Exit Strategies

Making the decision to sell
Part one in a series

Private
Company
Services

A series for privately held business owners

Introduction: Introduction to the series

The perpetuation of ownership and the succession of management are among the most difficult challenges that a privately held business will ever encounter. The decisions surrounding these issues will determine what will become of the organization to which business owners have devoted their lives, and what will be the return on what is likely their most valuable financial asset.

Yet, ironically, these critical—and complex—decisions are among those for which the owner is least prepared, since they may be confronted only once in a lifetime. Owners may have many decades of experience at managing a business, but little or no experience with the monumental task surrounding his or her exit.

Should the business be sold? Should there be an outright sale? Sale of a minority interest? IPO? Leveraged ESOP? Recapitalization? What is the right time to sell? How is the business to be valued? Add to this the myriad of options available: the often divergent goals of seller and buyer; the tax, funding and legal implications of the transaction; and the nature and structure of the deal itself. The number and complexity of choices can quickly become overwhelming.

Our experience assisting privately held business owners to develop and implement effective exit strategies shows clearly that, first, every situation is unique since each seller will have different objectives. An optimal solution for one owner may be undesirable for another. Second, optimizing the outcome upon exit depends on a carefully thought-out and well-planned exit strategy.

We have created this series, R*ealizing Shareholder Value: Private Company Exit Strategies*, to guide privately-held business owners in the development and execution of an effective exit strategy.

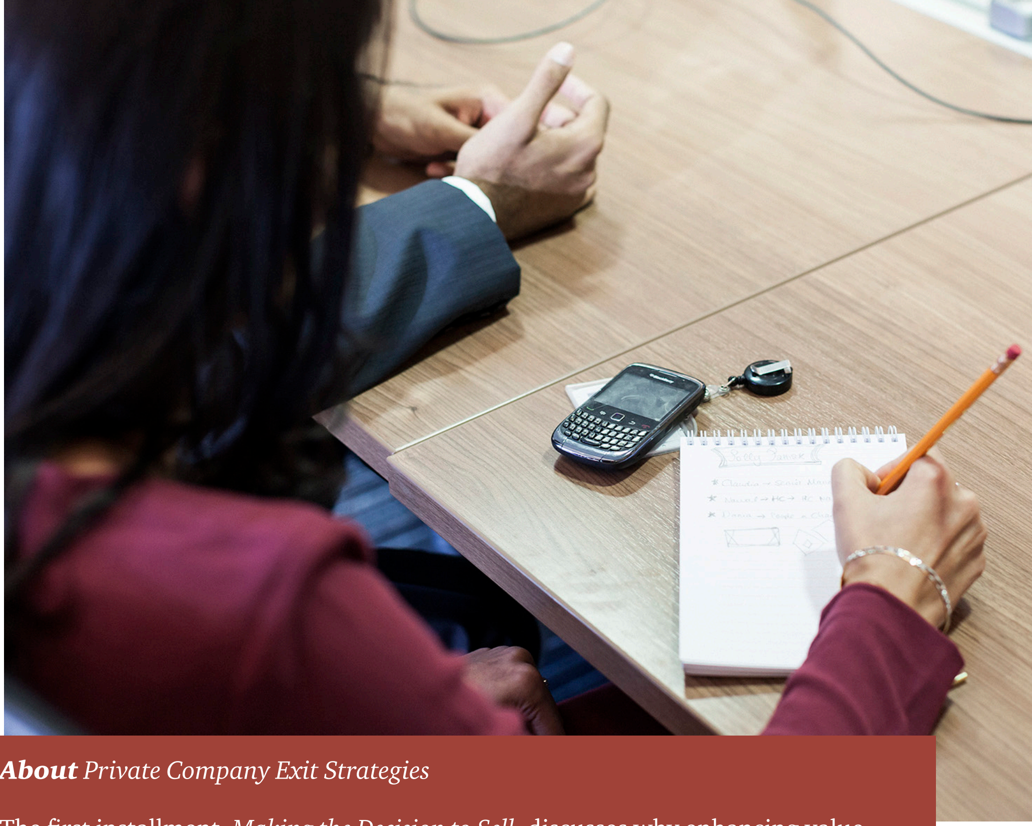
This, the first installment, explores the framework for developing an effective exit strategy—setting the appropriate objectives and understanding the importance of effective and early planning.

- **Finding the Right Buyer:** The importance of understanding the different types of buyers. How understanding the buyer's agenda is critical for an optimal outcome. The benefits of selling to a private equity firm versus a strategic buyer. Managing a continuing role in the business. Expectations about control. Determining the appropriate transaction structure. Reconciling buyer and seller objectives.

