Exit Strategies

Finding the right buyer
Part two in a series
Introduction: Realizing shareholder value

We have created this series, Realizing Shareholder Value: Private Company Exit Strategies, to assist privately held business owners in developing and executing an effective exit strategy.

Part 1, Making the Decision to Sell, discussed why enhancing value upon your exit begins with the process of identifying your goals and objectives, both business and personal in nature. Your goals and objectives, to a large extent, determine the best exit strategy and the right type of buyer.

This second installment, Finding the Right Buyer, focuses on your business through the eyes of a potential buyer. Knowing the goals of each type of buyer will help you identify the buyer and deal structure that present the best match for your personal goals and/or the one that will more likely place a higher value on your business. This installment takes you through various deal alternatives, the pros and cons of each, and why you—or a buyer—may have a preference. It also highlights some of the key value drivers that have historically received the most attention from the different types of buyers.

Armed with a better understanding of these issues, you can begin to mentally prepare yourself for the ultimate sale of your business. Effective preparation and execution of your exit strategy are the topics of subsequent installments in this series. Preparing the Business for Sale will discuss valuing and evaluating the business, determining the right time to sell, undertaking a pre-sale checkup and implementation of corrective actions, putting together an effective information and financial package, conducting sell side due diligence, assessing and addressing Sarbanes-Oxley readiness, and managing employee matters in the transaction setting. The Deal Process will cover managing the due diligence process, using advisors effectively, negotiating and getting to closing, avoiding pitfalls, and structuring a tax-efficient sale. Life After the Deal will discuss estate and tax planning considerations, how to handle personal wealth issues effectively after the sale, and how to handle the effects of various 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.
Seeing your business through the eyes of a potential buyer

Any type of potential buyer for a business will look for quantitative and qualitative indications of a strong, successful business, including competitive advantage in the marketplace, diversity of customer base, and a solid business strategy. Even when an investor intends on bringing in a senior management team, the strength and depth of the overall management group will be a key area of focus. Human capital topics and resources have become increasingly important in a competitive, globalized marketplace.

Yet, each potential buyer will weigh the value of each of these components differently. By better understanding a potential buyer’s philosophy about what drives value, you can understand how a buyer will assess your business as a potential acquisition. Additionally, the specific value drivers will likely vary from buyer to buyer. Some of these drivers will be measured objectively, some subjectively.

In order to best understand and ultimately capture the subjective value (the enhanced value that is perceived solely by either one or a group of particular buyers), owners should gain an understanding of three different broad categories of buyers:

1) logical strategic or pure-plays—could include your existing competitors, or a company looking to get a foothold in your particular industry; (2) vertical integrators—potential buyers who can be identified by looking up and down the supply chain; (3) financial buyers—more opportunistic buyers who may or may not have expertise in your industry but who may be interested in investing capital and leveraging operations with debt, with an eye on short-to medium-term appreciation in the enterprise value of your business or broader consolidation play.

And, importantly, you will need to understand the goals of each of these potential buyers and how they develop an acquisition strategy and execute the process.

Your goals and objectives, to a large extent, determine the best exit strategy and the right type of buyer.
Exploring exit options

To identify the right buyer for your business, you first need to determine the exit strategy that will best accomplish your goals. Five of the most prevalent primary strategies discussed are:

01
Full or partial sale to a third party, with or without an auction

02
Corporate partnerships or joint ventures

03
Selling the company to employees—employee stock ownership plan (ESOP)

04
An initial public offering (IPO)

05
Selling/transferring ownership to family members

It is expected that the vast majority (perhaps 95 percent or more) of family-dominated businesses not seeking to pass the business on to the next generation will find that their only viable exit is to sell the business to a third party. There are financial and practical reasons why a management-led buyout faces challenges in today’s capital market. And while people may talk about an IPO as an exit from the business, it’s really better characterized as a capital-raising event as opposed to an optimal liquidity event. Going public may permit an owner to free up only a portion of the personal wealth that is tied up in the company, and a full exit may take years or may, in fact, never be achieved.

The best choice for a private company owner will depend on many factors: personal goals, financial needs of the owner and the business, and the state of the industry, to name just a few. And each strategy has its advantages and disadvantages.
Outright sales and market mentality

Selling the business to a third party creates an opportunity for the owner of a privately held business to diversify from a concentration of his wealth tied up in the business. From a simplistic perspective, an outright sale may be made to either a strategic buyer (one who seeks synergies with the seller’s business) or a financial buyer (one who is more likely focused on shorter term investment goals).

The strategic buyer

The strategic buyer seeks a good fit with some aspect of the seller’s business. The strategic buyer frequently is in the same business and is trying to access new markets, increase market share, or acquire expertise, patents, or company know-how, including strategic management resources. The strategic buyer sees the target as a way to acquire those elements that fit with or enhance its existing business. Often times, this decision stems from a potential buyer’s analysis that it is cheaper and faster to buy an existing company than it is to build or develop their own from scratch.

