

# Planning an exit from your business and the role of partial recaps

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The M&A market is back. Through July of 2010, the number of completed U.S. middle-market transactions (defined as deals less than \$1B in value) totaled more than 3,300, a 77% gain from the prior-year period and the highest year-to-date figure since 2000. This recent rebound in the M&A activity has many business owners once again thinking of exit planning. Succession planning is one of the most important issues that owners of closely-held, family-owned businesses face. In many cases, the business represents the single largest asset of the individual's estate and represents the primary source of income for multiple family members. Yet many business owners find that as they near retirement, they have neither selected a successor, nor instituted a clear plan to address the transition process. In an ever-changing marketplace, it is difficult to determine what a business is truly worth to an outside buyer – the fair market value of the business – and what factors can significantly impair or enhance that value.

## Demographic Trends

Demographics tell an interesting story about America's family businesses today. A generation of post-World War II entrepreneurs succeeded in creating great wealth and must now decide how to pass on their estate to their heirs. In many cases, day-to-day owners/operators of businesses are reaching an age at which retirement, while not imminent, is on the horizon. Several recent studies by a consortium of accounting and consulting firms suggest that as many as 50% of all closely-held, family-owned businesses in the U.S. will face some ownership transition issue in the next five to seven years due to the number of retiring baby-boomer entrepreneurs.

When planning a business exit, the most common solution is the sale of the business to a strategic buyer, the current management team or the employees through an ESOP, all of which can lead to unanticipated problems. Not only are there the obvious risks of fluctuations in market conditions and valuations at given points in time; but more importantly, there is also the risk that a deal cannot be completed at terms agreeable to the owner. Business owners who attempt to sell their business coincident with retirement often encounter substantial difficulty in finding a willing acquirer other than strategic buyers (i.e. a competitor, supplier or customer). Many potential financial acquirers (private equity and venture capitalist groups) require ongoing involvement from existing management because they consider the owner/operator key to the continued success of the business. But often no other member of the existing management team has the necessary skills to ascend to this substantial role in the business, which can prolong the owner's involvement in the business and delay complete retirement.

Resolving this dilemma is not as difficult a proposition as it might first appear, especially if the business owner plans a staged approach to exiting the business. One method of accomplishing a staged exit is through a partial recapitalization – a transaction in which a financial partner buys either a controlling or minority stake in the business, with the owner retaining the remaining portion of the equity. To finance the purchase, the financial partner invests its own funds and uses the company's balance sheet and earnings to support a leveraged capital structure. Under this structure, the owner continues to be involved in the business until a second-stage exit, at which time the owner sells the remainder of his/her equity in conjunction with the equity sponsor.

## Partial Recapitalization Benefits

By structuring the exit as a partial recapitalization, the business owner is able to achieve several important benefits, some of which provide the owner with advantages not achieved through an outright sale, including the continuation of salary and benefits as well as deferral of capital gains taxes.

**LIQUIDITY & DIVERSIFICATION** At closing, the owner generates liquidity by selling a portion of their equity, thereby enabling diversification of the owner's investment portfolio through the reinvestment of the proceeds in a variety of asset classes, as illustrated in the following figures.

The portfolio, which prior to the transaction had been concentrated largely in a single asset, can be diversified post transaction to consist of a number of investment instruments in both domestic and global markets. Diversification of an investment portfolio in advance of retirement is regarded as a core strategy in attempting to protect the overall value of the owner's investment portfolio.

**OPERATIONAL CONTROL** Many business owners have built their busi-

nesses over a long period of time and giving up control of the business is difficult to embrace, especially if done abruptly. Fortunately, the retention of existing management is an integral part of most private equity sponsors' investment strategy, as this approach provides the business with continuity and an experienced team that is focused on growing the business. Private equity firms prefer to macro-manage a portfolio of holdings, rather than micro-manage the daily operations of their portfolio companies.

However, as a significant investor, private equity firms often retain certain elements of control, especially if the holding is underperforming. For example, private equity groups will often negotiate the right to replace incumbent management with their own operators, should the company not perform as expected. In order to facilitate the growth of the company and to supplement the talents of the management team, the private equity sponsor provides business and industry expertise that may not have been previously available. To provide this counsel, private equity managers often employ a mix of investment and operational talent, calling in professionals with investment banking and management consulting backgrounds, as well as senior executives with significant experience in the target industry. Most often these professionals have track records of managing rapid internal growth and assimilating acquisitions as part of a leveraged build-up plan.

**ELIMINATION OF PERSONAL LIABILITIES** An owner of a privately-held business often must personally guarantee their company's debt in order to secure a sufficient level of capital. In a partial recapitalization, however, the private equity sponsor often eliminates the need for the owner's personal guarantees, which substantially decreases the business owner's risk in the event of the company's default under the terms of the debt.

