

Mind Your Own Business

In this issue: Considering Exit Strategies



Inside:

- Responding to an Unsolicited Buyer
- Preparing Your Company for Exit
- There's More Than One Way to Exit a Business
- Tax Aspects of an Exit
- Cash or Shares
- Reasons Owners Sell
- Should You Hire an Investment Banker

“Consider an exit strategy less as a termination, and more as another logical transition for both you and your company.”

Benefits of an Exit Strategy

- Protects the value of the business you've built.
- Creates a smooth transition to your management team.
- Creates a strategic direction for your business's growth.
- Avoids burdening family members if the exit is unexpected.
- Manages expectations of family members and avoids conflicts amongst them.
- Generates an income for retirement or disability.
- Enhances the future worth of your business.
- Reduces or defers the potential tax impact on your estate, spouse, or family.

Why design an exit strategy while I'm still enjoying the business?

Think of it this way: your business is an asset in which you have invested money. It has a revenue stream that supports your salary, your lifestyle and possibly a distribution of yearly profit. The business should be increasing in value so that when the time comes, you'll be able to harvest additional wealth and/or preserve wealth for your family.

Most owners plan for business growth but planning an exit strategy is the most commonly overlooked planning consideration. At the same time exit strategy plays a

key role in determining the strategic direction for the company long before you actually do exit. By not planning an exit strategy beforehand, business owners, their heirs, or their successors may find that their options are limited in the future.

Your business goes through many transitions and you should think of your exit strategy as another, very important, business transition. Any major future change in the business (rapid growth, an acquisition, merger with another business, a new product line, more family

members in the business, etc.) means that you are, in effect, exiting the business as it is today. Unless you plan these exits or transitions then they'll probably happen in unexpected ways.

Consider an exit strategy less as a termination, and more as another logical transition for both you and your company. If its a planned and managed transition it will have benefits for the business, its owners and their heirs.

Plan for the Future of Loyal Employees

If you've built your business up over many years you'll not have done it alone. You'll have a core of loyal employees who have accompanied you on the journey. If you don't plan for and control your business exit then you may be doing these employees a disservice. Consider this example:

Mo Siegel built up the business of Celestial Seasonings® over many

years based on the passion he instilled in his loyal managers and other employees. It grew to be the largest supplier of herbal teas in the US. In 1984 he sold Celestial to Kraft® for a very large sum. The culture of Kraft® was very different and they changed the culture of Celestial to match it. It was a bad fit. Many of Siegel's hand groomed managers left in anger and disgust.

Four years later Siegel bought the business back, restored the old culture and recruited back many of those lost managers. In 2000 he found a company that shared Celestial Seasonings® vision. He merged his business with Hain Pure Foods® to form Hain Celestial Group®. Siegel stayed for three more years to oversee the transition and then retired in peace.

“To get the best price and terms you want multiple buyers bidding against one another.”

Responding to an Unsolicited Buyer

Business owners may receive unsolicited offers to buy their business from companies or individuals. Often these offers are from those simply “fishing” for bargains rather than executing a defined growth or acquisition strategy. These are worth reading but seldom worth responding to.

In other cases you may receive an inquiry from a business that has knowledge of your markets and a clear idea of what type of business they are seeking to acquire. This might come directly from the buyer or, more often, through an intermediary such as an investment bank. This is flattering but is it worth responding to?

If you’ve given any consideration to an exit from the business, even if that exit is a few years away, it would probably be worth a response. But how should you respond?

Qualify the inquirer. If it’s from a business or individual do they understand what business you’re in and do they have the financial resources to acquire it? If its from an Investment Bank does their client have this understanding and these resources?

Ensure Confidentiality. Before entering into a discussion have them execute a Non-Disclosure Agreement to ensure that the fact of your discussions, as well as their content will not be leaked to employees, customers or competitors as this could be damaging. An Investment Bank can give you an added layer of confidentiality between yourself and potential buyers.

Understand their strategy. What are their plans for your business, your employees, your customers? Does this fit with your vision?

How do they value a business?

It may be too early to talk about a price but its not too early to ask about how they arrive at a value for a business that they want to acquire. Do they only value the physical assets? How do they value your expertise and that of your employees. How do they value your customers or “book of business”, etc.

