Exit Strategies for Owners

Part 1: Taking Your Company to Market

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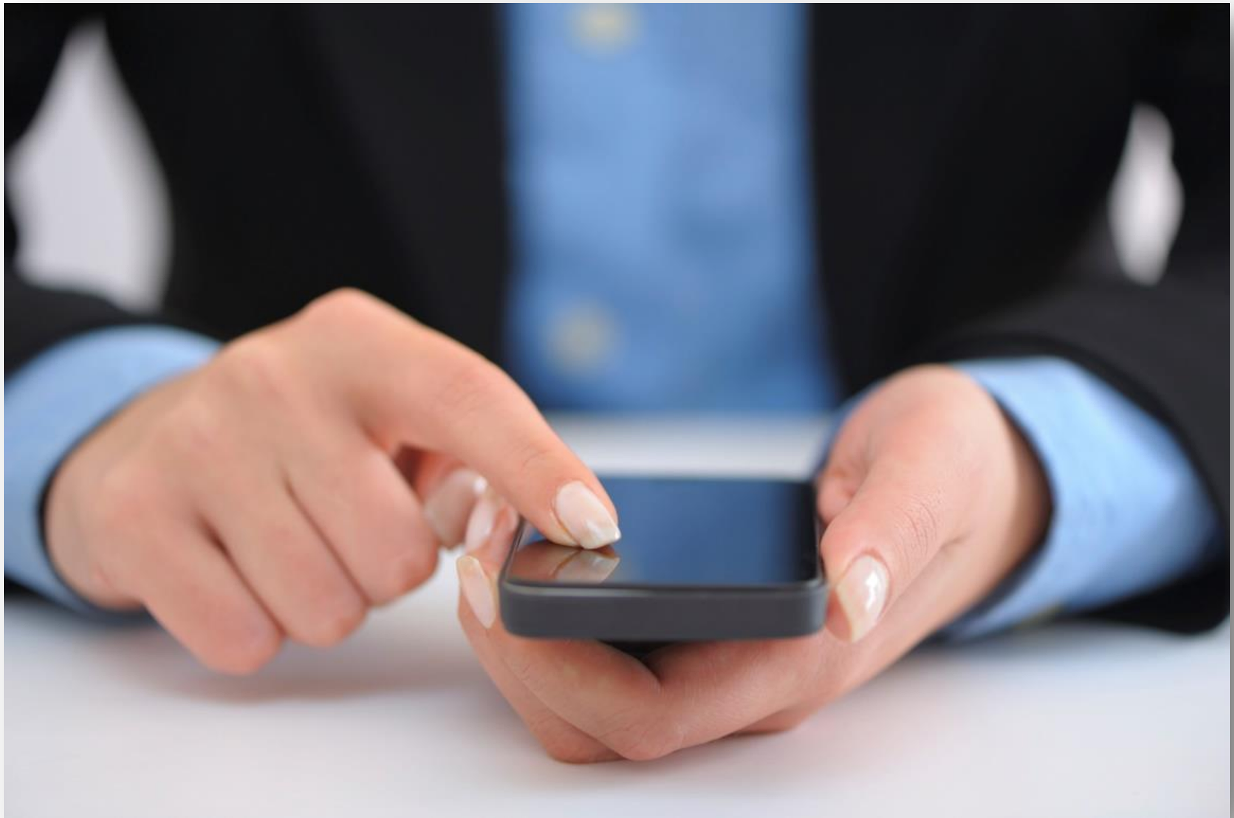

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About the Speakers

Gary Gibbs, CBA, ABV
Executive Vice President

Assists clients in analyzing prospective business acquisitions, structuring transactions and developing acquisition strategies

Involved in stock and securities sales of more than 100 companies involving more than $1 billion

About the Speakers

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Vice President

Specializes in delivering strategic financial support to executives

Held a variety of senior and executive financial management roles during 20-year career in the private sector

Learning Objectives

Establishing time horizon

Understand types & classes of buyers

Build the value of your business

Avoid pricing surprises with due diligence

Efficiently structure sales transaction

Timeline of Exit Planning

The amount of time allowed for planning is typically correlated with value received:

Less time = Less value

More time = More value

Timeline of Exit Planning

Time allows for owner to develop value enhancing processes, procedures and personnel

- Strategic planning
- Operating protocols
- Entity structure
- Management systems
- Human capital

Timeline of Exit Planning

Owner’s lifestyle transition

Financially prepare

Mentally prepare

Motive for transition

Timeline of Exit Planning

This is a **LONG** process, not an event!

