VALUFINDERGroup℠
Middle Market Investment Banking

FOR OWNERS

An Owner's Alternatives

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Most owners of middle-market businesses assume that to realize some or all of the value of their company an outright sale is required. While a sale is one alternative, it is hardly the only option an owner has to enjoy a liquidity event. In the pages linked below, and in the "InHouse Recap" section that follows, we provide a brief overview of several of these options and structures for monetizing your company's value. At your convenience, Valufinder is prepared to answer your questions and to discuss in detail any of the following options.

The measure of choosing well, is, whether a man when he looks back at the facts still feels good in what he has chosen
\- Julius Kotlowitz

- **Outright Sale**
- **Earnout**
- **Leveraged Recapitalization**
- **Additional Options**
- **Discover Your Alternatives**

In an Outright Sale you receive cash or some combination of cash, notes and stock for your entire ownership interest. You may remain under contract for some period of time to ease the transition for the buyer but you retain no equity in your specific business. Should the transaction be a merger for stock of the buyer, then you would retain a degree of ownership in the combined entity. A sale is usually structured as a purchase of the stock or the net assets of the company.

> ***Knowledge gives a certain amount of power. A knowledge of details has served in many a crisis. A knowledge of details has often caught an error before it became a catastrophe.***
> - Aimee Buchanan

Stock Sale

In a stock sale the corporate entity is sold and the buyer assumes all assets and liabilities, both known and unknown, including contingent liabilities. These would include the costs of environmental cleanup, a lawsuit which has been filed but not decided or a post-closing lawsuit filed for a product or service sold under the original owner. The seller only pays taxes on the capital gains realized on the shares sold. With current long-term federal capital gains rates at 15%, this is very beneficial to the seller.

Asset Sale

In an asset sale the buyer attempts to limit their exposure to potential liability by specifying in the contract which assets are being purchased and which liabilities assumed. An asset sale can also be helpful to a seller by allowing the owner to retain certain assets not essential to operating the business such as real estate or certain accounts receivable. However, the tax treatment is generally less attractive to a seller who owns a "C" corporation since the possibility of double taxation exists.

Assuming the net assets are sold and the principal asset of the "C" corporation is the cash proceeds from the sale, the company is taxed on the gains realized on the sale of assets AND the shareholders are taxed on their capital gains when the corporate entity is liquidated and the cash distributed to the owner(s). Usually in an "S" corporation or an "LLC", some or all of the company's taxation may be avoided and only the owner will pay taxes.

Since the buyer typically prefers an asset sale and the seller a stock sale, these differences and their relative values are usually hammered out in negotiations. We are simply highlighting the differences between a stock and asset sale. A seller needs to consult with a tax advisor to explore and understand their personal circumstances in greater depth.

Sometimes a buyer and seller cannot agree on a purchase price. Based on a subjective interpretation of the meaning or impact of certain facts, you may feel your business is worth 7x EBITDA while the buyer thinks a 6x multiple is more appropriate. As examples: the buyer may feel the most recent EBITDA figures are not necessarily indicative of future potential since the owner had two down years and then a large increase in the current EBITDA; or, the owner has invested heavily in a number of new initiatives that the owner thinks will generate significant returns within the next 18 months and the buyer is not sure of the amounts, the timetable, or the additional monies needed to make the initiatives successful.

In these instances, an Earnout can bridge the gap. An earnout is a contingent payment the buyer makes to the owner IF certain previously agreed upon goals are achieved after the sale of the business. While an earnout can be tied to a near-term goal, the typical earnout period is between three and five years and the owner can usually remain, if they so wish, in their current management position.

Customarily, the seller and the buyer agree on a set of projections; the earnout is typically a percentage of some easily measured item on the income statement such as Revenues, Operating Profit or EBITDA. It can be paid, if earned, at the end of each fiscal year during the earnout period or cumulatively at the end of the earnout period. The variations of an earnout are limited only by the ingenuity and creativity of the owner, advisors, and the buyer.

The Leveraged Recapitalization is another important liquidity tool for sellers who wish to obtain between 85-95% of the value of their business in cash but still want to own 10-40% of the equity of the company. This option allows the owner to still own a meaningful percentage of the Company yet it helps solve some vexing business issues such as: how to transfer the business from one generation to the next; how to diversify owners' wealth when much of their net worth is tied up in their businesses; how to attract growth capital; how to resolve differing shareholder objectives; and allowing the buyout of select shareholders.

