intelligent edge ADVISORS
420 Lexington Avenue, Suite 400
New York, NY 10170
intelligent-edge.com

MONETIZING PRIVATELY-HELD AND FAMILY-OWNED BUSINESSES

Overview

Financial and wealth advisors often serve private clients who are wealthy on paper, but the bulk of whose wealth is tied up in the ownership of a privately-held or family-owned business. The concentration and illiquidity of this form of wealth presents challenges to company owners and their financial advisors. To complicate matters, many entrepreneurs are hesitant to cede control of their company, even though they acknowledge the need to diversify.

Fortunately, the current market environment is conducive to the sale or monetization of privately-owned businesses. Strategic and financial buyers are flush with cash, the credit markets are open, and interest rates remain near historic lows. Private companies are more profitable and their valuations have bounced back to near historic norms. Finally and perhaps most importantly, the tax rate on capital gains is at the lowest level in decades, but for how long is anyone's guess.

Most company owners and their financial advisors are surprised when they learn of the range of strategies that can be used by business owners who are desirous of either wholly or partially "cashing out". However, regardless of which strategy is used, the broad objectives the owner needs to achieve remain the same.

- First, *reduce risk* associated with wealth concentration.
- Second, *generate liquidity* to diversify into other investments.
- Third, *achieve optimal tax-efficiency* and avoid triggering an immediate taxable event, if possible.

The strategies used most frequently by business owners to monetize their private business equity include the following:

- Sale to strategic buyer
- Sale to financial buyer
- Recapitalization
- Sale to management or group of key employees
- Sale to employee stock ownership plan
- Divestiture (sale or disposition of non-core assets)
- Sale or gift to family member or second generation
- Personal line of credit secured by company shares
- Going public via an IPO

The strategy that is employed will ultimately depend upon numerous factors, the most important of which are the:

- Amount of investable assets the business owner has accumulated outside the business.
- Vision the owner has of his personal and business life after the transaction.
- Current condition and future prospects of the business.
- State of the deal market for M&A and business monetization transactions.

It is also critical for company owners and their financial advisors to grasp the importance of astute transactional tax structuring, because from the client's perspective, the objective should *not* be to simply maximize the sales or monetization proceeds, but rather to maximize the after-tax proceeds that are available to them.

Sale to Strategic Buyer

Strategic buyers are competitors or other corporations involved in the same or a similar business as the seller. Strategic buyers will typically pay the highest price for a business because of potential financial and operational synergies.

Strategic buyers are currently flush with cash because many borrowed as much as possible during the financial crisis as a defensive move in order to have sufficient cash to continue operations in the event the credit markets completely shut down. Now these companies find themselves sitting on hordes of cash earning close to a zero rate of return while paying debt service on that debt, so they feel a rather urgent need to put that cash to work.

The stock price of many publicly-traded companies has significantly increased since the depths of the financial crisis, so strategic buyers have access to both cash and stock to use as currency to facilitate transactions.

The current valuation of potential target companies, although they've increased significantly since the depths of the financial crisis, are still reasonable. Strategic buyers are therefore currently in a good position to do acquisitions and they are in fact quite active in the marketplace executing mostly "add-on" or "fill-in" acquisitions, many of which involve middle-market companies, to help spur growth in a slow growth environment.

Sale to Financial Buyer

Private equity firms are often referred to as *financial buyers or financial sponsors*. Private equity firms typically raise funds from institutional investors and are structured as investment funds. These firms identify industries with significant growth potential and make direct investments in mature and stable middle-market businesses. They look for companies that provide the opportunity to create significant value.

Private equity firms typically will *not* pay as high a price as a strategic buyer primarily for two reasons. First, they don't have the same opportunity as strategic buyers to take advantage of financial and operational synergies. Second, they need to earn a high internal rate of return on their invested capital over a fairly short period of time, typically three to five years, at which time the company will ideally either be sold to a strategic buyer or go public. To achieve their return targets, private equity firms have to be careful to not overpay at the outset.

Financial buyers are also flush with cash they've raised from investors and must either put this cash to work or return it to their investors. Because the credit markets have not yet opened up to allow the private equity firms to consummate the "mega" deals they were once accustomed to, many private equity firms have focused on the middle-market companies. Many have hired operating partners with experience in a particular industry (many are former CEOs), to assist them in managing and creating value to their acquisitions of middle-market companies in specific industries they are targeting.

Recapitalization

A leveraged recapitalization, commonly referred to as a "recap", can be an attractive alternative to an outright sale. A recap permits a business owner to generate liquidity which is taxed at the capital gains tax rate (now 15%), while a retaining a significant ownership stake in the company.

