

# Exit Strategies: Avoiding the Pitfalls

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## Introduction

Consider the following real situation. Over the course of many years, a business owner worked hard to build a profitable firm with substantial value. When he decided to liquidate his well-earned investment, he chose the first available transaction vehicle that came along – a merger for stock and debt with a competitor. Imagine his dismay, when, through no fault of his own, the combined company fell into financial hardship. Because he received stock and debt in the buyer for his interest, his investment in money, time and effort was lost, seemingly overnight. Having to come out of retirement to salvage his damaged company was not part of his exit strategy.

This sequence of events unfortunately happens all too often. Even the brightest, most experienced business owners are vulnerable to this nightmare scenario. While it is impossible to completely prevent the unforeseen, owners owe it to themselves to examine the potential risks and rewards of all transaction alternatives. Although no liquidity event will ever be perfect, often only one or two truly match their unique financial and lifestyle objectives.

Did you ever stop to think whether a sale or merger is really in your best interest? Too many times, business owners become so caught up in the numbers of a proposed deal, that they are unable to see the host of other liquidity options – many of which may be more desirable than the deal at hand. A carefully planned exit strategy will answer many questions such as:

- ♦ How much and under what terms can I extract value under each transaction vehicle?
- ♦ Which transaction vehicle offers me the most consideration on a risk-adjusted basis?

- ♦ What are the timing, amounts and risks of payment associated with each transaction vehicle?
- ♦ How will a particular transaction impact my preferred succession interests?
- ♦ What are the precise tax consequences of each different transaction vehicle?
- ♦ What lifestyle issues need to be understood relating to each transaction vehicle, and how will my relationships with partners, family, employees and customers be altered?
- ♦ What internal housekeeping needs to be done in order to accomplish the desired transaction?

## Value Extraction

The options for extracting or harvesting value are numerous – sale, merger, employee stock ownership plan (ESOP), leveraged recapitalization, management buyout (MBO), private placement, initial public offering (IPO), to name a few. There are perhaps a dozen unique ways for business owners to take money off the table. However, in any particular instance only a few transaction vehicles are simultaneously feasible and desirable. The key to maximizing the value you have created, consistent with your lifestyle and planning objectives, is to carefully examine all of the ramifications of each strategy.

As a seller, you have an “optimal transaction” that most closely matches your monetary and non-monetary goals and objectives. Other than maximizing proceeds, there are nine primary transaction characteristics that should be addressed in any proposed transaction:



In reality, transactions are a function of trade-offs, and no one transaction will ever perfectly accomplish every objective. Moreover, individuals rank the importance of transaction characteristics differently, making the case-by-case assessment of your liquidity goals and objectives of paramount importance. Once your variables are qualified and quantified, they should be ranked based on their importance to you as an owner. Only then can you begin to minimize the risks of a wrong decision.

### Case Study

Kendra Rollins is the 45-year old hypothetical owner of ABC Manufacturing Co. (ABC). Kendra's company is in a very mature market, having \$50 million of stable, annual revenue, \$3 million in operating profit and relatively low debt of \$4 million. Kendra's husband, Paul, works with her at ABC, along with their eldest child, Amy. Amy had shown an early interest in the business, coming back to work for the company right after college and quickly earning a role in upper management. Amy's younger brother Joel, however, placed his academic and professional focus on writing software and is trying to start his own company.

For quite some time, Kendra and her largest competitor, Big Manufacturing, Inc., have discussed the possibility of combining their companies. While Kendra does not believe their corporate cultures are compatible, she feels that Big Manufacturing, Inc. is her best shot at achieving personal liquidity. As their discussions became more frequent and specific in nature, Kendra hired a valuation expert to get an idea of what her company was worth. The valuation expert concluded that ABC should fetch a multiple of eight times operating profit. Subtracting the \$4 million in debt from this \$24 million company valuation implied that the value of Kendra's equity was approximately \$20 million. Armed with this knowledge, Kendra hired VALUE Incorporated to determine what her most feasible and desirable liquidity options were.