Transaction characteristics include:

Difficult	Time-consuming	Expensive	Emotional	Scary

Good advisors make the transaction less: difficult, time-consuming, expensive, emotional and scary.

Owner’s Motives Drive Process

What does the owner want to accomplish with the exit plan?

Sell and move on?

Sell and continue to work?

Sell and stay for a transition?

Sell and stay on for another “payday”?

Owner's Motives Drive Process

Who does the seller want to sell to?

Internal transfer

External transfer

No preference

Owner's Motives Drive Process

What are the owner's financial objectives?

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- **Reward employees** who contributed to company’s success – “fair market value”?

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What are the owner’s financial objectives?

- **Maximize value** – “strategic value” vs. “market value”?
- **Reward employees** who contributed to company’s success – “fair market value”?
- **Reduce or eliminate exposure/risks** associated with company ownership?

Polling question #1

Types and Classes of Buyers

3 classes of buyers

- Internal buyers
- External buyers
- Internal buyers supported by external buyers

Types and Classes of Buyers

Internal buyers

Co-owners

Executive team

Types and Classes of Buyers

External buyers

Strategic buyers

Financial buyers

Strategic Buyers vs. Financial Buyers

Strategic buyers

In the business or related business

Vertical or horizontal enhancement strategy

Cost and/or revenue enhancements

Second spreadsheet value enhancements

Strategic Buyers vs. Financial Buyers

Financial buyers

Typically an investor, not an operator

Looks at standalone value of company

May bring little to no operational or industry knowledge to investment

Return- and time-horizon-driven

Players

Strategic buyers – Industry participants, customers, vendors, competitors, private equity with current investments in synergistic companies

Financial buyers – Investors, management, private equity

Types and Classes of Buyers

Sponsored management buyer

Existing/legacy management team sponsored by private equity

Outside/industry management team sponsored by private equity

Existing management team, with new members, sponsored by private equity

Polling question #2

Common Value-Related Definitions:

Enterprise Value

Transaction purchase price typically stated on a debt-free, cash-free basis.

Includes equity and debt

Common Value-Related Definitions:

Equity Value

Enterprise value minus interest-bearing debt and capitalized leases

Common Value-Related Definitions:

Debt

Interest-bearing debt and capitalized leases

Does not include accounts payable or accrued expenses

Common Value-Related Definitions:

EBITDA:
Earnings **B**efore **I**nterest, **T**axes, **D**epreciation and **A**mortization

Commonly used to describe the annual cash flow of the business

For valuation purposes, EBITDA must be sustainable

Common Value-Related Definitions:

Gross Asset Value

(Allocable Purchase Price)

Enterprise value plus accounts payable and accrued liabilities assumed by buyer

I Have an Offer to Sell My Business…

If an owner has been offered $5 million for his business, what does the buyer mean?

- Enterprise value of $5 million?
- Gross asset value of $5 million?
- Equity value of $5 million?