The chart highlights some of the elements that strategic buyers typically seek.

<table>
<thead>
<tr>
<th>What does a potential buyer seek?</th>
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<tr>
<td>Access to new markets</td>
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<tr>
<td>Growth in market share</td>
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<tr>
<td>Access to new products</td>
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<tr>
<td>Access to management or technical talent</td>
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<tr>
<td>Enhanced reputation</td>
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<tr>
<td>Reduction in operating expense</td>
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<tr>
<td>Access to distribution channels</td>
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<tr>
<td>Access to new technologies</td>
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<tr>
<td>Reduction in number of competitors</td>
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<tr>
<td>Access to new brands</td>
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Note: percent of companies listing the objective

PricewaterhouseCoopers: A Survey of Mergers and Acquisitions
Strategic buyers in a similar business probably have a sense of the seller’s financial performance in certain areas, even though this information is not publicly available.

When the synergies are significant, the strategic buyer is often willing to pay more, especially when those anticipated benefits are specific to the buyer compared to others and are achievable with relatively little investment or careful integration planning. When considering a strategic buyer, you will want to anticipate these possible synergies in order to capture the potential value associated with them.

Owners should consider the ramifications on employees and stakeholders, if these are important factors. You will need to weigh the advantage of a possibly higher sale price against the likelihood that the strategic buyer, as part of achieving its synergies, may eliminate a portion of your existing management team post-transaction.

The following lists some of the advantages and disadvantages of selling to a strategic buyer.

**Advantages**

- May provide highest valuation for shareholders in the near term
- May enable the entrepreneur to completely walk away (i.e. obtain the greatest liquidity)
- Potential operating synergies can improve the business
- Typically, strategic buyers are very knowledgeable from an operational and business perspective, facilitating due diligence and closing; may be able to close much faster than financial buyers
- Qualified buyers may not be constrained by financing contingencies or be at the mercy of the credit markets

**Disadvantages**

- Management may lose autonomy, lose their jobs, or have their roles diminished
- Possible negative impact on culture and morale
- May affect customer loyalty
- Upside value potential may be sacrificed (unless there is significant stock or earnout consideration)
- Key concern is being caught up in bureaucratic delay—“decision paralysis”
- A secondary concern is related to access to competitive information, should the deal fall through
The financial buyer

The financial buyer, on the other hand, may not be focused on synergistic opportunities from the immediate transaction if the company is intended to be an anchor for an industry acquisition strategy. Once a portfolio company is acquired as a platform, financial buyers become more like strategic buyers in their approach, and the lines between the classifications become more blurred. By nature, the financial buyer hunts for opportunities to invest in undervalued companies, provides financial support, and exits their investment for a profit in the shorter to medium term. While some financial buyers (generally referred to as private equity, venture capital, or investment funds) may focus on particular industries, financial buyers are often more generalized in their targeting, whereby the attractiveness of the investment opportunity is considered as well as the particular industry of the underlying business.

The most marketable businesses to a financial buyer tend to be those with solid cash flows, a defendable market position, lower capital expenditure requirements, and products and services in markets that are growing. The ability to leverage the business is a critical factor in driving the price to these investors, with the health and aggressiveness of the credit markets a critical factor.

However, the size of the private equity market has grown substantially, with fundraising and availability at record levels and demand significantly exceeding the supply of quality investment targets. The additional efficiency reflected in the private equity market can benefit a seller through higher prices.

Though distressed funds constitute a smaller segment of the market, depending on the reasons for the company’s troubles, operationally minded financial buyers may be interested in pursuing turnaround situations or deals with more complications.

Typically, financial buyers are extremely sophisticated in terms of deal structure and diligence. In order to achieve their targeted investment returns, they will generally finance the acquisition with significant leverage (i.e. additional debt). As a result, they are more sensitive to issues such as management quality and depth, sustainable EBITDA (earnings before interest, taxes, depreciation, and amortization), and free cash flow.
The following lists some of the advantages and disadvantages of selling to a financial buyer.

**Advantages**
- Current management/shareholders may retain upside potential
- Current management/shareholders will likely maintain significant involvement in direction and operations of the business
- Entails relatively less business disruption and effect on customer loyalty and employee morale
- Provides access to “deep pockets” for acquisitions and other growth initiatives
- May provide owner with ability to realize additional returns
- Can offer transaction structure flexibility

**Disadvantages**
- Likely requires ongoing involvement of owner in business going forward in short term
- Heavy debt requirements may limit capital available for growth
- Heavy debt load limits margin for error
- Upside potential is dependent upon strong management direction and growth
- Heavy financial reporting requirements
- Requires extended due diligence period because of reliance on lender participation
Corporate partnerships or joint ventures

Entering into a partnership or joint venture may be a growth strategy to consider if you and another business identify mutual synergies to gain; but it also can provide an alternative if you don’t want to sell the company immediately, or if one party is not interested in buying the other immediately and wants to explore a relationship first. Perhaps an otherwise potential buyer is not interested in buying because your business is not in a high-growth phase, yet your business has a certain market that is attractive. Or, a potential partner may be a foreign company that is seeking a presence in the United States but does not want an ownership stake, or is not yet ready to jump into a new geographical market “with both feet” and wants to stagger its position and exposure.