A recap involves the restructuring a company's balance sheet. In a typical transaction, the owner of the company will partner with a private equity firm which invests equity in conjunction with debt provided by senior (bank) and possibly subordinated (mezzanine) lenders. Essentially, the owner's stock is exchanged for cash and an equity stake in the newly capitalized entity. The end result is a substantially different capital structure going forward.

A recap can allow business owners to tax-efficiently unlock the majority of the illiquid value contained in their business while continuing to retain a significant ownership interest in the enterprise. For instance, the owner might receive 80% of the value of the business in cash while continuing to own 20% of the newly capitalized company on a going-forward basis. In essence, the owner gets a "second bite at the apple".

A recap can be attractive for business owners who are not ready to retire and want to continue growing their business, but have built significant value in their business. The strategy enables them to continue to grow the business while retaining significant upside potential in the company, but with much less personal risk because with the backing of a strong financial partner there is no longer any need for the owner to sign personal bank guarantees and the owner has taken some chips off the table to diversify.

In sum, the advantages of a recap are significant:

- Significant amount of cash is generated for the owner.
- Proceeds are taxed at the long-term capital gain rate.
- Cash can be used to diversify into other investments.
- Owner retains significant ownership stake and meaningful upside potential.
- Owner is motivated to grow the business and is backed by a strong financial partner but there is less personal risk (no more personal bank guarantees).
- Owner maintains position as CEO with salary, benefits and other “perks”.

Management Buyout (MBO)

A group of *senior managers or employees* can acquire control of a business from the company owner through what is known as a management buyout or MBO.

With respect to a sale to management or a group of key employees, the current owner knows the abilities of the key employees and they know the inner workings of the company. However, a serious risk is that these key employees may not in fact be successful entrepreneurs. That is, once the risk of owning and running the business is completely on their shoulders, they may not perform as hoped and that is a huge unknown.

For this reason, it is usually difficult for key employees to obtain financial backing from private equity firms and financial institutions and therefore they often can’t raise sufficient funds to make a serious cash offer. In most instances, the amount offered by employees rarely matches the sum offered by an outside party if an outside party is bidding.

As a result, in many employee buyout situations the owner is asked to carry back a substantial amount of the purchase price in the form of a promissory note with a significant portion of the purchase price therefore deferred and contingent. The negotiations often end suddenly when the owner sees the mix of consideration offered by the employees, typically a very low cash component and a large promissory note, and realizes the considerable risk he or she is taking by selling to employees with unknown entrepreneurial capabilities and then acting as creditor to them.

Additionally, since the owner is negotiating with people who work for him or her, a failed attempt to do an MBO has the potential to negatively impact the dynamics of the employer/employee relationship.

As a general rule of thumb, unless the owner has accumulated sufficient investable assets outside the business to sustain his or her desired lifestyle after the sale of the business, an owner should sell to key employees only if the pricing, terms and conditions of their purchase offer matches or exceeds one that a third party buyer is willing to offer.

Sale to Employee Stock Ownership Plan (ESOP)

An ESOP is a qualified retirement plan that can be created and is allowed to buy some or all of the owner’s shares of company stock. In a leveraged ESOP the ESOP borrows money to fund the purchase of the owner’s shares. Internal Revenue Code Section 1042 permits the deferral of the capital gains tax for a sale of stock to an ESOP if certain conditions are met, which can be an attractive feature to the owner. In addition, the owner can maintain control of the company, and the owner can still sell the company to a third party at a later date when the company is hopefully worth more.

By using an ESOP the owner can take some chips off the table now in a tax-advantaged manner and diversify, while retaining control of the company and maintaining upside potential in the shares the owner retains. Creating an ESOP is not a simple process and can be expensive, but there are significant potential benefits.

Divestiture (Sale or Disposition of Non-Core Assets)

If a business owner is not ready to retire and wishes to continue to run the business, but would like to generate some liquidity now in order to diversify, the owner may wish to sell or dispose of non-core assets, those that are not essential to the continued operation and growth of the company. This is often referred to as a divestiture.

For instance, a company may be considering the possibility of exiting a certain line of business or closing a division that does not fit in with the future growth plans of the company, yet this business line or division may have value to a competitor. Or a company may have shut down a facility and the value of the underlying real estate may be attractive to real estate developers or investors.