I Have an Offer to Sell My Business…

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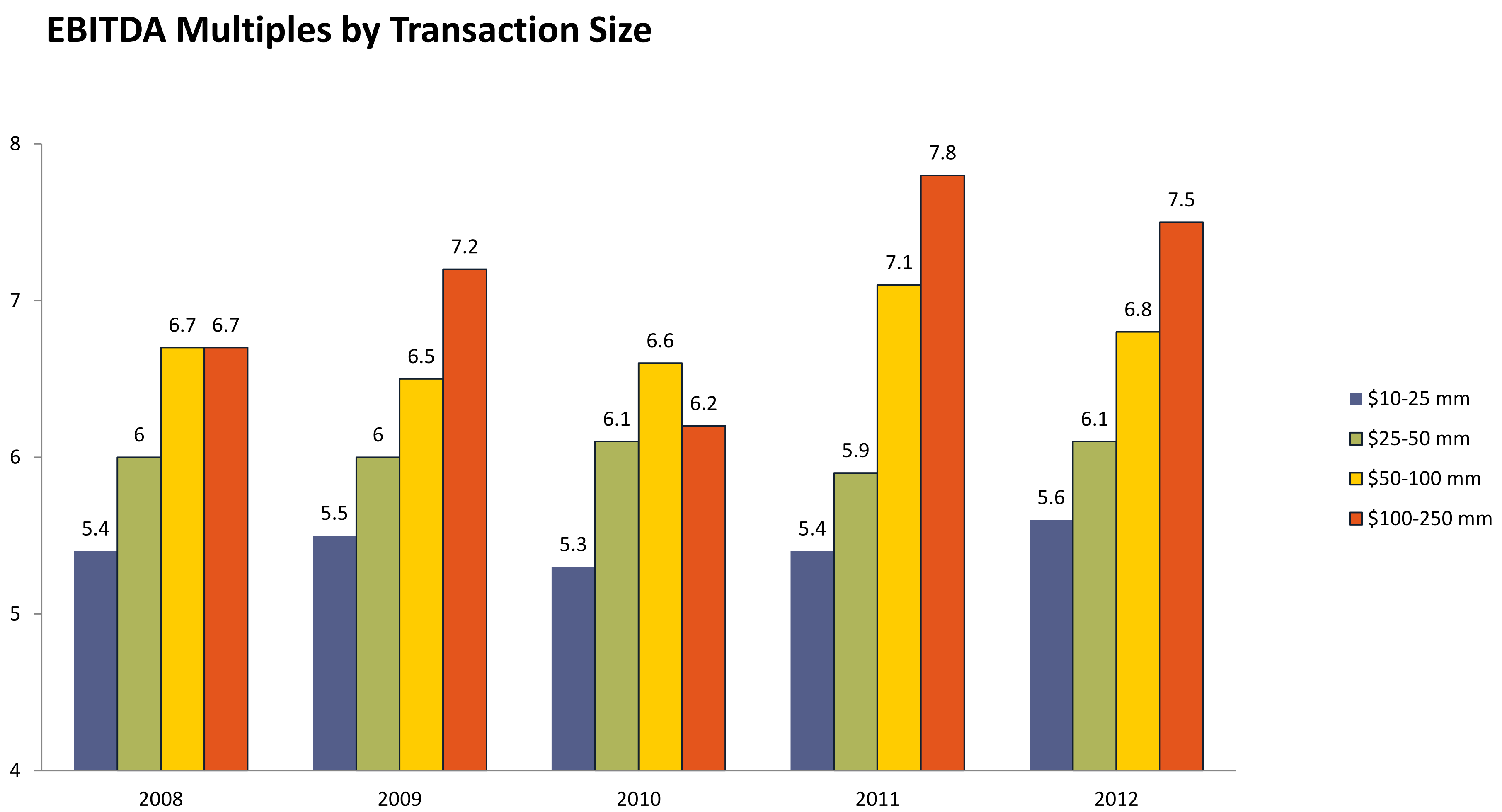
- Enterprise value of $5 million?
- Gross asset value of $5 million?
- Equity value of $5 million?

Which assets does a buyer purchase?

Using a multiple of EBITDA: Buyer gets all the assets required to earn that EBITDA, including accounts receivable, inventory, equipment and real estate. Also assumes the payables (but not the debt).

EBITDA Multiples by Transaction Size:



Source: GF Data Resources

Value Enhancements Pre-Transaction

Does my company exhibit maturity?

- Strategic planning
- Financial budgets/plans - predictability
- Operational processes and controls
- Reliable, timely information systems

Value Enhancements Pre-Transaction

Is my human capital sufficient to sustain the company?

