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BUSINESS TRANSITION ADVISORS

EXIT PATHS FOR BUSINESS OWNERS

WHITE PAPER

Introduction

When business owners start to think about exiting their companies, the number of possible Exit Paths can seem limitless. In reality, there are only eight:

1. Transfer the company to family member(s).
2. Sell the business to one or more key employees.
3. Sell to employees using an employee stock ownership plan (ESOP).
4. Sell to one or more co-owners.
5. Sell to an outside third party.
6. Engage in an initial public offering (IPO).
7. Retain ownership but become a passive owner.
8. Liquidate.

Which of these Exit Paths do owners intend to use?

- 59% of owners anticipate a third-party sale.
- 30% anticipate a transfer to the next generation.
- 31% anticipate a management buyout.
- 6% expect to sell to an ESOP.

This white paper examines the advantages and disadvantages of each Exit Path and 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. They paid book value of about $1 million. Now, seven years later, they are at a crossroads: Ben is interested in reducing his role in the company and has approached Tom and Larry about purchasing his one-third interest. However, there's a kicker. Ben is not interested in selling his interest on the same basis as he acquired it (book value). Instead, he wants one-third of the company's fair market value.

Since the company had increased its book value to $2.5 million and its annual cash flow from $200,000 to more than $2 million, Tom and Larry faced a major cash crisis and wondered whether they should 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 owner's personal Exit Objectives.

- *Ben wants to exit immediately for fair market value.*
- *Tom wants to continue to work for a number of years but isn't too keen on dedicating the company's entire cash flow to the purchase of Ben's stock. Tom believes that it is a risky proposition to use cash flow to pay off Ben rather than to fuel future growth. Further, Tom figures that, at just about the time Ben is paid off, it will be his turn to retire (at an even greater value, he hopes).*
- *Larry, the youngest, shares Tom's cash flow concerns but is sensitive to the desires of several non-owner managers—the next generation of ownership. Several key employees are quietly but insistently clamoring for ownership or similar ownership-based incentives. Larry wants*

to remain active in the company as its principal owner for the next 15 to 20 years and knows he can't indefinitely defer meaningful incentives to the key-employee group.

How to Choose an Exit Path

How can the owners of Front Range Powder Coating choose an Exit Path when they each have very different Exit Objectives? When they finally met with their advisors to determine the best Exit Path for Ben, their first question was "How do we agree on an exit strategy that is fair to all of us?"

The answer their advisors gave them is one that applies to all owners and is comprised of six key steps:

Step 1: Start thinking about your exit before you are ready to exit. Owners who give themselves time to plan give themselves the greatest number of Exit Path options.

Step 2: Owners should each put their Objectives and the resources available to reach each Objective in writing. Objectives may include when they want to leave and how much money they will need. Resources include business value, non-business income, and business cash flow.

This exercise helps owners evaluate how well each Exit Path matches their Objectives and resources. It also facilitates frank discussions based on realistic possibilities (rather than conjecture or wishful thinking).

Step 3: Each owner sets his or her own Objectives related to the desired date of departure, amount of cash desired upon departure, and desired successor.

Step 4: Owners should retain a professional to determine a company's fair market value in order to place all owners on the same Objective page. Valuation results often eliminate potential Exit Paths. For example, if the value of a company is high but the owner is not willing to devote the time necessary to orchestrate a transfer to employees, a sale to a deep-pocketed third party is a better option for that owner.

Step 5: Owners must perform cash flow projections to determine whether there is sufficient cash available to even consider an insider purchase (in this case, a purchase of Ben's stock).

Step 6: Owners must evaluate the tax consequences of each Exit Path.

Keep in mind that while this analysis takes place, owners must continue to increase the value of their companies. Additionally, they will likely need to revise their existing buy-sell agreements to reflect the true value of their companies.

Let's now examine each Exit Path available to business owners in detail.

Transfer to Family Members

Owners who consider transferring their businesses to family members usually do so for a host of non-financial reasons:

- Put the company in the hands of a known entity—specifically one's own flesh and blood—who the owner believes will run the company as he or she did.
- Provide for the well-being of the owner's family.
- Perpetuate the company's mission or culture.
- Keep the company in the community.
- Allow the owner to remain involved in the company.

The major disadvantage to a transfer to family members is the owner's heightened exposure to financial risk. In almost all cases, family members are incapable of paying an owner the amount of cash he or she wants or needs for the company. As a result, owners remain tied to the company's future financial performance. To mitigate this risk, most owners choose to stay active with the company to ensure its (and their own) financial success.

Since family-member buyers have limited financial resources, owners often receive little or no cash at closing. That's a clear disadvantage to owners who must convert their largest illiquid assets (i.e., their companies) into cash for retirement.

Realistically, not all owners have children who are willing and able to assume ownership of a company that is much larger and more complex than when its owner was their age. Even children who have demonstrated success in managerial roles may not be equipped to assume the responsibility of ownership.

