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Liquidity events and shareholder exit planning

BY TERREL BRESSLER

Thinking of a shareholder transition can be daunting, since it deals with "retirement." Preparing one's estate is often put on the back burner until it is too late. But proper planning can make these transitions less onerous and more comfortable for all parties involved.

Determining objectives

Transitioning ownership will affect the shareholders, the shareholders' children, the management team and the employees. The effects of a transition on these groups—and the effects these groups might have on a transition—should be carefully considered.

It is helpful to consider the "big picture" as the first step in the transition process. The big-picture thought process should begin well before the actual transition event. Answering key questions will help business owners begin to solidify and establish their transition goals.

- How is the company positioned in its marketplace?
- Do you want to continue growing the business, and do you have the resources to do so?
- Where do the owners see the company in five years?
- How strong is management, and what are the succession plans?

These questions help define the overall path and timing of a shareholder transition. Determining the company's position in the marketplace provides a sense of its strategic value and whether it can and should continue as an independent enterprise. If the company is in a highly competitive market with many new and emerging competitors, a transition might be considered sooner. A company with strong strategic value may currently demand high value from acquirers, which will diminish as competition continues to affect the company.

If maintaining the company's current market position requires significant investment and additional shareholder focus, the owners must determine whether the additional investment of time and resources will result in an adequate return to them. The business might be better served by a new owner who will be energized to take the company to the next level. These deliberations can become complicated if the family wants to keep the business but the next generation is not ready to assume management control. An honest assessment will help determine the appropriate shareholder transition path.

Members of the shareholder group may have differing perspectives on the future. If some shareholders have a longer-term view of the business, they might be likely buyers through a recapitalization or leveraged buyout of the business. If all the shareholders are thinking of an exit, a sale transaction might be more appropriate.

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Management and management succession also help determine the appropriate transition alternative. If the company has a strong management team and can run independently of the business owners, the business can be sold to almost any buyer. A strong management team is essential in recapitalizations and in sales of the business to financial buyers or ESOPs. Companies with weak management teams might have appeal only to strategic buyers. There could also be a gradual succession to other family members who have an interest in owning and operating the business.

Working through these big-picture issues at the outset allows the owners to determine which alternative best fits the circumstances, and to identify and fix problems in their business model to make the company more marketable. Changes that need lead time, such as establishing a board of directors and improving financial reporting, can be made in anticipation of a future liquidity event.

Once the big-picture issues are discussed, shareholder objectives should be refined. Here are several major issues to be addressed:

- Do I want the maximum price for my company?
- Am I concerned about business legacy issues?
- How do I want my management team and employees treated?

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• Do I have special tax consequences that need attention?

The answers to these questions will help solidify the type of transition and the plan to achieve it. The timing of a transaction will depend on external factors, such as the health of the M&A and financing markets, and internal factors, such as the company's performance.

Ownership transition alternatives

Basically there are two major ownership transition alternatives, an *external sale* to buyers outside the business and an *internal sale* to buyers who are currently inside the business. The objectives of the shareholder group provide an essential framework to help determine which path is most appropriate.

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External sale. If *value maximization* is the goal, then an external sale will likely be the way to achieve that objective. In a well-orchestrated sale process, the business attributes most desired by the buyer community can be described and highlighted. External buyers will generally contribute additional capital, management talent and a "second wind" to businesses that may have plateaued under family ownership.

Strategic buyers, who are already in the business area or in a similar business area, are usually willing to pay more because they can take advantage of synergies with their existing business by eliminating costs and redundancies in operations after closing. While these cost savings can lead to a higher value for your business, these same synergies may also have negative implications. If the synergistic savings result from the elimination of your facility or your loyal management team, receiving top dollar might not have the same appeal. Careful analysis of your objectives will help you determine whether an external sale to a strategic buyer is the appropriate path for your transition.

Private equity buyers will not pay as much as strategic buyers but can pay a relatively high value. The PE firm is buying the business as a going concern and covets the facilities, the management team and the operations as a base for further growth. PE buyers need the management team to make the business perform at a high level and will incent the team through stock options and equity participation to increase the value in the business. PE buyers might also provide the seller with the opportunity for a "second bite of the apple." In these situations the seller can roll a portion of the equity into the new deal with the PE fund. There are many instances when the "second bite" of the deal exceeds the proceeds from the initial shareholder liquidity event. This situation is ideal when the seller believes there is still significant upside in the business yet lacks the capital, the management resources or the stamina to continue to grow the business.

Internal sale. An internal sale is an alternative for owners who are more interested in their *business legacy* than they are in selling for top dollar. In these sales scenarios, an opportunity to buy the business is presented to the management team, employees or family successor. The seller may also continue to have a role in the future management of the business. Inside sales may require additional outside capital, so the new owner's ability to attract capital and grow the business will be reduced until much of the transaction financing has been paid back. In many cases, seller financing is necessary to support an ESOP, transfer to a family successor or management buyout, and therefore a total liquidity event is not possible.

ESOP transactions allow the selling shareholder an opportunity to defer the capital gain on the sale of the equity interest. These are generally flexible structures that can have partial or total liquidity for the seller. Sellers into ESOPs do not receive the higher company valuations that an external sale will generate, but they preserve their business legacy.

Management buyouts are inside sales in which management buys the company and provides the shareholders with liquidity through borrowed capital. Frequently the money is borrowed using the company and its assets as collateral for the financing. The gap between the capital that can be raised externally and the purchase price is often provided by the selling shareholders as a "seller note." Like ESOPs, management buyouts do not generate the highest value, but they preserve the business legacy.

A *recapitalization* may be useful to provide liquidity to one or more of the owners without selling the company to another party. A recapitalization could also be used to provide a measure of liquidity to all shareholders through a dividend. While a recapitalization can provide some shareholder liquidity, recapitalizations do not set a market value on a company. Recapitalization transactions are tax inefficient and are limited by the amount of capital that can be raised by the company.

Allow time for planning

Careful planning and consideration of the objectives of all affected parties is necessary to tailor a transaction that maximizes the value to the exiting parties and leaves all the shareholders satisfied with the result. If proper planning occurs, many estate, tax and business issues can be mitigated. FB