Exit Strategies for Owners of Privately Held Businesses

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Tax Conference

Exit Strategies For Owners of Privately Held Businesses

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The Issue

How to realize on the value of the business beyond annual dividends or distributions?

- Alternatives
- Valuation
- Preparation
- Terms
The possibilities are varied...

- Sale to the public markets
- Private Sale
- ESOP Transaction
- Recapitalization

- Each enables the current owners to realize upon a significant portion (or all) of the equity value of the business.
- Each has its own benefits, limitations, costs, and risks.
Sale to the Public Markets

**Pro**
- Provides liquidity now and later
- Can be attractive value
- Has a lot of sex appeal

**Con**
- Not as much liquidity as you think
- Requires size
- Management and compliance costs
- Life in a fish bowl
Declining IPO Market

The public equity market has declined significantly since the end of 2000 and remains closed to all but large companies.

- In 2001, IPO volume declined 78.0% and aggregate value declined 60.7% compared to the prior year.
- The average issuance was $438.2 million in 2001 versus $348.0 million YTD as of August 31, 2002.
- IPO volume has been driven by the financial services and healthcare sectors.

**Total Initial Public Offerings**
For the Years Ended December 31, 1991-2001 and the Year To Date August 31, 2001 and 2002
($ in billions)

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Sources: IDD Information Services, Inc, Securities Data Corporation, Nasdaq Issuer Services, and CommScan EquiDesk.
Private Sale

**Pro**
- Can provide total liquidity (or not)
- Process can be relatively quiet
- Structural flexibility

**Con**
- Time consuming
- Effect on employees
- May result in a leveraged company
Trends in Middle Market M&A Volume

Middle market M&A deal value and volume has declined since peaking in the late 1990s.

- Tight senior credit market.
- Weak financial performance from target companies.
- Lower trading multiples of public companies.
- Valuation gap between buyers and sellers.

**Closed Middle Market M&A Transactions**
For the Years Ended December 31, 1992 - 2001
And the Year-To-Date Periods Ended September 30, 2001 and 2002
(Transactions valued between $25 - $500 million)

![Graph showing trends in dollar value and number of transactions from 1992 to 2001 with percentage declines indicated]

Sources: Securities Data Corporation and Mergerstat.
Drivers of Middle Market M&A Activity in 2002/03 - Increased Private Sales

Since the beginning of 2002, privately held companies have represented a higher percentage of overall deal volumes as private sellers have shown a willingness to accept the lower market valuations.

- Privately owned sellers are the largest component of middle market M&A transactions.
- Corporate divestiture continue to add volume as parent companies look to raise capital and reduce leverage.

**Composition of Closed Middle Market M&A Transactions by Seller Type**
For the Quarters Ended March 31, 2000 Through September 30, 2002

Source: Mergerstat.
## ESOP Transaction

<table>
<thead>
<tr>
<th>Pro</th>
<th>Con</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Varying levels of liquidity</td>
<td>• Employee ownership</td>
</tr>
<tr>
<td>• Tax deferral for sellers</td>
<td>• Adds complexity</td>
</tr>
<tr>
<td>• Employee ownership</td>
<td>• Requires liquidity to fund redemptions</td>
</tr>
</tbody>
</table>
Recapitalization

Pro
• Provides liquidity while retaining control
• Can add new owners
• Depending on structure (SCorp/LLC/Partnership) can be tax free

Con
• Produces leveraged company
Valuation

No matter what the choice, value is the critical variable for the owners.

Value is driven by:
- Company specific issues
- State of mergers and acquisition market
Excellent Management Team

- Strong leadership at the top.

- Deep, talented, and knowledgeable.
  - senior management
  - middle management

- No “holes” or apparent weaknesses.

- Enthusiastic and “on board”.
Perceived Limited Downside Risk
Excellent Growth Characteristics

Projected Sales Growth for Company ABC
For the Years Ending December 31, 2002 - 2004
($ in millions)

- Evidence of traction.
  - Multiple tangible avenues.
    - Organic
    - External

- Detailed plan in place to pursue.

(1) The following graph was prepared for illustrative purposes only.
Outstanding Financial Performance

- Meet or exceed budget during relevant period process.

- Strong free cash flow.

- Demonstrated consistent success over time.

- Achieve above average performance through an economic cycle.

- Demonstrably accurate cost system.
Sustainable Competitive Advantages

- Low cost producer.
- Trademarks / Brand Name Value.
- Top player in industry niche or a strong #2.
- Leverage within supply chain.
- Proprietary Technology / Patents.
- Barriers to entry.
“Bald Is Beautiful”

- No material contingent liabilities.