In summary, the disadvantages to an owner pursuing a family transfer are as follows:

- Without planning, there is little or no cash at closing available for the owner's retirement.
- The owner faces ongoing financial risk.
- The owner must remain involved in the company post-closing.
- Children may be unable or unwilling to assume the ownership role.
- Family issues complicate treating all children fairly or equally.

Sell to Key Employees

In terms of advantages and disadvantages, a sale to key employees is remarkably similar to a transfer to family members. (Recall that Larry's exit strategy involved a transfer to key employees.) The two paths are so similar that if you substitute "key employee" for "family member," the advantages/disadvantages lists would remain the same.

Any owner who considers a transfer to key employees hopes to achieve nearly the same Objectives as the owner transferring to a family member:

- Put the company in the hands of a known entity.
- Perpetuate the company's mission or culture.
- Keep the company in the community.
- Allow the owner to remain involved in the company.
- Achieve the owner's financial security.

The perils of this Exit Path are almost exactly the same as those present in a family transfer:

- Without planning, there is little or no cash at closing available for the owner's retirement.
- The owner faces ongoing financial risk.
- The owner must remain involved in the company post-closing.
- Employees may be unable or unwilling to assume the ownership role.

Many of these disadvantages can be minimized if owners begin planning this type of transfer well in advance of their departure dates.

Transfer to Employees Via Employee Stock Ownership Plan (ESOP)

ESOPs are qualified retirement plans (typically, profit-sharing plans) in which all employees participate. ESOPs must invest primarily in the stock of the sponsoring employer.

Transfers to key employees and ESOPs appeal to owners who wish to transfer their companies to known entities, perpetuate their companies' missions or culture, and keep their companies in their communities.

Owners who use ESOPs to transfer to employees may enjoy three benefits that owners in a standard transfer to key employees may not:

- **Beneficial tax treatment**. Using an ESOP, an owner may be able to defer or avoid taxes on the sale of the stock to the ESOP. Even more importantly, the company can pay for the owner's stock with pre-tax dollars.
- **More cash sooner**. The owner may be able to close the sale with all of the cash necessary for a financially secure retirement, due to more favorable tax treatment and the greater possibility of at least some outside financing.
- **Motivated work force**. Perhaps because all employees indirectly participate in the benefit of ownership as ESOP participants, performance may improve. Studies have indicated that this can be the case.

Of course, not all aspects of the ESOP Exit Path benefit the owner. Disadvantages include the following:

- Owners must take into account the cost and complexity of setting up and maintaining an ESOP.
- At closing, owners may receive more cash than they would in other key-employee transfers but perhaps not as much as they would have had they sold to a strategic buyer.
- In securing an ESOP loan, the owner's assets may be tied to the company as collateral.
- In many cases, key employees may not benefit as significantly as the owner might have anticipated nor as much as the employees may demand to stay on and run the company after the owner leaves.

Of course, good planning—well in advance of the owner's exit—may substantially minimize or eliminate these disadvantages.

Sale to Co-Owners

Once again, an owner (like Ben) who examines a sale to a co-owner or co-owners finds the advantages and disadvantages nearly identical to those on the lists for a transfer to family members or key employees.

The advantages of a sale to co-owners are as follows:

- Buyers whose commitment, skills, and knowledge are known to the departing owner.
- Perpetuation of the company's mission or culture.
- With planning, the owner can remain involved in the company.
- Gradual, incremental sales staged over several years offer an owner the possibility of upside gain while maintaining his or her voting interest until finally cashed out.

The disadvantages of a sale to a co-owner are as follows:

- The owner is generally not cashed out at closing.
- The owner experiences ongoing financial risk.
- Owner involvement may need to continue post-closing.
- The owner typically receives less than full fair market value. (That prospect holds little appeal to Ben!)

A number of planning concepts that take time to implement (usually 3–10 years) may allow Ben to reap his full share of the company's fair market value and do so with less risk. For example, this buyout can be designed so that Ben sells no voting stock until he receives the entire purchase price.

Sale to a Third Party

This Exit Path usually offers owners the best chance to receive the **maximum purchase price** for their companies. In addition, owners of larger companies who sell to third parties are best positioned to receive the **maximum amount of cash** at closing.

Owners who top their list of Objectives with "leave for Tahiti the day after closing" initially choose this Exit Path. This route also appeals to owners who want to propel the business to the next level on someone else's dime.

The list of advantages is as follows:

- Achieves maximum purchase price.
- Usually maximizes cash at closing.
- Allows the owner to control his or her date of departure.
- Facilitates future 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 Path.

The first difficulty is that this Exit Path does not match most business owners' stated intentions. According to *The BEI 2016 Business Owner Survey*, 62% business owners have considered transferring their companies to an insider (family member, key employee, or co-owner).