- To drive the company forward

Executive management depth

- To execute the plan

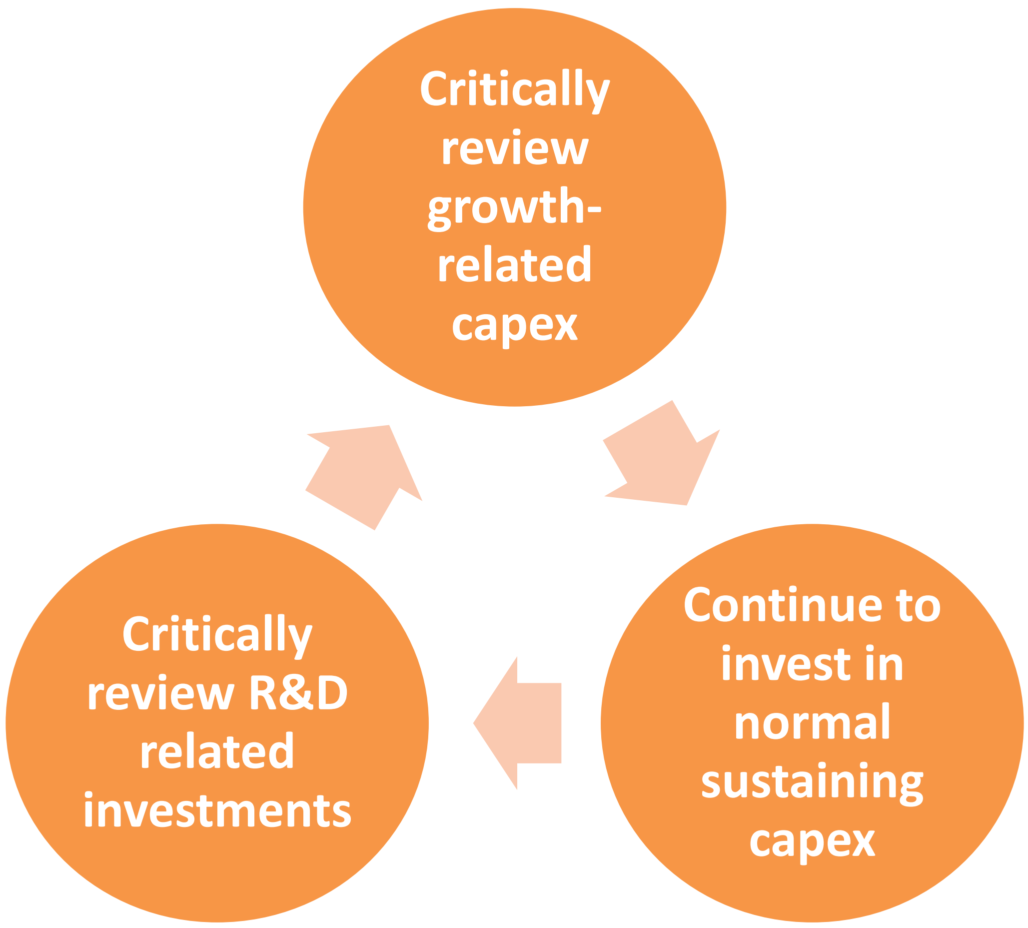
Operational depth

- To provide meaningful insight into the company's financial performance

Financial depth

Value Enhancements Pre-Transaction

Capital investment strategy



Value Enhancements Pre-Transaction

Perception

Clean your facilities;
doing so can enhance the buyer's perception of value.

Encourage professional interaction with potential buyers.

Value Enhancements Pre-Transaction

Increase EBITDA

- Sales enhancement
- COGS enhancement
- Manage OpEx

Value Enhancements Pre-Transaction

Reduce Risk

Rationalize underperforming products, lines, assets, etc.

Obtain contractual rights.

Reduce concentrations.

Value Enhancements Pre-Transaction

Increase Attractiveness

Gain critical mass

Out-perform competitors – better gross and operating margins

Develop stronger business model

Mitigate Pricing Surprises

Mitigate pricing surprises with pre-transaction due diligence.

Due diligence is all about price adjustments.

All sellers should perform internal due diligence in preparation for a potential transaction.

