EXIT OPTIONS

THE PROS AND CONS

11/5/2024

TWO GENERAL CATEGORIES FOR PRIVATE OWNERSHIP TRANSITION

INSIDE	OUTSIDE
• Intergenerational transfer • Management buy out • Sale to existing partners • Sale to employees	• Sale to third party • Recapitalization • IPO • Orderly liquidation

INTERGENERATIONAL TRANSFER

An intergenerational transfer is the transfer of business stock to direct heirs, usually children. 50% of business owners want to exercise this option. In reality, only about 30% actually do so.

PROS	CONS
• Business legacy preservation • Planned • Lower cost • More control • Less disruption • High buyer/seller motivation	• Family dynamics • Illiquid buyers/lack of funds • Lower sale price • Key employee flight risk • Tradition may outstrip good strategy • Path of least resistance – not always a path to growth or success

MANAGEMENT BUY OUT (MBO)

In an MBO, an owner sells all or part of the business to the company's management team. Management uses the assets of the business to finance a significant portion of the purchase price.

PROS	CONS
• Continuity • Highly motivated buyers (pent-up desire) • Preserves key human capital/knowledge • Planned • Can be combined with private equity to access additional capital and resources for growth	• Management "sand-bagging" • Distraction • Threat of flight (coercion of owner) • Illiquid buyers • Lower price and unattractive deal terms for seller • Heavy seller financing introduces risk

SALE TO EXISTING PARTNERS

In a sale to existing partners, success is closely linked to the existence and quality of a buy-sell agreement. This is not an option for single-owner businesses.

PROS	CONS
• Less disruptive • Planned • Well-informed buyers • Controlled processes • If buy-sell agreement is in place and funded • Lower cost	• Lower sales price • Potential discord • Competency gaps? • Buy/sell may restrict selling options • Realization of proceeds from sale is often lower (and less)

SALE TO EMPLOYEES (ESOP)

In a sale to employees, a company uses borrowed funds to acquire shares from the owner and contributes the shares to a trust on behalf of the employees.

PROS	CONS
• Business stays in the “extended family” • Shares purchased with pre-tax dollars by the ESOP • Taxable gain on the shares sold to the ESOP by the owner may sometimes be deferred • ESOP is an employee benefit • May cause employees to think and act like owners	• Complicated and expensive • Requires securities registration exemption • Company compelled to buy back shares from departing employees • Generally suitable only for gradual exit over time

SALE TO A THIRD PARTY

In a sale to a third party, an owner sells the business to a strategic buyer, financial buyer or private equity group through a negotiated sale, controlled auction or unsolicited offer.

PROS	CONS
• Higher price (highest of the options) • More cash up front • Walk away faster • Stability of deal terms • Business refresh (growth, new energy) • Cost effective • Breaks deadlock at management level with family	• Long process (9-12 months) • Distraction/loss of focus • Privacy concerns • Emotional for owners • After sale tie-downs • Highest absolute cost of options (but higher benefit) • Complete – involves about 1,000 professional hours • Can be difficult to close

RECAPITALIZATION/REFINANCE

Recapitalization or refinancing involves finding new ways to "fund the company's balance sheet." This method essentially brings in a lender or equity investor to act as a partner in the business. An owner can sell minority or majority position.

PROS	CONS
• Allows partial exit • Reduces owner risk • Diversifies asset concentration • Provides capital growth • Second bite of the apple • Works well with other exit options	• Continuing accountability to partners (not a clean break) • Loss of control • Culture shift • Slow transaction • Expensive relative to benefit

ORDERLY LIQUIDATION

In an orderly liquidation, the business is shut down through a simple, quick process. This option makes sense if asset values exceed the ability of the business to produce income required to support an investment

PROS	CONS
• Good option when the asset value exceeds the value of going concern • Sum of the parts are greater than the whole (asset division produces value) • Efficient way to exit • May be less expensive than some of the other options	• Uncertain proceeds (no guarantee) • No money for goodwill • Emotional (stigma?) • Hard to predict costs • Damage to employees/jobs • Higher tax (C corporations)

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