The following lists some of the advantages and disadvantages of a corporate partnership or joint venture to consider.

Advantages
- May provide access to new markets
- May expand product offerings
- May deepen relationships with customers
- May provide access to technology, people, material supply, and capacity
- May provide opportunity to acquire partner or to be acquired in a two step process

Disadvantages
- Complicated to set up with appropriate detail
- Can be difficult to sustain long term
- Partners may not be contributing equally or may have disparity in economic leverage and strength
- The needs and interests of the parties change
An employee stock ownership plan (ESOP) is often considered a hybrid exit strategy, since the owner is selling to a trust that is owned by the employees but often still managing the business. It can, however, be an effective strategy to generate liquidity and address key succession and employee issues envisioned by an owner or group of shareholders. Because of the complexities of the fiduciary issues, valuation, ownership restrictions, and applicability for multi-national companies, an ESOP is sometimes found to be too complex to live with for the amount the company is going to receive, though it can be an excellent vehicle in the right situation and expectations of value. Tax planners often cite an ESOP could be ideal for someone looking to take proceeds from a business to invest in stock, assuming the price is acceptable to the buyer.

The following lists some of the advantages and disadvantages of selling to an ESOP:

**Advantages**

- Allows owner to pass ownership on to employees/management in a tax-efficient manner
- A corporation can make tax-deductible contributions to the ESOP
- Structured tax benefit on repayment of loan principal
- Allows tax-deferred roll-over of the price paid for the seller’s stock

**Disadvantages**

- Possible irregularities of cash flow and need for additional financing due to requirement to cash out employees at retirement
- Increases administrative burden, including DOL and IRS requirements, as well as fiduciary duty to ESOP
- Transaction valuation is generally not as high as with other options due to reliance on leverage and lack of synergies
- No new equity is provided for business use—possibly limiting future growth capital—if ESOP used for liquidity event
IPOs

A company may begin to think about going public (offering securities of the company for sale to the general public) when the funding required to meet its business growth objectives has exceeded its debt capacity. While under the right circumstances “going public” may be attractive, the costs of an IPO are high, and sellers rarely have as much control after the transaction as they expect. Given the complexities of today’s financial markets and heavy costs of exchange listed status, an owner should carefully consider whether the public market option is the most logical in light of other alternatives.

The following lists some of the advantages and disadvantages of an IPO.

Advantages

– Provides access to long-term capital
– Improves financial position
– Provides liquidity for shareholders
– Prestige and public awareness
– Increases ability to attract and retain key personnel via stock options
– Additional currency for future acquisitions

Disadvantages

– Lack of operating confidentiality
– Pressure for short-term performance
– Reduced business flexibility
– Initial and ongoing cost; Sarbanes requirements and internal control
– Executive compensation scrutiny
– Potential liability to public shareholders
**Sale or transfer to family members**

A sale or transfer of the business to the next generation is often an issue of estate planning rather than structuring a transaction. How and when you will relinquish management control to the next generation is also a primary issue with this exit option.

The following lists some of the advantages and disadvantages of selling or transferring a business to family members.

**Advantages**
- Allows family members to enjoy fruits of owner’s labor
- May allow for involvement of other key managers
- Owner’s legacy lives on
- Minimal cultural disruption
- Tax advantaged transfer can be accomplished with proper planning

**Disadvantages**
- IRS scrutinizes family transfers of ownership
- Estate transfer may require significant funding for estate tax
- May need to prove the price paid is reasonable if the IRS audits the transaction
- Salary continuation agreements need to be established in light of value paid for the seller’s stock
Keeping your eye on the goal

Identifying the right buyer is dependent upon, first, identifying your goals. Do you want to retain a financial stake after the sale in order to participate in some upside potential? Or are you ready to completely cash out? Do you want to retire or do you want to remain involved in the business? If you want to remain engaged, what amount of control would you like to retain and for how long?

Finding the right buyer for your business is possible only when you have thoroughly considered your objectives and priorities, both business and personal and 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).

The right buyer is often the one who will attach the optimal value to your business. But choosing the deal that’s right for you may not be all about money. If you wish to protect your legacy, you might look for a buyer who will keep your name on the door, or who won’t fire key employees for three years, or who will not close your plant and take all of the production to another country.

Only you can decide which of the criteria are the most important in your definition of value. While such a decision may not be simple or straightforward, gathering information on the pros and cons of each option as well as the likely process that will need to be undertaken is a smart way to help you reach such a determination.
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