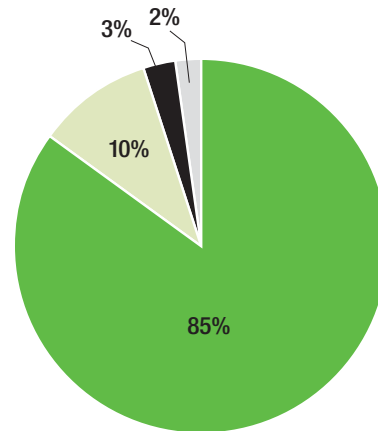
**UPSIDE POTENTIAL** Because the business's new equity partners typically anticipate exiting the investment within a five-to-seven-year period, the owner participates in any growth in the business during that time period. Using a partial recapitalization, the business owner may have a "second bite at the apple" – a second liquidity event – which in some cases can exceed the amount received from the initial sale. This second liquidity event is often structured as an outright strategic sale or sale to another financial partner. By retaining equity in the company, the selling shareholder is able to benefit from the enhanced growth prospects related to the influence of private equity capital and management experience. Also, the private equity group is assured that the owner has "some skin in the game" and their incentives for growth are clearly aligned.

**GROWTH CAPITAL** To fund add-on acquisitions or major capital projects to realize growth and cost savings beyond management's initial projections, private equity groups will often provide additional capital above their initial investment. These add-on acquisitions can substantially increase the overall value of the entity, thereby providing the business owner with an equity stake in a more rapidly growing enterprise going forward.

## Private Equity Capital Availability

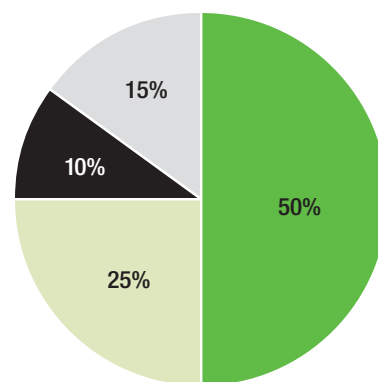
Private equity funds are still perched upon enormous amounts of uninvested capital, despite an uptick in M&A activity. These surpluses of capital are the product of the earlier drought in private equity deal activity, combined with record-breaking fund raising years. In the last two years, private equity fund raising exceeded investments by approximately \$200 billion. Presently, private equity is seeking a home for more than \$400 billion of capital. Assuming a modest

Pre Transaction - Concentrated Portfolio



■ Equity in Family Business  
■ Fixed Income  
■ Stocks & Mutual Funds  
■ Real Estate & Alternative Investments

Post Transaction - Diversified Portfolio



■ Equity in Family Business  
■ Fixed Income  
■ Stocks & Mutual Funds  
■ Real Estate & Alternative Investments

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1:1 debt-to-equity ratio, this translates into more than \$800 billion of potential M&A activity. Private equity funds are typically structured with a limited lifetime of ten years, with portfolio investments typically occurring in the first three to five years. To avoid returning capital to their limited partners, fund managers are expected to be aggressively seeking transactions over the coming months. A significant amount of this capital should make its way into the middle market. Of the firms that have raised new funds in 2010, more than 75% are targeting the middle market.

Although in most instances investors demand a controlling interest in the company, they leave the responsibility for day-to-day operations in the hands of the existing owners and management team. While this abundant capital means that partial recapitalizations are more popular now, the overwhelming number of private equity firms in the market makes it a daunting task to manage the process of soliciting the interest of and negotiating with several potential partners. Properly done, a managed process selectively teases out the best pricing and terms of

a recapitalization transaction with a value-added investor while minimizing disruption to daily operations.

#### Continual Succession Planning

Careful and detailed succession planning is an important component of achieving a business owner's objectives (funding an owner's retirement goals; ensuring the health and survival of a family-owned business; etc.). As retirement approaches, every private business owner should begin to ask some of the important questions continuing to update his or her succession plan as the business evolves.

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for value that was not there. Rather than paying all of the purchase price to the seller at the time of the transaction, an earn-out provision enables the buyer to pay some (typically most) of the purchase price at closing, and pay the balance only if, and when, certain financial results are achieved.

Depending on the circumstances, it may be prudent for a potential seller or buyer to employ the services of a valuation professional in order to obtain an independent opinion of value of the subject entity. For example, in certain situations, financial and/or tax reporting rules and regulations may require an opinion of value from an independent valuation professional in order to comply with applicable standards. In other cases, the potential seller or buyer may not possess the necessary skills or knowledge to reasonably estimate the value of the subject entity. Moreover, while not strictly required, we recommend that a potential seller or buyer use a valuation professional who is accredited, such as a Certified Valuation Analyst (CVA) through the National Association of Certified Valuation Analysts (NACVA), or a Certified Public Accountant Accredited in Business Valuation (ABV) which is a designation through the American Institute of Certified Public Accountants

(AICPA). These accreditations require the valuation professional to demonstrate the necessary specialized education and experience in order to express opinions of value in conformity with applicable professional standards. By capitalizing on potential strategic advantages and by maximizing the structure of the deal, a buyer has the potential to increase his return on investment. Combining these opportunities with the soft market prices resulting from the recent recession, it appears that now is an ideal time to explore acquisitions as a way to grow one's business and improve profitability.