Mitigate Pricing Surprises: Key Items

3rd-party oversight of financials

None

Compilation

Reviewed

Audited

Mitigate Pricing Surprises: Key Items

Quality of earnings

Sustainable

Matching principle

Accuracy of historical results

Out-of-period expenses or income

Mitigate Pricing Surprises: Key Items

Other Items

Revenue recognition

Overstated assets

Understated liabilities

Polling question #3

Due Diligence – Examples of Findings

"Independent contractors" should be treated as employees – subsequent IRS exam - $5.0+ million of payroll obligations

Project manager – Mentioned new contract bid at a loss to gain a new customer – reduced earnings $1.2M (x 5.5 = lost value)

State income taxes for out-of-state activities, income, sales, business taxes

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Due Diligence – Examples of Findings

State taxes often overlooked:

- Texas Franchise Taxes
- Michigan Business/Income Tax
- Washington Business & Occupations Tax (modified gross receipts)
- Ohio Commercial Activities Tax
- New Mexico Gross Receipts
- Goal – income tax that does not require net income

Creation of "nexus" for state taxes

- Transporting product into the state
- Sales personnel in state, or warehouses
- Your dealer does your warranty work in that state

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Due Diligence – Examples of Findings

Inventory quality – slow-moving, damaged, made obsolete by new products, needs rework, plant tours can be revealing

Warranty obligations not tracked, or recorded

Obligations earned by employees not recorded

Returns for seasonal goods not recorded

Owner's story about the business inconsistent with or absent from financial reporting

Annual financial statements by CPA routinely have large adjustments

Due Diligence – Examples of Findings

Monthly financial statements prepared ad-hoc, without checklists, other checks and balances. No monthly closing checklist

Accounts receivable quality problems, slow pay

“Trailing payables” – can be larger than expected

Contractual obligations to customers or suppliers at less than favorable arrangements

Threatened or pending litigation with customers, employees, suppliers

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Due Diligence – Examples of Findings

Employee benefit plans out of compliance:

401(k) withholding not timely transferred (fines)

401(k) audit requirement not satisfied (more fines)

Profit-sharing anti-discrimination or “top heavy” problems – compliance not tested or not reported by plan administrator (not their job, per contract) or by preparer of tax returns, DOL filings - form 5500 (even more fines).

ESOP out of compliance

Due Diligence – Examples of Findings

Property assets on the books that cannot be found anywhere; were previously sold, or abandoned

Accounting methods being used that are not approved or accepted by IRS – Service businesses that fail to record work-in-process

Variances between the underlying records, such as accounts receivable details or inventory details, and the general ledger used to prepare the financial statements. Variances can be very large – millions.

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Due Diligence – Examples of Findings

International transactions not reported

- Transfers of cash or assets to or from a foreign country are required to be reported, regardless of any tax consequence, income or other.
- Failure to report foreign transactions is now subject to a fine, $100,000+ effective 2014.

Domestic company a “flow-through” entity subject to single tax, **foreign company not set up as “flow through”** – subject to double taxation

DISC tax benefit not utilized by seller, buyer reaps a benefit

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Due Diligence – Examples of Findings

Major supplier relationship issues

Are there current supplier relationships that are "grandfathered"? Subject to change with a new owner?

Major customer relationship issues

In two cases, a major customer confirmed, face-to-face with buyer, an ongoing relationship, only to terminate the relationship within 60 days of closing, for a different supply arrangement, planned for months.

Product returns, warranty issues, quality issues, or possible outsourcing "off-shore"

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Polling question #4

Tax-Efficient Acquisition/Sale Structure

Goal – to maximize value "after-tax"

Have taxes paid in prior years increased seller's basis, reducing the gain on sale?

If there is a taxable gain or income to seller, is there an offsetting tax deduction to buyer?

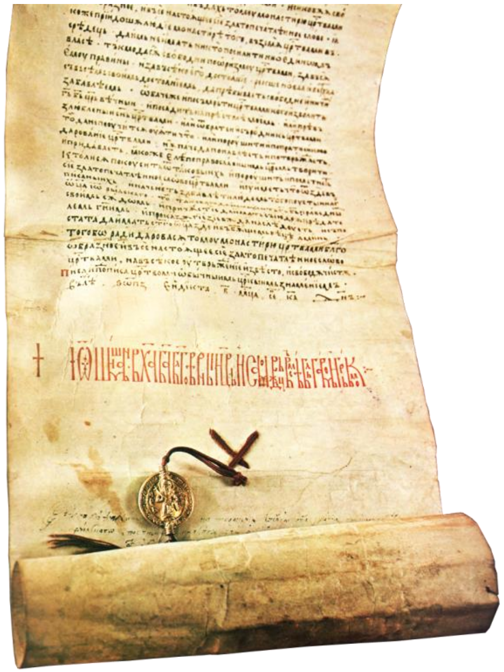
Transactions have four parties – seller, buyer, seller's tax collector, buyer's tax collector.