- **Preparing the Business for Sale:** Issues in valuing and evaluating the business. Determining the right time to sell. Pre-sale checkup and corrective actions. Putting together the best package and sell side due diligence. Assessing and addressing Sarbanes-Oxley readiness. Employee matters in the transaction setting.

- **The Deal Process:** Managing the due diligence process. Using advisors effectively. Negotiations and getting to closing. Avoiding pitfalls. Structuring a tax-efficient sale.

- **Life After the Deal:** How to effectively handle personal wealth issues after the sale. Estate and tax planning considerations. How to handle the effects of various exit strategies.



***About** Private Company Exit Strategies*

The first installment, *Making the Decision to Sell*, discusses why enhancing value upon the owner's exit begins with a process of identifying the owner's business and personal goals and objectives—and how, to a large extent, they determine the best exit strategy and right type of buyer.

The second installment, *Finding the Right Buyer*, focuses on seeing the business through the eyes of potential buyers and buyer types and on understanding how their various objectives and value drivers fit with the seller's personal and financial goals.

The third installment, *Preparing the Business for Sale*, suggests some tactics to consider as well as mistakes to avoid in preparing for the sale of a private business.

The fourth installment, *The Deal Process*, discusses the process of getting from negotiation to closing and explores ways to avoid pitfalls along the way.

The fifth and final installment in our series, *Preparing for Life after the Deal*, discusses how to preserve and transfer the wealth generated by the exit from your business.

To view all published installments in the series, visit www.pwc.com/pcs/exitstrategies.

Time for a transition: why sell the business?

Ownership transfers are initiated for many reasons, most commonly:

1. Retirement of the primary shareholder
2. Competitive pressures
3. Death or illness of the owner
4. Financial difficulties
5. Readiness of heirs to take control of the business
6. Desire for liquidity and asset diversification on the part of the primary shareholder

Retirement

Retirement is the most frequently stated reason for ownership transfer. Because they are emotionally as well as financially connected with their organizations, many private business owners are unwilling to seriously investigate opportunities to transition ownership before they are “forced” to by age or illness.

Competitive pressures

The second most frequently stated reason for ownership transfer is intensified competition. For many owners, competitive pressures have increased as a result of consolidation, resulting in lower costs and higher market power for competitors due to the benefits of scale. Many industries that in the past have experienced only local or regional competition have become global, with capital flowing to the most promising industry players regardless of their geographic location.

Death of owner/financial difficulties

Business owners are compelled by external factors to initiate a transition more often than they choose the appropriate timing. Both the death of the owner and financial difficulties of the business are unanticipated events that can drive a transaction.

The common theme of these scenarios is that they are generally reactive in nature, which generally yields a suboptimal result. The objective of this series is to educate the potential seller to enable him/her to be proactive—to empower the owner to control the process and optimize the outcome.

The perpetuation of ownership and the succession of management are among the most difficult challenges that a privately held business will ever encounter.

Defining objectives: the mission-critical step

You recently chatted with an investment banker about your thoughts for the future of your business. He tells you an IPO is definitely the way to go. Is it?

It depends.
Neither of your two grown children has indicated a desire to take over your business someday. Business is good, so you're thinking of selling soon. Should you?

It depends.
You're thinking of selling your business in the next year or two. You've just been informally approached by a potential buyer and an intriguing ball-park price was suggested. Should you sell? Is the price fair?

It depends.
The fact pattern of your business—and your life—is different from all others. Your unique set of facts can lead to an optimal harvest as long as—and only when—you have thoroughly defined your objectives and priorities.

Achieving optimal value begins with a clear articulation of the goals and objectives of the sellers. Objectives will be both financial (liquidity, sale price, taxation/estate planning) and non-financial (succession, legacy and reputation, employee and stakeholder concerns, family dynamics, and other special interests).

Some of the many questions you will need to ask yourself include:

- Do I want an ongoing management involvement in the business? For how long?
- Do I want to retain a financial stake in the business post-sale?
- Have I determined what is really important to me? For example, do I wish to maximize the value I receive for my business, or are other issues as important? More important?
- To whom do I want to sell/transfer the business—to family members, financial investors or competitors? Do I really care?
- Do I want to keep the business in the family?
- Are there employees or others whom I want to protect or reward?
- Are there other motivating factors for me? Do I want the business to retain its name and identity following my exit? Is it important that my business retain its independence?
- What are my financial needs?
- Does my business have all the necessary managerial expertise required to be successful in the future?
- Does the business have an appropriate capital structure and access to further funding to enable it to take advantage of the future opportunities?