With the leveraged recapitalization (recap) you sell a significant portion, approaching 100%, of your equity to a private equity buyer group versus an outright sale to a strategic buyer. The buyer uses a combination of its own equity (cash) from its investment fund and bank/institutional debt to finance the purchase. You then make a small discounted investment with some of your proceeds, possibly on a tax-free rollover basis, in the equity portion of the new capital structure, retaining between 10 to 40% of the equity. No taxes are due on the rolled over portion until the second liquidity event, two to six years down the road. In addition, the current owners would maintain management control, their customary titles and typical compensation for a senior manager.

> ***There is no better measure of a person than what he does when he is absolutely free to choose.***
>
> -Wilma Askinas

In many cases the initial payment you receive AND the "second bite of the apple" you take later can provide an overall value far in excess of what you would achieve if you sold outright to a strategic buyer. As an example, a seller could end up with 90% of the cash value (pre-tax) of the company in the bank and continued ownership of 33% of the company.

Depending on the company's circumstances, there are many different structures that can be created in a recap. One interesting variation is an InHouse Recap.

InHouse Recap

An InHouse Recap is ideal for owners who do not want to sell their business but would like to create a personal liquidity event—taking out a large percentage of their company's value in cash, without selling a meaningful portion of the business or signing any personal guarantee. Moreover, the cash dividend is typically only taxed at a 15% federal tax rate. For more information on an InHouse Recap, please view our **InHouse Recap** section.

Minority Investor

A related option to the Leveraged Recapitalization is using a Minority Investor. In this option, you receive nearly full value in cash for your business but make a slightly larger reinvestment than in a typical leveraged recap and end up owning in excess of 50% for majority control. The private equity buyer would be in a minority position. Not all financial buyers are comfortable with doing these deals but we maintain good ties to the middle market buyout firms which welcome them.

With either the leveraged recap or minority investor option, to the outside world nothing will have changed. Furthermore, this new arrangement with sophisticated and seasoned partners allows you to tap into an extensive network of financial and management resources. You can take advantage of new market opportunities, achieve new levels of growth, and then take that "second bite of the apple."

Employee Stock Ownership Plan

While a less common transaction tool, the Employee Stock Ownership Plan (ESOP) offers significant advantages to both owners and their employees. An ESOP functions like a profit sharing plan. The employees, in essence, purchase the business from the owners via a leveraged ESOP loan and have a path to eventual ownership as the loan is paid down.

The company obtains a loan from a commercial lender and lends that money to the ESOP, which buys stock from the existing shareholders. Over time, the company contributes to the ESOP to service and pay down the debt. Both the interest AND principal payments are tax-deductible to the company. This tax incentive enhances cash flow and working capital for the company. As the loan is repaid, stock is allocated to particular employee accounts with the ESOP.

Owners get very favorable tax treatment when they sell their stock to the ESOP. As long as owners sell 30% or more of their equity, they can defer any taxes on the gain AS LONG AS they reinvest the proceeds in securities (stocks and bonds) of domestic operating companies, public or private.

However, ESOPs have some major limitations. They are complicated to set up and administer, and require an annual valuation much like a company pension plan. Only companies with stable or strong growing earnings should consider taking on a leveraged ESOP loan.

In addition, if you want to step aside as an owner but do not have good back-up management, then an ESOP is not for you. Usually the owner cannot cash out completely but gets the proceeds over several years as the loan is paid off. Moreover, while you remain in authority, your decisions are more transparent to your employees/fellow owners and possibly subject to review.

The ESOP valuation and purchase price may be subject to possible review for being excessive and a breach of the owner's fiduciary responsibility to the company. Further, since the valuation tends to be aggressive because of the ESOP's enhanced cash flow (provided by the ESOP's tax benefits), it cannot be replicated by a normal buyer. Therefore, it becomes difficult to sell an ESOP company to a non-ESOP buyer at the same multiple.

Private companies implementing an ESOP usually must provide a "put option" to employees, allowing them to sell their stock back to the company at fair market value usually determined by the valuation and under certain conditions: retirement, termination, or resignation. This can have a detrimental effect on the company's cash flow, especially if a number of employees exercise their options at the same time.

We hope the above overview was helpful in demonstrating that an owner may have a number of attractive alternatives to completely selling. At your convenience, Valufinder is prepared to explore with you your alternatives before you make any final decision. However, whatever decision you make, Valufinder is prepared to facilitate the appropriate process necessary for obtaining your goals, including nothing at all if that is your choice. Please **contact us** with any questions or for more information, on a confidential basis and without any obligation.

***A single conversation across the table with a wise man is worth a month's study of books*.**
Chinese Proverb

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