- Excellent information systems, reports, and financial controls.

- Clean Due Diligence.
“Curb Appeal”

• Inside

• And Out
State of Mergers and Acquisition Market

- Acquisition values in general
- State of equity and debt financing markets
Recent Valuation Trends - Variances in M&A Multiples

Declining M&A volume and tightening credit standards have resulted in lower and converging purchase multiples.

- Historically, deals over $100 million have enjoyed a multiple premium of between 0.75x - 1.50x EBITDA relative to smaller deals.
- Larger deals still warrant a premium but the criteria has shifted to deals over $250 million receiving an additional 0.50x-0.75x EBITDA.

Price/Adjusted EBITDA Multiples
For the Years Ended December 31, 1994-2001 and the Latest Twelve Months Ended September 30, 2002
(Transaction size in millions)

Source: Portfolio Management Data.
Recent Valuation Trends - Multiple Comparison

While the average buyout multiple paid has declined, strategic buyers remain aggressive on middle market transactions.

- Average premium paid by strategic buyers is 1.4x for the LTM 7/31/02 versus 1.9x in 2000.
- Average premium paid by strategic buyers for deals less than $250 million is 1.25x for the LTM 7/31/02 versus 2.3x in 2000.

Source: Portfolio Management Data.
Recent Valuation Trends - Significant Capital Available

Private equity firms spent a significant amount of time addressing portfolio performance issues during 2001 but now appear ready to focus on new investments.

- Private equity funds have a significant amount of capital available to "put to work."
  - In 2000, $63.3 billion in capital raised versus $41.1 billion invested.
  - In 2001, $35.4 billion in capital raised versus $23.1 billion invested.

- $92.8 billion in uninvested equity represents $232.0 billion in "buying power."

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**Available Private Equity Capital**

For the Years Ended December 31, 1990-2001 and the Year to Date as of October 21, 2002

($ in millions)

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Sources: Buyouts and Thompson Financial.
Recent Valuation Trends - Stabilizing Lending Markets

The overall credit markets have begun to stabilize following a steady decline since 1997.
- Senior lenders remain conservative but are beginning to show life.
  - Banks have primarily shifted to asset based loans to protect themselves from defaults and bankruptcies.
  - New entrants to the senior loan market should provide more liquidity and competition.
  - Fewer commercial banks are tightening credit standards - some banks even reported easing standards.
  - More banks are providing fully underwritten commitments.
- Subordinated lenders have become more aggressive.
  - Subordinated debt as a multiple of EBITDA increased through the first half of 2002.
  - Competition is growing among middle market mezzanine providers, resulting in flexible structures and lower pricing.

<table>
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<th>Average Debt Multiples for Highly Leveraged Loans</th>
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<td>For the Years Ended December 31, 1995-2001 and the Quarters Ended March 31, 2001 Through June 30, 2002</td>
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Source: Portfolio Management Data.
Recent Valuation Trends - Growing Equity Component

To remain competitive in light of lower debt multiples, equity sponsors have increased the amount of equity contributed to transactions.

- PEGs/investors are willing to accept lower returns - lower opportunity cost given the recent adjustment in the public equity markets.

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**Equity as a Percentage of LBO Financing**

For the Years Ended December 31, 1987-2001
The Nine Months and Quarter Ended Sept. 30, 2002
*(Equity as a percentage of the total capital structure)*

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![Equity as a Percentage of LBO Financing Chart]

Source: Portfolio Management Data.
Preparation and Planning

Tax and Accounting Planning

- For the Owners
  - Tax and Estate Planning
  - Ownership Structure
  - Ownership Identity
  - Charitable Intentions

- For the Company
  - Benefit Plans
  - Quality of Earnings
    - Perks
    - One time expenses
    - Non core holdings
  - Quality of Reports and Systems
Preparation and Planning

• Legal Planning
  – Good housekeeping
  – Ownership and control of assets and people
  – Contingent liabilities
Terms

- In a sale, the price paid at closing is only part of the valuation equation.

- Working capital adjustment
  - Accounts for seasonal swings
  - Ensures no ‘hanky-panky’

- Indemnification terms govern post-closing exposure
  - Limits on amount of exposure (“cap”)
  - Deductibles on exposure (“basket”)
  - Time of exposure (“survival”)
Current Indemnification Terms

Sample terms based upon approximately 30 deals closed in the last 3 years.