Second, sellers to third parties may not receive all cash, or even a substantial amount of cash. Much depends on the size and intrinsic strength of the company, and on the state of the mergers-and-acquisitions marketplace.

On a personal level, owners who choose this Exit Path must be prepared to walk away from their companies but often not before working for the new owner 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 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 public companies (which often do lead to massive layoffs), they assume that their employees will suffer the same pains after the company merges or is acquired.

However, in our experience, few employees lose their jobs after a third-party sale. 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 larger (and often public) companies do the acquiring, employee career opportunities frequently improve. Compensation and benefit packages rise to the level of the larger organization. When competitors make an acquisition, they put high value on the workforce of the acquired company.

The disadvantages of a sale to a third party are as follows:

- Inconsistent with the original exit goal of 59% of owners.

- Loss of owner identity.
- Loss of corporate culture and mission.
- Receipt of a significant part of the purchase price subject to the company's post-closing performance.
- Potentially detrimental to employees.

Note that owners of smaller companies are less likely to close all-cash transactions and will likely have to accept promissory notes and a loss of control.

For more information on sales to third parties, please contact us.

IPO

The IPO Exit Path rarely occurs but 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 in an IPO than in any other form of transfer, including a sale to a third party. Second, an IPO brings an infusion of cash from a pocket other than the owner's, which propels the company to a new level.

Not surprisingly, the following advantages of an IPO are extremely attractive to the owner weighing various Exit Paths:

- High valuation on ownership interest.
- Cash infusion for the business.

Unfortunately, the IPO is not without significant disadvantages. The primary disadvantage 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 future date. Also prescribed is the rate at which the owner can sell his or her new shares. Last but certainly not least, when the former owner does sell his or her shares, the price per share varies (often significantly) from the price at closing.

The closing a non-event not only from a liquidity standpoint but also from a departure standpoint. In most IPOs, the owner is required to stay on with the acquiring company. Staying on is difficult because the former owner is no longer in control. The former owner may still be the CEO, but he or she is accountable to shareholders, analysts, the Securities and Exchange Commission, and other governing bodies to which the former owner was not bound prior to the sale.

Finally, an IPO creates a public company. As such, it is subject to reporting requirements and must uphold fiduciary responsibilities not required in privately held companies. Many business owners chafe under these additional requirements.

To summarize, the disadvantages of an IPO are as follows:

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

Assume Passive Ownership

Another Exit Path that an owner can choose is to keep the business while assuming the role of a passive investor. This Exit Path attracts owners who wish to do the following:

- Maintain control.
- Become gradually (or rapidly) less active in the company.
- Preserve company culture and mission.
- Minimize risk.
- Maintain or even increase their cash flow with less risk of income loss.

The first four advantages listed above are the same as those listed in other Exit Paths. However, the last deserves comment.

In some cases, especially in businesses with a value of less than $5 million, owners feel that they are at less risk keeping their businesses than selling them when a third-party buyer makes a major part of the purchase price subject to a promissory note or some type of earnout.

The disadvantages of this Exit Path are fairly obvious:

- The owner never permanently leaves the business.
- The owner receives little or no cash when he or she leaves active employment.
- The owner is delayed on his or her journey to a significant post-business life.

- The owner continues to experience risk associated with ownership.

Liquidation

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

Not surprisingly, the disadvantages of this Exit Path are numerous. First, liquidation yields less cash than any other Exit Path, primarily because no buyer pays for non-existent goodwill.

Second, owners who liquidate often must allocate a greater proportion of their proceeds to taxes than do owners in any other type of sale or transfer.

Finally, owners considering liquidation must anticipate a devastating effect on employees and, to a lesser extent, on customers.

Given the disadvantages of minimal proceeds, significant tax consequences, and negative effects on employees and customers, few owners pursue liquidation unless they have no alternative or they operate in an industry that is clearly in decline. However, in those cases, if owners engage in significant tax planning years in advance of their exit dates, they can accomplish significant income-tax savings.

Choosing Your Path

Which Exit Path is best for you? Which one meets your Exit Objectives? Which is best for Ben, Tom, and Larry in our case study?

Comparing the advantages and disadvantages of each Exit Path is a good way to start making that determination. Making this comparison through the lens of your Objectives is the basis for your Exit Planning Process.

Owners need to establish their Objectives (financial and personal) before they can identify the best buyers for their businesses. Once established, Objectives (i.e., the timing of your exit, the amount of cash you need, and the type of future owner you prefer) become standards by which you can evaluate the various Exit Paths.

In determining company value, you learn important information about 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 you will leave on the table in a sale to key employees, co-owners, or family members. For all owners, valuation indicates the distance they must travel 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, use your Objectives and the value of your business to carefully weigh the benefits and detriments of each Exit Path. Armed with this analysis and at least one advisor skilled in Exit Planning, you can map out the most appropriate Exit Path for you.

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