Common Acquisition Structures

LLCs are most common and most appealing.

Buyer and seller must have experienced tax counsel to prepare the operating agreement.

S Corps and C Corps may use a "drop-down" LLC method.



Common Acquisition Structures

Stock purchase for legal reasons, but an asset purchase for tax reasons.

- Contracts and property transfer easily.

- Tax basis step-up allowed.

Choosing an Entity: S-Corporation

S-Corporations are pass-through entities.

Income is taxed once, making them tax-efficient whether the owners want to sell or not.

C-Corporations incur a double tax.

Equity built up in a C Corp does not increase the owners' cost basis, as in an S Corp.

Choosing an Entity: Don't Overlook It

Many CPAs and advisors don't consider the tax benefits upon sale because year-to-year taxes for S Corporations and C Corporations are similar.

Choosing an Entity: Don't Overlook It

Results: **Buyers may choose not to complete a transaction when sellers fully understand and realize the unfavorable tax consequences of C Corporation status.**

Seller's solution is to sell stock but:

- **Buyers forfeit tax step-up** and tax benefits so they want a price reduction.
- **Buyers resist stock deals** due to liability concerns.
- Even in a stock transaction, **C Corporation owners pay more tax** than the amount of S Corporation tax for the same transaction, because of basis build-up in the S Corporation.

Choosing an Entity: Cost of C-Corporations

	A	B	C	D	E	F	G	H	I	J	K
1					C Corp		S Corp		C Corp		S Corp
2					Stock		Stock		Asset		Asset
3					Sale		Sale		Sale		Sale
4											
5		Annual Revenues			30.0		30.0		30.0		30.0
6		Annual EBITDA			5.0		5.0		5.0		5.0
7		Existing Debt at time of sale			8.0		8.0		8.0		8.0
8											
9		Enterprise Value			25.0		25.0		25.0		25.0
10		Assumption of Accounts Payable							2.0		2.0
11		Allocable Purchase Price			25.0		25.0		27.0		27.0
12		Debt at Time of Sale			(8.0)		(8.0)				
13		Equity Value			17.0		17.0				
14											
15		Tax Basis of Assets Sold							(15.0)		(15.0)
16		Tax Basis of Stock Sold			(0.1)		(5.0)				
17		Gain on Sale			16.9		12.0		12.0		12.0
21											
22		Tax on Ordinary Income			0.0		0.0		4.6		2.1
23		Tax on Capital Gain			4.5		2.8		0.0		1.6
24		Tax on Distribution - C Corp Asset Sale Only			0.0		0.0		3.3		0.0
25		Total Tax			4.5		2.8		7.9		3.7
26											
27		**Effective Tax Rate on Gain**			**27%**		**23%**		**66%**		**31%**
28											
29		**Net Proceeds for Owner:**									
30		Enterprise Value Sales Price			25.0		25.0		25.0		25.0
31		Less Debt			(8.0)		(8.0)		(8.0)		(8.0)
32		Less Tax on Transaction			(4.5)		(2.8)		(7.9)		(3.7)
33		Net Proceeds after Tax			12.5		14.2		9.1		13.3
34											
35		Decrease C Corp vs. S Corp			($1.8)				($4.2)		
36											
37		**% C Corp Proceeds/S Corp Proceeds**			**88%**		**100%**		**68%**		**100%**

Conclusion

Successful transactions require:

Management talent
Research and planning
Experienced advisors

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Business transactions are a long process, not an event.

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It is too late to plan after documents are signed. It may be too late after "letter of intent" is signed.

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S Corporations result in low taxes.

- C Corporations result in high taxes.

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Thank You!

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