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BUSINESS OWNERS' EXIT OPTIONS

Business owners planning for retirement may have a greater range of exit options available to them than they realize. If they truly are ready to "let go" and cash in on the fruits of their success, then an outright sale of the business usually is the preferred route.

However, some owners may wish to give their key managers the opportunity to take over the business, but are concerned that these employees don't have the capital to match the price available from outside buyers. In fact, under certain circumstances, existing management can be the best buyers.

Finally, some business owners are not yet ready to spend their remaining days at the beach! After decades of building the value of their business, they cannot bear to let go entirely. This attitude is consistent with the entrepreneurial personality. Such people prefer to remain in control, but just want to take some money "off the table" for personal security.

A creative, well-structured financing package can address this array of exit options.

Competitive "Auction" Sale

There are two types of third-party buyers for businesses: strategic buyers and financial buyers.

Strategic buyers are companies in the same or related businesses that recognize the value of an add-on acquisition that provides economic synergies to their existing enterprise. For example, incremental business volume to a strategic buyer often can be added without duplicating infrastructure costs that already are in place, thereby yielding more to the bottom line. For this reason, experienced investment bankers/sell-side brokers always target strategic buyers first when they market a business for sale. Simply put, strategic buyers usually pay a higher price.

One cautionary note when dealing with a potential strategic buyer is the risk of revealing confidential customer information to a competitor. This concern can be addressed up front with a confidentiality agreement, but it is important to limit revealing the most sensitive information until there is a binding agreement between the parties.

Financial buyers are a different target. These are private investment funds seeking acquisitions in which they can build value over a five- to seven-year investment horizon. The price they are willing to pay is driven purely by the economics of their investment returns.

Sometimes these funds already have existing portfolio companies in the same industry that are seeking a strategic add-on. This is the "platform" on which they intend to build an industry concentration that they believe has attractive potential. In this sense, the private equity buyer is making a strategic investment and likely is very knowledgeable about the business owner's industry. The supply of private equity funds today far exceeds the supply of good investment targets, so these financial buyers are ideal targets when running a competitive auction sale.

Management Buyout

Some business owners feel an understandable obligation to give their management team a succession opportunity, even though these key employees may have little capital of their own. After all, these are the people who helped to make the owner rich! The owner also may realize that if the business is sold to a strategic buyer with management already in place, some of the company's key people probably will lose their jobs.

However, there also are self-serving reasons beyond gratitude and kind-heartedness for why owners should consider their key executives. The truth is that some business sales cannot take place without the eager participation of lead management. Moreover, successful management teams often can be the most competitive buyers. There are two paths to a management buyout, each with contrasting risks and opportunities.

Private Equity Partner - Private equity funds nationwide are eager to partner with proven management teams in the acquisition of their businesses. If the key managers have a good track record and a vision for further growth and profitability, they can be an absolute magnet for investment capital!

The private equity fund will take care of all necessary capital raising – including their own equity, senior bank borrowings and anything else needed to fully fund the purchase price, expansion capital and working capital going forward. The management team will not be required to guaranty any borrowings. They will receive a "carried" minority ownership interest, often with the right to earn more based on performance, as well as employment agreements.

The management team also will be under persistent pressure from the investor to increase value through growth, additional profitability and add-on acquisitions. If successful, management shareholders can make a lot of money upon the private equity firm's exit – through either private or public sale five to seven years later. However, as controlling shareholder, the private equity firm determines the exit schedule and terms, not management.

Leveraged Buyout - An alternative form of management buyout is the classic leveraged buyout, where the assets and cash flow of the target company are used to raise the maximum debt possible to buy out the controlling shareholder. The total funds needed to cover the purchase price and working capital usually cannot be raised with bank debt alone. Additional funds may be raised in the form of "mezzanine" financing – that is, long-term debt that is subordinated (junior) to the senior bank debt and accordingly is viewed by the bank as underlying "capital."

Mezzanine financing is available through specialized funds of all sizes, beginning at $1 million and up. It's a complex form of financing that, due to its subordination features, is quite expensive and should be used only as a supplement to less costly bank debt. A primer on this form of financing is available through the link below:

http://lrnathanassoc.com/funding_sources/index.html - mezzfunds

A seller's note taken back by the owner may be negotiated as a means of boosting the price further, but this obligation likely will need to be subordinated to both the bank and mezzanine debt. This non-cash portion of the selling price, sometimes cynically referred to as a "hope note," might be secured by the acquiring management's new ownership shares. If the total financing in a leveraged buyout is structured properly, the management team should end up with a controlling ownership position. However, in the absence of their significant equity contribution, the key managers likely will be expected to personally guaranty the senior bank portion of the debt.

Shareholder Recapitalization

Business owners who have built successful companies over many years, but are not yet ready to relinquish control, might wish to take some money "off the table" for personal financial security. A well-structured leveraged recapitalization can enable owners to put cash into their personal bank accounts and preserve the outright sale opportunity for another day.

A leveraged recap cannot rely solely on bank financing. Banks are reluctant to see corporate borrowings withdrawn for personal use. Moreover, bank loans usually require the personal guaranty of the majority shareholder, which would be inconsistent with the owner's objective of diversifying personal risk. The use of long-term subordinated mezzanine debt as a supplement to bank financing is a recognized and appropriate way to monetize ownership value. Moreover, banks view mezzanine loans as junior capital that strengthens the balance sheet. Mezzanine funds will not restrict working capital and usually do not require a personal guaranty.

Conclusion

Business owners have a range of choices as they consider retirement, winding down, or monetizing their ownership value and preserving the option of an outright sale for another day. They may choose to sell to a strategic buyer, which has the potential to yield the highest price, or to a financial buyer. They might consider selling to their deserving management team in partnership with a private equity investment fund, or through a leveraged buyout. Finally, they might elect a partial cash-out through a shareholder recapitalization.

Whatever their choice, a well-structured financing package that is customized to fit individual objectives can expand the range of realistic options available to controlling shareholders seeking an exit. However, each situation is different, with its own personalities, issues and conflicting priorities. The good news is that abundant capital is available in today's market to facilitate the optimal solution for each case.

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