An Attorney's Perspective: Determining the Right Exit Strategy for your Business

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Most boards, founders and CEOs will face the difficult dilemma of planning for the future of their companies when they can't or don't want to run them. When looking to future company ownership, there are a variety of options to consider. Many of them result in instant liquidity for the owner, while some require the owner to wait for a longer period of time. Regardless, each of the following options has pros and cons to consider.

Sale to A Third Party

The most common exit strategy is for a business owner to sell the company to a third party. Potential third-party buyers often fall into two broad categories: private equity (PE) investors and strategic investors, including family offices and independent sponsors. As attorneys, we find that our PE clients have very different investment philosophies than strategic investors. For example, PE investors generally own many businesses and look for opportunities that don't require them to operate the day-to-day business, often relying on industry veterans and a company's former middle management team to run daily operations. As a result, our PE clients often require sellers to keep some "skin in the game" by rolling over (maintaining significant ownership) a portion of their stock, which provides additional potential upside to the seller along with risk on such retained ownership.

In contrast to PE investors, strategic investors (businesses that are in the same industry as the business owner) are more likely to have professionals who will take over the day-to-day operations of a business since they have experience operating in the given industry. On the other hand, strategic investors generally will purchase all of the seller's interest in the business, which gives a seller more liquidity but removes the seller's ability to benefit from any future upside in the business. As attorneys for strategic investors, we see them willing to pay higher multiples for quality businesses that can have an immediate impact on their bottom line.

Sale/Transition to Employees

Employees of a company can also be logical buyers of a business since they already have knowledge and experience with the company and loyalty to the long-time business owner. Often, the largest obstacle for the employees is the ability to find the capital necessary to fund the purchase.

One method for funding a purchase by employees is through an employee stock ownership plan (ESOP). In an ESOP, the company sets up a trust fund into which it will contribute shares of its stock or cash to buy existing shares from the owner. Alternatively, the ESOP can borrow money from a lender to buy the shares, with the company making annual contributions to help repay the loan. The company can use the proceeds of the loan to provide liquidity to the company's owner.

One of the advantages of using an ESOP is that it provides a tax-advantageous method for generating liquidity and transitioning stock to employees, since company contributions to the trust are generally tax-deductible. This method also rewards long-term employees by giving them the opportunity to become owners of the company. A primary disadvantage is that it increases the administrative burden on the company and creates legal complications, such as creating a fiduciary duty to the ESOP. In

addition, the valuation of the company is usually not as high as with some of the other liquidity options because the liquidity is being created from continuing company cash flow and available current leverage.

Another method for employee ownership is a management buyout. The advantage to the sellers is that the business remains with familiar faces, cutting down on due diligence costs, major disruption to the business and uncertainty. However, management buyouts can be a costly, time-consuming endeavor because management needs to find the equity and debt necessary to achieve the buyout, while continuing to run the business.

Initial Public Offering

Depending on the size of the business and the health of the public markets, a company can also consider an initial public offering. This option can provide liquidity to all the shareholders of the business and can raise the prestige of the company. After going public, the business will have a valuable tool for attracting and retaining key employees: public company stock. In addition, the company will be better able to issue its own stock as part of any future acquisitions.

However, there are many drawbacks to going public. The process can be costly and take tremendous time and resources. The company will be subject to reporting requirements that take time and money to fulfill. The company's financial information will of course become public, and the company will face pressure to meet the public's expectations on performance.

Dividend Recap

Certain business owners seek to realize some liquidity and take a portion of risk off the table. A dividend recapitalization is a technique to accomplish this goal. This entails borrowing funds from a lender, secured by the company assets. The loan is then distributed to the company as a dividend to the owner.

The company now has more leverage on its balance sheet, but the owner can realize liquidity as a result (which is often tax advantageous). The capital markets are competitive, and often good companies can borrow attractive multiples of earnings at very low rates without any personal recourse to the owner. Of course, this may not work if the company already has incurred significant debt or if its free cash flow will not allow it to meet its debt obligations. In addition, business owners may not like the idea of taking on debt to pay themselves, as leverage often scares business owners who are not used to operating with debt. This technique is a quick and inexpensive way to retain ownership and capitalize on the value of the business.

A recent example of a dividend recap involved a private equity client that wanted to take some profits out of one of its portfolio companies. Since the client had only owned the company for two years, it was not ready to sell the company. However, a rapid growth in earnings caused a lot of profit to be held in the company. Rather than sell, the private equity firm had the company take on additional debt, the proceeds of which were distributed to the private equity firm. The amount of debt taken on by the company was equal to the private equity firm's initial investment, so the firm could recoup its investment while keeping all the upside of the business.

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Decisions, Decisions

As there are many available techniques to monetize a business, owners, boards and executives should consider their available exit options and evaluate them often. Selling a business takes an extended period of time, requires the input of accountants, consultants, legal and others, and relies on factors such as economic conditions and purchase trends. With assistance from a good team of trusted advisors, investors can effectively evaluate the benefits and drawbacks of the many exit strategies available, and leverage those relationships to choose and implement the option that is best for a business and its stakeholders.

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Much Shelist is a Chicago-based full-service business law firm with an office in Irvine, CA. Founded in 1970, Much Shelist has nearly 100 attorneys. The firm offers services in a wide range of practice areas, including corporate law; mergers and acquisitions; private equity; venture capital and emerging growth companies; commercial finance; taxation and business planning; labor and employment; commercial real estate and construction; business litigation and dispute resolution; insurance coverage and risk management; intellectual property and technology; health care law; and wealth transfer and succession planning. For more information, visit www.muchshelist.com or follow the firm on Twitter at @MuchShelistLaw.

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