Answering these questions requires a clear view of the future strategic direction of the business. Whatever your decision, it is only through a clear understanding of your personal and business priorities that you can choose the exit options that will best meet your needs.

What drives value: where are you now?

Because a privately held business owner's life is often so closely intertwined with the business, it is usually difficult for him/her to objectively and effectively assess the value of the business. The first step in assessing the value of the business is to identify its value drivers.

Value drivers are the real and perceived aspects of a company that enhance the company's value from the buyer's perspective. Typical value drivers may include:

- synergies expected from a merger/acquisition
- quality and reputation of the business
- cash flow and profitability
- customer relationships
- growth trends for key products and services
- distribution network
- intellectual property, such as patents, trademarks and brand name
- quality of management team
- technology
- people and intellectual capital

Once value drivers are identified, the owner can begin to assess the strength of those value drivers and take actions to enhance them. For example, systems may need to be upgraded to support growth; the business may need to move to offshore manufacturing. The balance sheet and cash flow may need to be improved, perhaps through cost cutting or debt restructuring. The management team may need to be upgraded, etc.

It is often prudent to consult with a trusted third party advisor to assist in making this assessment. Due to the emotional ties to the business, it is frequently very difficult for an owner to be completely objective in his/her assessment, which can directly impact the attractiveness and value of the business to potential buyers.

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Family considerations

As discussed earlier, apart from financial considerations, one of the primary decisions that must be addressed surrounds whether the goal is to keep the business in the family. Frequently, the emotional or philosophical issues relating to family business succession can be more challenging to resolve than business or financial issues. These sensitive topics should be addressed when determining the objectives, before the business issues are addressed.

Many business owners start out with the intention of transferring their business to their immediate family; ultimately, however, that may not be a viable, realistic or optimal solution. Many factors come into play with such a decision, among them:

Age, desire, skill sets, management experience, potential sibling rivalries, life cycle of the business, capitalization of the business and reactions of key non-family employees.

These issues should be discussed with your trusted advisor when beginning to formulate an action plan and objectives.

Employees and the decision to sell

An effective exit strategy should consider the impact of a sale on current employees. Concerns may range from the desire to retain key management personnel to providing security for a valued long-term rank-and-file employee. An effective strategy also identifies and implements needed management changes long before an actual transaction is on the horizon.

Performance management

The business succession process provides an unprecedented opportunity for the owner to take a fresh look at where the company is headed, establish new goals, identify any missing talent, and take action steps to secure appropriately skilled outside talent.

Having an established strong managerial track record provides confidence to potential buyers or investors, thus increasing the overall value of the enterprise.

Effective communications

Even in the early stages of formulating an exit plan, communication issues are important. At the very earliest stages, it is critical to identify the key individuals who will need to be involved in the process. This is important for several key reasons: First, it avoids unnecessary or premature concern to other employees. Second, it is easier to manage the consistency of the message to potential investors when working with a smaller group. Third, the key individuals who will be critical to preparing for a potential transaction are likely the same individuals that are most responsible for the success of the business, and the resulting underlying value to a buyer.

As a specific transaction begins to unfold, communication needs will shift: a larger circle of employees may need to be involved in due diligence work. Yet, here again, knowledge should be limited to the smallest possible number of employees.

The impact of ownership succession on an organization can be positive or negative, depending on how carefully the transition is managed. Sometimes employee performance deteriorates as a result of uncertainty and fear of change—a justifiable reaction, since jobs may be eliminated or modified during the business transition. However, business succession can also improve employee performance if the planned changes are quickly and effectively communicated to the staff. Employees often work harder to prove themselves to new management. In addition, new internal or external managers are sometimes more willing to address certain personnel issues (e.g., dealing with "dead wood") than the prior management, resulting in improved efficiency and morale.

Exit strategy options: structuring the transaction

Effective deal structuring can often produce significant value upon the disposition of a business. The sooner owners begin to understand the implications and importance of effectively structuring transactions, the better positioned they are to lay the groundwork for future success.

Although there are many ways to transfer ownership, the most common are sales/transfers of ownership within the current family or employee group and sales to a third party. Other options include minority sales and recapitalizations,variations that can allow for retention of partial ownership or management control, as well as IPOs and ESOPs. Each arrangement is accompanied by a unique set of concerns.