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2013 could lose almost 29% of their taxable gain to federal and state taxes.

Financing options in a leveraged ESOP transaction include traditional bank financing, seller financing, and even third party mezzanine financing. Generally, leveraged ESOP transactions are financed with a combination of two or three of these options. The use of mezzanine financing is a growing trend, allowing selling stockholders to realize a larger portion of their sale proceeds in cash vs. seller notes. Ultimately, it is important to design a financing structure that meets the selling stockholders' goals and objectives, while allowing the company flexibility to fund future growth or manage a potential downturn in the business.

#### Company tax benefits

Although tax benefits exist for less than 100% ESOP owned companies, including the ability to repay the ESOP loan using pretax dollars, the combination of a 100% ESOP owned company taxed as an S corporation is unmatched. Under a 100% ESOP S corporation structure, the company's earnings are free of federal and generally state income tax.

The ability to shelter company earnings from federal and state income tax rates that can be 40% or more can be significant. First, the ESOP loan incurred to fund the purchase of selling stockholder stock can be repaid more quickly, all other factors equal. Second, the company can compound future growth on a pretax basis. Third, acquisitions of domestic corporations can be paid off more quickly and yield higher returns as their future earnings are also income tax free. A

growing number of ESOP companies have seen tremendous success from this unique tax structure. This tax structure could also become more meaningful in an environment of potentially rising tax rates.

It is also important to note that in a lot of situations and when properly designed, significant tax savings can be achieved in the initial year of the ESOP. Such tax savings often far exceed the costs of establishing the leveraged ESOP.

#### Benefits to employees and management

ESOPs can provide long term employees retirement security. Generally, in order to participate, employees must be at least 21 years of age and have worked for the company at least one year.

Stock is allocated annually, as the ESOP loan is repaid, to eligible employees based on that employee's compensation compared to the company's total payroll. For example, an employee with a \$50,000 salary will receive twice as many shares as one making \$25,000. It is important to note that stock is being allocated on employees' behalf, and they are not legally receiving shares of stock. The legal stockholder is the ESOP trust. Employees are therefore beneficial owners only with regard to the value of the stock allocated to their participant accounts.

Employees must also earn the right to receive the assets in their account when they terminate employment with the company. This right, known as "vesting", usually takes from three to six years. Further, once they leave and are vested, there are special rules regarding when they are entitled to receive a distribution of their account balance. Generally, ESOPs are designed so employees receive a distribution of cash,

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information presented to it in the context of a sale event.

Various business practices that are tolerated in companies without outside investors will need to be discarded as part of the process. Absent compelling circumstances, family members of senior management will need to be removed from the payroll. Perks such as automobiles, sporting events, tickets and country club memberships will usually be discarded. Related party transactions such as leases of buildings by founders to the company or shared use of facilities or equipment will be discontinued. Decisions will generally be made on the narrow basis of what will drive the ultimate objective of increasing earnings.

Except under unusual circumstances, once a private equity investment is made, the board will shift to a majority of outside directors. Most of these will be from the private equity firm itself, although industry experts may also be brought in as board members. The board meetings will be focused events with attention directed to both the achievement of short-term objectives together with long-term strategic planning.

A key consideration of a private equity firm is liquidity in its investments, as return on investment can be enhanced by delivering a return to the fund's own investors within a relatively short time frame. The private equity firm will insist on terms that allow it to exit its investment in a portfolio company at the appropriate time. The mechanism for achieving this liquidity is the private equity firm's right to force the company to repurchase their investment after a fixed number of years. This put right will typically be in the form of a right to sell its shares back at the greater of fair market value or the amount invested plus a fixed return. Although this put mechanism exists in almost deals, it is rarely exercised. Rather, the existence of the put right will compel the company to put itself up for sale. The sale will either come through a strategic buyer or through another private equity firm that will take out the existing investor.

Members of management who adapt to the world of private equity can thrive. In fact, many members of management will follow a private equity firm from deal to deal. Those who do not adapt to this world will typically have a short and unpleasant experience.

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not stock. In addition, it is important to design a leveraged ESOP so that significant cash distributions are delayed until the ESOP debt is repaid.

While key management will generally participate in the ESOP, it is often important to provide them additional equity incentives in the form of some type of deferred compensation arrangement. When properly designed, such incentives can a) align key management's goals and objectives with that of the ESOP and b) provide an incentive to remain with the company long term. Further, if the selling stockholders are part of key management, they can also participate in an equity incentive plan, allowing them to participate in future company appreciation. It is important that such incentives, when taking into consideration their total compensation package, be considered reasonable.

#### Is an ESOP for you?

Like all succession vehicles, ESOPs are complex and require careful consideration before implementation. However, with careful consideration and planning using the help of qualified ESOP advisors, for certain companies an ESOP might be the right solution.

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