The proceeds of the sale or disposition of such non-core assets could be distributed to the owner through a special dividend distribution and possibly taxed at the long-term capital gain rate. With respect to the sale or disposition of real estate assets, certain capital markets tools and techniques could be combined to indefinitely defer, and possibly eliminate, the capital gains tax on the proceeds.

Sale or Transfer to Family Member or Second Generation

Private company owners can sell or transfer (usually through a combination of gifting strategies) their business to a *family member (or members) or the next generation,* who are typically actively involved in the business.

With respect to selling or transferring their business to a family member or the successor generation, many surveys report that as many as eighty percent or more of family business owners would prefer to transfer ownership of their business to a family member to carry on the business. However, when later polled, the majority sold their businesses to third parties and there are several reasons for this.

First, similar to employees, the family members typically do not have the necessary cash and it is usually difficult for family members to obtain the financial backing of private equity firms and financial institutions. Therefore, they often can't raise sufficient funds to make a serious cash offer and the owner is often asked to carry back a significant portion of the purchase price in the form of a promissory note. In most instances, the amount offered by family members rarely matches the sum offered by an outside party if an outside party is bidding.

Second, books have been written on this topic, but suffice it to say that a lifetime of intra-family dynamics, combined with the day to day pressures of running a business, often make succession to the next generation very difficult.

As a general rule of thumb, unless the owner has accumulated sufficient investable assets outside the business to sustain his or her desired lifestyle without regard to the business, the owner should probably sell to a family member or the next generation only if the pricing, terms and conditions of their purchase offer matches or exceeds one that a third party buyer is willing to offer.

Personal Line of Credit Secured By Company Shares

The owner might consider arranging a personal loan secured by his or her shares in the company. This option is usually completely overlooked. One of the key benefits is that this type of borrowing should not cause an immediate taxable event to the company or the owner if structured properly. This technique basically uses corporate debt capacity (assuming it's available) to avoid a taxable stock sale or dividend. In addition, the interest expense generated by the personal loan could be used by the owner to shield investment income generated by his or her investment portfolio, which could be funded with the loan proceeds.

The transaction could be structured with a "put" option of the stock back to the company to get the lender comfortable. The company can support this put obligation either through its existing credit arrangement or with a standby letter of credit issued for this specific purpose. Of course, the exercise of the put to the company as a source of repayment of the loan would very likely be considered a taxable event to the business owner. And at some point the debt will need to be repaid.

In the meantime, the business owner has achieved a very attractive result – he/she maintains full ownership and control of the company, generates cash to diversify the concentration risk, avoids triggering a taxable event and generates currently deductible interest expense.

Public Offering

An initial public offering (IPO) is possible if the company is in an industry deemed attractive by investors and has a history of steady earnings growth. There is a very high cost associated with going public and, in addition, the privacy and authority that many private business owners have come to take for granted are eliminated. The owner will be the CEO and employee of the publicly-traded company and live in a "fish bowl" where all decisions will be open for the investment community to second guess. In addition, the necessity and constant pressure to hit short-term quarterly revenue and earnings expectations of the investment community cannot be overstated.

As a general rule, if the owner's objective is to exit from the company in the near term an IPO is *not* a viable exit strategy. Rather, it should be viewed as a financing tool that can be used to grow and take the company to new heights, assuming the owner wishes to remain actively involved in the company for the foreseeable future.

Conclusion

A wide range of strategies are available to empower business owners to monetize their business equity. Determining which will produce the optimal result for a client will depend on a number of factors including the vision the owner has of his personal and business life, as well as the company, after the transaction, the current condition and future prospects of the business, the amount of investable assets the owner has accumulated outside the business, and the state of the deal market for M&A and business monetization transactions.

Intelligent Edge Advisors

Intelligent Edge is a concentrated wealth advisory firm that works exclusively with financial advisors to plan, structure and execute tax-efficient liquidity events on behalf of their clients who own privately-held businesses. The firm utilizes a multidisciplinary approach when selling or monetizing a privately-held business in order to maximize tax-efficiency, taking into consideration any commercial real estate that is associated with a business and when it might make sense to sell for stock rather than cash (and importantly, how to best monetize the stock received). By collaborating with business owners' trusted advisors and integrating three highly specialized disciplines—M&A and corporate finance, real estate capital markets, and single stock concentration risk management—we are able to create a tailored solution for each client that is consistent with the individual's overall financial planning goals.

For more information please contact:

Elizabeth Ostrander, Director of Business Development
212.308.3343 ext 228 / eostrander@intelligent-edge.com

Tom Boczar, CEO
212.308.3345 / tboczar@intelligent-edge.com