Selling/transferring ownership

Selling to the Family

A privately-held business usually represents a lifetime of work on the part of the owner and founder. Upon retirement, the owner would like family members or other heirs to enjoy the fruits of his/her labor. However, non-family managers and employees may be suspicious of family transfer arrangements; family members not involved in the business may voice their objections as well. Key employees and family members alike may have concerns about who controls the business. The earlier these issues are considered, the more likely there will be a satisfactory resolution.

Selling to a Partner or Co-owner

When partners or co-owners purchase a business, ownership agreements should include restrictions regarding the circumstances of the transfer (e.g., only by gift or at death); the potential transferees (e.g., only the entity itself, family members or other existing owners of the business); the transfer price (e.g., usually of formula approach or appraisal.) The restrictions are often coupled with a right of first refusal in the hands of the co-owners or the company to purchase the stock if there is an attempt to transfer or sell it outside a permitted class.

Selling to an Employee

Sometimes the logical choice for management succession is an existing employee, who in many cases has been groomed by the owner. Where certain employees are key to the business or closely involved in day-to-day operations, steps must be taken to ensure that the employees will remain in the business after the owner is gone. If the employee departs, possibly to a competitor, the value of the business could be significantly affected.

Sale to a third party

The simplest way to transfer ownership is through a sale to an outside party. Sales to larger public companies are a common form of transfer. However, the outside sale of assets or stock can have complications and unintended consequences. Some buyers may not have the resources or credit available to obtain financing, and may rely on the owner for a private installment sale or to guarantee part of the acquisition debt.

This option creates an opportunity for a privately-held business owner to diversify a concentration of wealth in the business.

However, in the context of a family business, the family may lose its identity or be unable to find a career path for family members associated with the business. A sale to an outsider may also change relationships with key employees, vendors and customers.

Initial public offerings (IPOs)

The expression "going public" describes the process of offering for sale to the general public securities (common or preferred stock or bonds) of a privately owned company. A company may begin to think about going public when the funding required to meet business growth has exceeded its debt capacity. While under the right circumstances "going public" may be attractive, the costs to a company are huge, and there is often a misperception about the amount of control that can be retained. The decision to go public requires in-depth analysis, and its advantages and disadvantages must be weighed carefully.

Employee stock ownership plan

An Employee Stock Ownership Plan (ESOP) is a type of qualified retirement plan that allows employees to be the owners of the business. The corporation can make tax-deductible contributions to the ESOP, either in shares of its own stock or in cash used to purchase company stock from a selling shareholder or from the company (treasury stock.) Payroll size is an important factor in evaluating the ESOP as a transfer vehicle. It determines maximum ESOP contributions, which in turn determine maximum ESOP purchase levels.

Benefits of ESOPs include pre-tax funding of the stock purchases, a tax-deferred roll-over of the price paid for the seller's stock, and an additional source of funding (use of funds previously allocated to a profit sharing, 401(k) or other retirement plan). However, there are many regulatory requirements that must be addressed. Like IPOs, ESOPs can be the right vehicle in the right situation, but are not appropriate in all circumstances.

The decision to go public requires in-depth analysis, and its advantages and disadvantages must be weighed carefully.

Timing: early planning is essential

Although every business will ultimately face the issue of the owner's exit, most privately-held companies do not have an effective transition or liquidity plan in place. Too often, private company owners delay planning because they are caught up in day-to-day operational demands, or because they find it difficult to acknowledge that the time has come to start thinking about letting go of the business. As a result, many companies are simply reactive in nature when it comes to planning a harvest strategy.

An effective harvest strategy begins long before an actual exit. Value is optimized when an exit is proactive rather than reactive—and lack of planning often leads to failure in the realization of goals. A sufficient time frame (two to five years) allows time for the company and its owner to:

- Demonstrate to potential buyers that it has long-term relationships with customers and vendors. It also provides sufficient time to ensure that an effective management team is in place long before a potential transaction, alleviating buyer concerns that the business value might be too dependent on the entrepreneur.

- Alter the strategic plan (e.g., choice of clients, markets) with a focus on creating a more attractive asset for sale down the road.

- "Put the financial house" in order. Any potential buyer will pay a great deal of attention to the financial results the company has achieved over the past several years. They are likely to scrutinize historical performance to get a better understanding of the risks and rewards associated with their potential investment. Historical performance also provides a benchmark for future performance.

- Create and organize quarterly and/or monthly management reports to help a future buyer understand the key metrics and performance indicators being used to manage the business.

- Develop a message around quality of earnings and performance, and anticipate the questions and concerns of potential buyers.

- Start considering who might be the ideal buyer and the concept of subjective value. By better understanding a potential buyer's philosophy and attitude about what drives value, a seller can better understand how to best position those attributes to maximize value.