Is it a fair price? If you have only one potential buyer you’re not getting the best price or the best terms. To get the best price and terms you want multiple buyers bidding against one another. The best way to get multiple bidders is go to market with an experienced Investment Bank as your partner. You will net considerably more from the transaction and get better terms.

“Be sure that you have solid employment agreements in place that include provisions to protect the company’s trade secrets (customer lists, business practices, etc.).”



Preparing Your Company for Exit

You’re probably not selling your business for the first time. If you’ve raised capital from a bank or from investors you sold the business to them. Not the whole business but its value. Now you’re selling all of it but many of the same factors are important.

1. Financial statements are amongst the first and most carefully examined documents in a sale. You will typically need to show the last three years financial statements very early in the process. These should be prepared by an accountant and, if possible, be audited. Use footnotes to explain any unusual changes in the numbers (e.g. loss of a major customer, etc.).

2. Taxes are also important later in the process. Your federal and state tax returns for the last three years should be in order. Business taxes, sales and use taxes, payroll taxes, property taxes, etc. should all be up to date or they will needlessly become an issue later on.

3. Management is likely to be a key asset in the sale. A buyer will want to meet key managers and to be assured that they will remain at least through a transition period. These key managers should be informed about the exit plan before you go to market and should be provided with incentives to stay. A buyer may want to bring in their own management team

later on and you may need to pre-negotiate a severance package for your loyal team. This may be a more delicate matter if these managers are family members.

4. Employees are an asset but can also present a risk. Be sure that you have solid employment agreements in place that include provisions to protect the company’s trade secrets (customer lists, business practices, etc.). Be sure that there are no risks of suits over unfair dismissal, discrimination, sexual harassment, etc.

5. Facilities need to meet all licensing, OSHA, EPA and other regulations and requirements. Review all these areas.

There's More Than One Way to Exit a Business

Type of Exit	Disadvantages	Advantages	Issues to Consider
Merger with Another Company	Management styles and business cultures may clash. Shares of the resulting company may be difficult to turn into cash.	Seller retains some control. Seller may receive a share of a larger business.	Find a merger partner with a similar philosophy. Include provisions for your share to be bought out.
Sale to a Company	Business is subsumed into another entity. Some employees may be dissatisfied.	Seller is likely to receive cash. May be able to stay with the company in management or as a consultant.	To get the best price provide key employees with post-sale incentives.
Sale to an Individual	Seller will likely need to loan the buyer a part of the price. Seller may have to retake the business if the buyer fails.	Business is not subsumed into a larger entity. Seller may retain an interest and some control while a creditor.	The term of the loan should be relatively short and require buyer to refinance so the seller can cash out.
Sale to Your ESOP (Employee Stock Ownership Plan)	No competitive pricing of the business so price can be contentious. Employees share the burden of poor management.	Loyal employees are rewarded if the company does well. This creates an incentive to stay.	Ensure that the ESOP allows this sort of transaction and asset concentration. Get an independent valuation.
Sale to the Public (IPO)	Investors are primarily interested in large, specialty or high earning companies. Business will be subject to many regulations.	Major shareholder can get cash and still retain control and management roles.	This is an expensive and complicated process that may not produce the desired return.

The Tax Aspects of an Exit

Inevitably the sale of a business, whether an asset sale or business entity sale, has significant tax implications and a tax professional should be consulted before you enter into a purchase and sale agreement. If you're not careful you can pay more than half of the sale price in taxes.

You'll pay capital gains tax on the gains from the sale, that is

the difference between the "tax basis" of the assets and what you sell them for. Your tax basis is generally your original cost of the asset, minus depreciation claimed, minus any casualty losses claimed but there are other considerations.

The allocation of the purchase price to the various assets of the business can be an important and protracted

negotiation between the seller and the buyer.

The seller wants to realize the smallest taxable capital gain and so wants to allocate less of the price to certain assets. The buyer may want a higher allocation (and a higher tax basis) to later be able to shield operational income from taxes with depreciation deductions.

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Sale to a Private Company: Cash or Shares?

An offer from a private company may be in a combination of cash and stock in the acquirer. Should you consider it?

The shares in a private company will be difficult to convert to cash unless you have a controlling interest (an unlikely outcome of a sale).

This means that your capital will be tied up at the discretion of the buyer.