A team of VALUE Incorporated analysts went to work, delving into every aspect of ABC's opera-

tions, interviewing managers and key employees, researching the industry and competitors and conducting frequent, confidential discussions with Kendra to fully understand her wants and needs as they related to a transaction.

It soon became quite apparent to the VALUE Incorporated team that, from her comments, Kendra was interested in achieving some immediate liquidity but was in no rush to lose control of the company. She was still relatively young, and she and her family were having fun managing the company they had built. The VALUE analysts also highlighted the fact that if she were to sell the company to Big Manufacturing, Inc., her daughter, Amy, would have fewer opportunities to advance in the combined entity.

The VALUE team ranked the most important characteristics by size (continued control, quick and easy implementation and maintaining succession interests) relative to Kendra's ideal transaction, as illustrated below:



With this knowledge, VALUE Incorporated recommended three alternative vehicles that best met Kendra's ideal transaction: an MBO, an ESOP and a leveraged recapitalization.

Kendra ruled out an MBO as the least feasible of the three given the managers' personal inability to obtain purchase financing and one manager's reluctance to include Amy Rollins in the buyout group. While an employee stock ownership plan was quite attractive to Kendra, her company's employee base was not sufficient to offer significant liquidity within the next 12 months. The VALUE Incorporated team demonstrated that a

leveraged ESOP was certainly feasible given ABC's level of fixed assets, but Kendra felt that the incremental cost and complexity of administering the ESOP within ERISA-mandated guidelines were too high to offset the favorable tax treatment ABC would receive. Upon examining the characteristics of a leveraged recapitalization, however, Kendra observed that it matched her ideal transaction more closely than any other transaction vehicle.

She ultimately chose to undertake a leveraged recapitalization, citing several reasons for her decision: (1) ABC was able to obtain significant asset-backed financing, (2) ABC's post-recapitalization debt to equity ratios were more in line with industry levels, optimizing ABC's cost of capital and increasing the company's overall value, (3) a leveraged recapitalization could be more quickly and easily executed than an equity transaction, (4) Kendra could maintain full ownership and control over ABC, (5) Amy could continue to be groomed to take over the company should she continue to show potential, (6) ABC's lower post-recapitalization equity value would enable Kendra to more quickly gift the company's shares to family members in the estate planning process and (7) a portion of Kendra's immediate liquidity would allow her to help finance her son's effort to become an entrepreneur and establish his software company.

To complete the leveraged recapitalization in a timely manner, VALUE Incorporated simultaneously introduced Kendra to several members of its network of strategic alliance partners. Transaction attorneys and accountants worked with Kendra's own trusted advisors to properly structure and plan for the leveraged recapitalization, while machinery and equipment appraisers worked with VALUE Incorporated's alliance lenders to come to terms on the value of ABC's equipment for collateral purposes.

In fact, Kendra utilized VALUE Incorporated's network of expert alliance partners to such an extent that VALUE Incorporated refunded her retainer in full. In addition to helping Kendra avoid the regrettable mistake of undertaking a less attractive transaction, VALUE Incorporated ultimately provided services at no cost to Kendra.

At the conclusion of the engagement, ABC was recapitalized, and Kendra and her family enjoyed the fruits of \$8 million in liquidity without sacrificing the control, succession and lifestyle issues they so highly valued.

## **Conclusion**

It is impossible to overstate the importance of planning for a once-in-a-lifetime event that can mean the difference between a successful investment in money and time and a financial disaster, not to mention the future well being of your company, its employees and customers.

Unfortunately, all too often the first question asked is "How much is it worth", when the more important question is "What should I do?"

*Travis Keath and Matthew Morris are both members of VALUE Incorporated, a value-based consulting firm specializing in measuring, creating and extracting value for its clients. VALUE Incorporated provides value extraction services to business owners to fill the needs illuminated and discussed in this article. They can be contacted in the Dallas office at [tketh@valueinc.com](mailto:tketh@valueinc.com) and [mmorris@valueinc.com](mailto:mmorris@valueinc.com), respectively.*