- Realistically understand the strengths and weaknesses of the business. The better understanding owners have of the "warts" (as well as the "gems") of the business, the better prepared they will be for discussions of these attributes with a potential buyer. This understanding can be used both to shore up relevant weaknesses in the business and highlight the key value drivers and investment considerations.

- Formulate and implement a comprehensive sell-side due diligence process that will position the owner to be better prepared for buyer skepticism, rigorous analysis and negotiations.

Each of these steps will be discussed in detail in later installments of this series.

The amount of leverage the seller will have is determined prior to negotiations with a buyer. Early planning can dramatically increase that leverage.

Position your business now

Regardless of a particular investment or economic climate, early and thorough planning will optimize value. Proper timing allows the owner to invest in building the strategy, building the team, and managing the process. Early planning allows time to sufficiently understand the strengths of your business and to identify and shore up weaknesses. It allows sufficient time to understand how buyers perceive value. Early planning allows the owner to embed value in the organization and move it away from the individual.

And, importantly, even if a sale is contemplated in the near-term, effective planning will allow you to run the business as if you're not going to sell it.

Early and effective planning provides the knowledge that will allow you to drive the exit process rather than allowing potential buyers to gain control. Then, as you build your strategy, build your team, and manage the process, you will be better positioned to focus on running your business as the sale process runs its course.

Effective planning enhances value in yet another way, even as negotiations for an actual transaction occur—it will allow you to have the best available information to make an informed decision whether to accept an offer… or to walk away.

Early planning allows time to sufficiently understand the strengths of your business and to identify and shore up weaknesses.

Ten tips for making the deal

Keeping these principles in mind can ease the process and help you avoid classic mistakes.

01

Mind the store.

The sale process consumes significant amounts of time, energy, and other resources. It is surprisingly easy for you—or your entire management team—to become so focused on managing the sale process that you or they neglect the day-to-day demands of running the business.

02

Be sure everyone's on the same page.

The sale process is a complex one, requiring input from and effort by multiple individuals across all functions of the business. Unless everyone rows in the same direction, messages will be mixed and the process will bog down.

03

Get the right advisors and the right expertise.

As a business owner, you know your business and you're used to making the decisions. In a sale, however, you're navigating uncharted waters.

04

Manage the business right up until closing.

Don't assume too early that a deal is done and start focusing energy on your life after the deal—dreaming of retirement and relaxing on the beach. This can lead you to stop managing the business effectively or to stick with an otherwise deteriorating deal simply because you're already emotionally committed to the life you've envisioned after the deal. Some deals never go through. And it's important to hit projections.

05

Value your business on its own merits.

Once you hear "what another guy got" for the sale of his business, you might not be content with a lower offer for your business, even though it may be optimal or appropriate given the circumstances. Every deal is unique, and the stories you hear rarely include information about the many differences between the two businesses.

06

Know that dollars are not the only factors.

You may be tempted to jump into the deal process upon receiving an offer that looks enticing. However, a promise of more money with more contingencies is not always the preferred route. Take time to understand the present value of structured components of consideration, such as seller paper or earnouts and the associated risks. Investigate whether the potential buyer has a good track record of sticking with original offers. There are many issues to consider: How quickly can they close? Are there financing contingencies? What additional due diligence do they want? In other words, what issues could stop you from signing this deal with this company?

07

Keep the circle of knowledge as small as possible.

News of an impending sale can make employees nervous and give competitors the opportunity to take market share away. You don't want someone whispering in someone's ear, "You don't want to use them. They're about to be sold."

08

Keep your options open.

Competition is a good thing. It's possible to waste a great deal of time and money in the deal process with a buyer who makes an exciting initial offer but then, late in the game, shows no intention of closing the deal at that price or on those terms. Meanwhile, you may have let other suitors fall away or taken your eye off company operations, only to see the deal fall apart. Speed is good—but not for speed's sake.

09

Be up front about potential issues.

Should a potential buyer find out negative information late in the game, it could result in a significant reduction in the price and could jeopardize the transaction itself. Present yourself and your company well, but remember that numbers and facts that stick are always better than ones that erode.

10

Be prepared.

Don't rush to market. Lack of adequate preparation before beginning the selling process is always a major pitfall. Optimizing value and getting to closing requires that you put your best foot forward, make your presentation polished and complete, and be prepared for questions.

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www.pwc.com

For further information, please contact:

J. Fentress Seagroves Jr.
PwC Deals Principal
(678) 361 8708
fentress.seagroves@pwc.com