key employee" for "family member" and the list is the same. The owner who considers this type of transfer hopes to achieve the same objectives as the owner transferring to a family member.

- To transfer the company to a known entity;
- To perpetuate the company's mission or culture;
- To allow the owner to remain involved in the company; and

- To achieve financial security.

The perils of this exit route are the same as those present in the family transfer:

- Little or no cash from closing available for retirement;
- Increased (and continued) financial risk;
- Required owner involvement in company post-closing; and
- Employees' inability or unwillingness to assume the ownership role.

Unlike the transfer to family members, however, owners who wish to pursue this exit route because children are not interested or capable of running the business can avoid some of the disadvantages listed above by structuring a transfer to key employees using an Employee Stock Ownership Plan (ESOP). Let's take a moment to look at that variation on this exit route.

TRANSFER TO KEY EMPLOYEES VIA ESOP

ESOPs are qualified retirement plans, typically profit sharing plans, which must invest primarily in the stock of the sponsoring employer. (Please see BEI's White Paper describing ESOPs for more details.)

As mentioned above, the owner considering the transfer to key employees does so because he wants to transfer the company to a known entity and to perpetuate the company's mission or culture. The owner using an ESOP to affect this transfer usually does not want to remain with the company after closing. And, because his financial security is not at risk as it is in other transfers to key employees, he does not need to remain. So, in addition to the advantages of a standard transfer to key employees, the owner who uses an ESOP to transfer a company to key employees enjoys two additional benefits:

- Beneficial tax treatment. Using an ESOP, an owner can defer or avoid tax on the gain from a sale. Even more importantly, the company can pay for the owner's stock with pre-tax dollars.
- Cash. The owner leaves the closing table having converted an illiquid asset into the cash necessary for a financially secure retirement.

Of course, not all aspects of this exit route benefit the owner.

- Owners must consider the cost and complexity of setting up and maintaining an ESOP.
- While the ESOP is borrowing to pay the owner's purchase price, the company's ability to grow and to expand is hampered.
- At closing, the owner may receive more cash than she would in other key employee transfers but she may be partially paying for her own buyout (because ESOPs typically involve an element of pre-funding by the owner's business).
- Similarly, the owner's assets may be tied to the company as collateral for securing the ESOP loan.
- Finally, in many cases, key employees may not benefit as significantly as the owner might have preferred nor as much as the employees may require to stay on and run the company after the owner leaves. In summary, the disadvantages are:
- Cost and complexity of ESOP;

- Company growth curtailed due to borrowing necessary to purchase owner's stock;
- Less than full value received at closing (compared to third party sale);
- Owner assets (post-sale) used as collateral; and
- Key employee ownership is limited.

But again, these disadvantages may be minimized or eliminated.

SALE TO CO-OWNERS

Once again, the owner (like Ben) who examines a sale to a co-owner or owners, finds the list of advantages and disadvantages nearly identical to those found on the lists for a transfer to family member or key employees. (For a more detailed discussion of these lists, please refer back to the "Transfer to Family Members" section.) The advantages to this type of sale are:

- Transferring the company to a buyer whose commitment skills and knowledge are known quantities;
- Perpetuating the company's mission or culture;
- Allowing the owner to remain involved in the company.

The disadvantages of the sale to a co-owner are:

- The need to take back an installment note for a substantial part of the purchase price;
- Increased (and continued) financial risk;
- Required owner involvement usually continues post-closing; and
- Less than full fair market value normally received (of little appeal to Ben!).

SALE TO A THIRD PARTY

This exit route offers an owner the best chance at receiving the **maximum purchase price** for his/her company. In addition, the owner who engages in a sale to a third party is best positioned to receive the **maximum amount of cash** at closing. Owners intending to leave after they sell, choose this exit route. This route also appeals to owners who want to propel the business to the next level - on someone else's dime. Our list of advantages looks like this:

- Achieve maximum purchase price;
- Receive substantial cash at closing;
- Allow owner to control date of departure; and
- Facilitate company growth *without* owner investment or risk.

This is undoubtedly an impressive list of attributes. But before you grab the phone to call your favorite investment banker, let's review the drawbacks of this exit route.

The first difficulty would have to be that this exit route does not match the stated intentions of most business owners. If you look back at the survey results quoted at the beginning of this issue, just over half of business owners wish to transfer their companies to an "insider" (family member, key employee or co-owner).

On a personal level, owners who choose this exit route must be prepared to walk away from their companies, but not before being required to work for the "new boss" for one to three years. All owners who sell to third parties wrestle (with varying degrees of success) with the issue of losing a meaningful part of their lives.

Also lost in a sale to a third party is the company's corporate culture or mission. As a company merges with a competitor or is assumed into a larger entity, its culture and its role inevitably change.

Last on the list of disadvantages is the owner's *perception* that a sale to a third party means that employees' jobs are at risk and that their career opportunities are, at best, limited and, at worst, jeopardized. This perception appears on the list of disadvantages because it is so widely held by owners of privately-held companies. Extrapolating from the mergers and acquisitions that they see among publicly-held companies (that in fact, often do lead to massive layoffs) they assume that the effect on their employees of a merger or acquisition of their privately-held companies will be the same.

