The Third Time's the Charm

The following case study is based on a true story. It highlights the importance for owners of closely held businesses the need to engage an experienced and professional exit planning team. The risks of losing value in terms of price and time is great even if the company is executing a planned sale to key employees. They should consult with an experienced team of advisors, like our NAVIX Consultants.

Key Lessons:

One of the four possible exit strategies available is to sell the closely held businesses to an inside buyer, such as a partner or key employees. We call this an Innie Exit Strategy. It is quite difficult to facilitate because of the following challenges:

- **Willing Buyer/Willing Seller -** A sale can only occur between a willing buyer and a willing seller. Exiting owners cannot compel other owners or key employees to buy their interest.
- **Missing Components -** Key employees often lack cash, collateral, and most importantly, an appetite for risk.
- **Taxes -** Without proper planning, the IRS can be the biggest benefactor at exit. Taxes can add up to 90% or more of the total value transfer.
- **Golden Goose -** The business must survive the transition and change. It is the golden goose which generates free cash flow to facilitate the exit.
- **Professional Help –** exiting owners need to work with advisors who are experienced in helping clients achieve successful exits.

The Third Time's the Charm

Bill Smith founded Bill Smith Manufacturing, a plastics manufacturer for the carpet industry, in the early 1950's. Bill ran the company for four decades before transitioning majority ownership to his son Billy. The company was successful over the years and both Bill and Billy achieved significant wealth.

In the early 2000's, Billy and Bill hired Mitch, a third party industry veteran executive from one of their vendors, to help lead the company. They enticed Mitch with the promise of a leadership role and the potential for ownership in a couple years. Mitch a great leader, loyal employee, and hard charging salesman immediately made a positive impact and bought into the company after two years. He purchased 10% of the company, paid a fair market price, and put 25% down.

For the next several years, the company prospered. Billy spent increased time volunteering and on mission trips. He only averaged two days a week in the office. Whilst, Bill continued his life's work in the company he founded. He came to the office daily, although his productivity reflected his age. It was Mitch who ran the company on a day to day basis.

When the construction market faltered in 2007 and revenue began to fall, Billy felt guilty because he was removed from operations. Given his regular absence, he thought it was best to make a change and decided to transition additional ownership to Mitch. He spent countless hours working with the company's attorney and accountant constructing a deal. They structured all terms highly in the Smith's favor. Without prior communication, Billy and Bill called Mitch into a meeting during which the attorney presented a term sheet. Mitch had minimal reaction. He waited two weeks before politely declining due to his fears about the economy.

The next several years were tough for Bill Smith Manufacturing. They were on the ropes. They were forced to make layoffs and reduce pay for all staffs. When business stabilized in 2013, Billy resumed work with their attorney and accountant to structure another term sheet for presentation to Mitch. Again, without prior communication, Billy and Bill called Mitch into a meeting during which the attorney presented a term sheet to Mitch. The term sheet was essentially unchanged, and so was Mitch's reaction. He waited two weeks before politely declining due to his concerns over the price.

After the second failed attempt, Billy reached out to our organization for help in early 2014 upon the recommendation of their accountant. We met at first with Billy and Mitch and later with Bill. After conversations with the three of them, we understood their combined objectives were to allow Bill and Billy to extract reasonable value from the business, to perpetuate the culture of Bill Smith Manufacturing, and to minimize overall taxation by focusing on the net benefit derived from a sale not the gross transaction price.

We met with all parties individually to talk about price. Not surprisingly, Billy thought it was worth more, and Mitch thought it was worth less. Collectively, we decided that Mitch should make an offer to buy Billy's and Bill's interests to change the dynamics of prior conversations.

At our recommendation, Mitch's offer incorporated items that met Billy's and Bill's culture goals and utilized deductible means of extracting reasonable value even if the offer was at a lower price than originally proposed by the Smiths. He would also pay Bill a deductible salary of $200,000 per year as Chairman Emeritus and pay Billy a deductible salary of $250,000 for his role on the board. He wanted their continued insight and asked them to retain a 25% combined interest in the company. He acknowledged that he was unable to meet their desired price, but he could get them more once the company returned to prior profitability. Finally, he committed to not taking any salary increases or dividends until all debt related to the transaction was extinguished. His term sheet incorporated a committed bank facility he had arranged and a component of seller financing. At our suggestion, Mitch structured his offer to align all parties' interests. During his presentation, Mitch conveyed to both Smiths that they might potentially receive a higher value from sale to a third party, but those groups were unlikely to understand or execute upon the company's culture. Mitch also explained his offer was the best he could do without over leveraging the business and sacrificing its longevity. He closed by saying that only the Smiths could decide how much these factors were worth to them.

After minimal negotiation, the Smiths elected to go ahead with Mitch's offer. Bill Smith Manufacturing entered 2016 on a positive trend. All interests are aligned, and Mitch is confident he can get the Smiths more money on the next sale.

The following table shows a summary analysis of why the third time was the charm for the Smiths. We assumed ordinary income tax rates of 40% and capital gains tax rates of 23.8%. Calculations exclude Mitch's prior ownership of 10%.

These clients achieved their goals of extracting reasonable value, maintaining the company culture, and minimizing taxes. All of this was accomplished while lessening the Smiths' risk, and allowing them to maintain a material level of ownership

	The First Try	The Second Try	The Third Try
Economic Environment	Rapidly Deteriorating	Nearing Bottom	Improving
Purchase Price	$12,000,000	$12,000,000	$10,000,000
Terms	Stock Sale over 7 Years No Retained ownership	Stock Sale over 7 Years No Retained ownership	Stock Sale over 5 Years $450,000 of Board Comp over 10 Years 25% Retained Ownership
Lender	100% Seller Financing	100% Seller Financing	75% Bank Financing 25% Seller Financing
Required Free Cash Flow	$18,000,000	$18,000,000	$13,353,000
Net Value Received by Smiths	$8,230,000	$8,230,000	$7,653,000
Deal Team Members	Billy, Accountant and Attorney	Billy, Accountant and Attorney	Bill, Billy, Mitch, NAVIX Consultants, Accountant and Attorney
Outcome	Failed Attempt	Failed Attempt	Successful Outcome

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NAVIX® is a proprietary process that helps business owners plan for and achieve successful exits.

NAVIX® helps owners of closely held businesses plan for and execute successful exits: achieving financial freedom, creating a sustainable legacy, and exiting on their own terms.

NAVIX® was designed out of experience seeing business owners struggle to achieve financial freedom, create a sustainable business legacy, and exit on their own terms. NAVIX® is a dual track process, that prepares both the business and its owner(s) for exit. NAVIX® is not just about planning; we also help clients execute the strategies and tactics needed to achieve a successful exit.

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