To overcome this include an option in the sale agreement that gives you the right to sell the shares back at a future date at a determined price (this is called a Put Option). A put option may be time limited in two ways:

(1) It may not be exercisable for a number of years, (2) it may only be exercisable for a short period of time. Make these terms fit your needs.

The exercise price of the option (the value of your shares) should not be left to the buyers. You should set a formula that is clear and not

subject to interpretation or manipulation. For example, linking it to total income is less contentious than linking it to profits as profits can easily be manipulated.

As an alternative to taking shares in a private company consider an "earnout".



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Specializing in the Middle Market – Businesses with sales of \$5 – \$150 million.

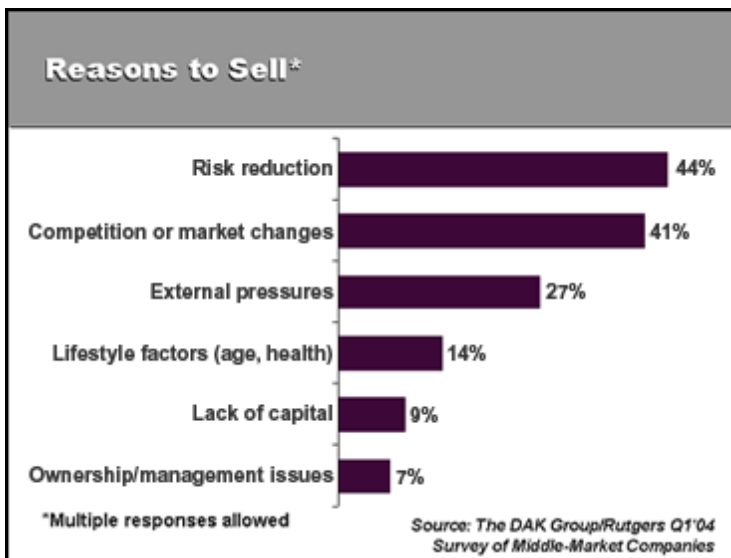
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We are a leader in mid-market sales, mergers and acquisitions, investment banking services, and corporate recapitalizations. Through our global affiliates we deliver professional client services with world-wide, world-class results.

Reasons Owners Sell

This survey was conducted in the first quarter of 2004. The responses were from owners and/or senior managers of 510 privately held companies that had been sold in the prior 12 months. The majority had revenues from \$5 million to \$100 million.

More than 50% of respondents were manufacturers. About 25% were from service. About 20% were from distribution.



Should You Engage an Investment Banker to Sell Your Business

That depends. It depends on you and it depends on the Investment Bank that you choose.

As the owner and/or CEO you're the head of your internal deal team. You have specific business expertise and operational knowledge that the Bankers will never have. On the other hand you need to keep your eye on the ball and insure that the business continues to run well and maintain or increase its value to potential buyers.

As for Bankers, there are good ones and bad ones, just like in all other professions. The bad ones can get lucky from time to time and the goods ones can make mistakes. Then there are

the cowboys who claim to sell businesses but really just want to sell a \$20,000 boiler plate "business reengineering study before going to market" (they never seem to go to market). Beware of Bankers who guarantee a sale price (the market sets the final price, not the Banker).

Its better to choose a Banker who is knowledgeable about their business (investment banking) than one who claims to be knowledgeable about your business sector. The Banker will never know your business as well as you do and claiming that they do will limit the research that they will do and will limit the universe of buyers that they present your business to. That can cost you money.

Talk to the Banker and trust your instincts. The Banker is a key hire and you've probably made many key hires in the past. Ask them questions and judge their ability to ask you the right questions. Bankers who are more interested in talking about themselves than in learning about your business are focusing on the wrong thing.

Find out about how the Banker takes a business to market. How will the business be presented and how will the prospects be found? What role will you play? What is their process?

What about fees? Investment Bankers make their money by making you a lot more money. They get paid a percentage of

the price that is paid for the business (the performance fee). This aligns their interests with yours.

Investment banks also charge an "engagement fee" at the start of the relationship. Months of work can go into research and into finding buyers and, even with multiple offers with the right price and the right terms, you can still refuse to sell. The engagement fee covers a small portion of the banks expenses incurred over those months. The fee can also screen out "sellers" who are really only "testing the water".

In conclusion don't:

- A. be shy about asking questions,
- B. be shy about negotiating the terms and fee structure.
- C. expect to get something for nothing.