In our experience, however, few employees have lost their jobs. Employees may, and often do, choose to leave a new employer for reasons that have nothing to do with limited or diminished career opportunities. In fact, because privately-held companies are typically acquired by much larger and often publicly-held companies, employee career opportunities are frequently improved. Their compensation and benefit packages are usually enhanced as they become part of a larger organization. Even in those situations in which a company is acquired by a competitor, the workforce of the acquired company is a highly-prized asset.

The disadvantages of a sale to a third party are:

- Inconsistent with original exit goal of two-thirds of owners who wish to transfer business to another type of successor;
- Loss of owner identity;
- Loss of corporate culture and mission;
- Potentially detrimental to employees; and
- Receipt of much of the purchase price subject to future performance of the company after it is sold.

IPO

The exit route marked "IPO" or Initial Public Offering is one that attracts the attention of business owners amenable to a sale to a third party for two reasons. First, the valuation of the ownership interest is usually higher than in any other form of transfer — including the sale to a third party. Second, an IPO brings with it an infusion of cash (from a pocket not belonging to the owner), which moves the company forward to a new level. These advantages:

- High valuation; and
- Cash for the business

are extremely attractive to the owner weighing various exit routes.

Unfortunately, the IPO is not without significant disadvantages. The primary one is that despite the high valuation placed on and paid for an owner's interest, *the IPO is not a liquidity event for the owner.* An owner's interest is exchanged, at closing, for interest (shares of stock) in the acquiring entity. The owner is typically prohibited from cashing out these shares until a prescribed amount of time passes. Also prescribed is the rate at which the owner can sell his new shares. And last, but certainly not least, when the former owner does sell his shares, the price per share varies (often significantly) from the price at closing.

Not only is the closing a non-event from a liquidity standpoint, it is also a non-event from a departure standpoint. In almost all IPOs, the owner is required to stay on with the acquiring company. Staying on is made more difficult by the fact that the former owner is no longer in control. She may still be the CEO, but she is accountable to shareholders, analysts, the Securities and Exchange Commission and more.

Finally, an IPO creates a publicly-held company. As such, it is subject to reporting requirements and must uphold fiduciary responsibilities not necessary in privately-held companies. Many business owners chafe under these additional requirements. To summarize, the disadvantages of an IPO are:

- No liquidity at closing;
- No exit at closing;
- Loss of control; and
- Additional reporting and fiduciary requirements.

ASSUME PASSIVE OWNERSHIP

Another exit route that an owner can chose is to keep the business while assuming the role of a passive investor. This route attracts owners who wish to:

- Maintain control;
- Become gradually (or rapidly) less active in the company;
- Preserve company culture and mission;
- Manage risk (or is perceived to be low); and.
- Maintain ongoing cash flow at higher level.

The first four advantages listed above are the same as those listed in other exit routes. The last, however, deserves comment. In some cases, especially in businesses with a value of less than $5 million, owners feel they are at less risk continuing investment in their businesses than from the sale to an outsider in which the purchase price consists primarily of a promissory note on some type of "earn-out."

The disadvantages to this exit route are fairly obvious. The owner:

- Never permanently leaves the business;
- Is not able to establish or fix lifetime business continuity;
- Receives little or no cash when he leaves active employment; and
- Continues to experience risk associated with ownership.

LIQUIDATION

There is only one situation in which this exit route is appropriate: the owner wants to (or must—usually for health reasons) leave the company immediately and has no alternative exit strategies in place. Liquidation offers then, the two benefits most important to the owner in that position: Speed and Cash.

Not surprisingly, the disadvantages to this exit route are enormous. First, liquidation yields less cash than any other exit route primarily because no money is paid for goodwill. There is none. Second, owners who liquidate pay a higher proportion of their proceeds in taxes than owners in any other type of sale or transfer. Finally, owners considering liquidation must anticipate a devastating affect on employees and, to a lesser extent, on customers.

Given these disadvantages:

- Minimal proceeds,
- Significant tax consequences, and
- Effect on employees/customers,

few owners pursue a liquidation unless they have no alternative.

CHOOSING YOUR PATH

Which exit route is best for you? Which one meets your Exit Objectives? Which path works best for Ben, Tom and Jerry in our earlier example? Comparing the advantages and disadvantages of each is a good way to start making that decision. Make this comparison through the lens of the first two steps of the Exit Planning process: Setting Exit Objectives and Determining Business Value.

Owners need to establish their objectives (financial and personal) before they can identify the best buyers for their businesses. Once established, objectives (such as the timing of your exit, the cash you need, and the type of future owner you prefer) become standards by which you can evaluate the various exit routes.

Recall Yogi Berra's warning, "You've got to be very careful if you don't know where you're going, because you might not get there." Establishing your Exit Objectives will tell you where you are headed.

The second step in the Exit Planning process is to determine the value of your business. This value tells you, the owner, what you can expect to receive in a third party sale or through an IPO, for example. An accurate valuation will also tell you how much, in a sale to key employees, co-owners or family members, you will leave on the table. For all owners, valuation indicates the distance they must travel before to reach financial security. How they reach this and other Exit Objectives depends on the exit path they choose.

In creating the best road map for your exit, carefully compare the benefits and detriments of each path, viewed in light of your specific Exit Objectives as well as the value of your business. Armed with your road map you can take the most appropriate exit path for you, whether it is the autobahn to financial security or a winding and leisurely excursion off the beaten path.