

Choosing Your Exit Strategy

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Your exit strategy impacts many directions that you might choose in growing your business. Not considering your exit strategy early may indeed limit your options in the future. It is not a matter of whether you will sell, or otherwise dispose of, your interest in this business. Your only decisions are when and how.

It Pays to Plan Ahead

It's always a good idea to plan your exit strategy early. It's also important that your founding operating partners and investors agree with it. If you wish to sell the business in five years, but your operating partner wants to own and manage it with you for 15 years, you have a problem. If you suggest to key employees that you have no plans to exit the company and then sell within two years, they are likely to be dissatisfied and could disrupt the sale. If you decide you would like to give your shares to your heirs, angel investors may object and choose an exit strategy that does not complement your future plans.

If you wish to share equity with employees or with heirs, it helps to start early, when the company valuation (and share price) is low. U.S. tax laws severely limit gifts to heirs; hence, it will take many years to pass the business on to your children. Assuming the company experiences consistent growth, sharing equity with employees can be rewarding at any stage in the business cycle. However, transferring total ownership to the employees, including the sale of your shares, is more easily accomplished and costs less when you start early.

If you choose to fund the early growth of your company using venture capital (VC), you are usually setting out on a course leading to an initial public offering (IPO), or to the sale of the company. Before seeking VC funding, it is mandatory that the entrepreneur contemplate the management and control issues that accompany VC funding and eventual public ownership.

Finally, if you plan to seek a business partner and/or outside financing from angel investors, banks or venture capitalists, someone will surely ask about your long-term plans regarding the business, and specifically, how long you plan to be with it. You need to have a thoughtful response.

Is Selling the Best Way Out?

Liquidation of ownership in your business is a very personal decision, and it is yours to make as the entrepreneur. Some founders say that creating a business and selling it within a few years is a

travesty to the employees who helped build it. Others have said they couldn't possibly go public, because a "big brother" would constantly be looking over their shoulders. From my perspective, there is no incorrect exit strategy. You, your partners, your investors and your employees are building a business. Your exit strategy is simply a very important part of your business plan.

Selling your business to another individual or independent business is one of four usual choices for liquidating your equity. It's a huge decision and generally one that is difficult to make. One day you own the company, and the next day you do not. To optimize the terms of the sale, the new owner may insist you continue to operate the business for an agreed-upon period of time. From another perspective, then, you move from controlling owner to employee in one quick step.

Proceeds from the sale of a private company usually consist of cash, shares of a public company, shares of a private company or a combination of the above. This is generally a move toward greater liquidity in your personal estate. You are selling illiquid shares of your private company for cash and/or shares of a company that will eventually become liquid.

This allows the successful entrepreneur, who often has nearly 100 percent of his or her assets tied up in the business, the option of diversifying his or her portfolio of investments. Some entrepreneurs sell to other private companies and achieve asset diversification by becoming part of the larger, merged business. While immediate liquidity may not be their primary driver, founders who take this course usually move closer to a liquidation opportunity.

The disadvantages of selling your business are also obvious. You have given up your "baby." You are no longer in control. You may have passed up the opportunity to grow the business (and the value of your shares) in the future.

When Should You Sell?

It may be time to begin working on selling your business when you are losing sleep (or your hair) because you realize one or more of the following:

- Your business is a very valuable asset.
- Ownership represents nearly 100 percent of your net worth.
- Some power outside your control (competitor, government, act of God, etc.) could take that away from you.

Personally, I like investing in small, well-run companies positioned to be “discovered” by an attractive buyer. As an investor, I prefer niche or boutique businesses in which:

- The investment required to achieve break-even in cash flow is less than \$500,000.
- The annual revenue potential within the first five to ten years is \$5 million to \$20 million.
- The likelihood that a large public company might be interested in purchasing the company is significant. In other words, these companies plan to sell to an attractive public company as the business approaches a preset valuation.

Is Going Public Better than Being Acquired?

Offering shares of your company to the public markets is viewed by some as an exit strategy. In my opinion, it is not. Initial public offerings, or IPOs, involve issuing new shares for cash at a time when the business is challenged with an opportunity to grow, which would be facilitated with an infusion of cash. However, going public generally limits your exit options and, by default, defines your exit strategy. Once the shares trade in public markets, significant employee ownership (that is, more than 50 percent) or control by your heirs is unlikely.

Selling ownership to public markets generally provides the cash for growth, while offering the principals of the company the promise of some future liquidity of their shares. Liquidation by the entrepreneur can be accomplished, but it is likely to require many years, unless, of course, the entire company is subsequently sold. Control by the founders is generally possible, but the company acquires a new set of investors with a short-term perspective on defining success. Dealing with the demands of the market makers and the Securities and Exchange Commission (SEC) will become a reality. And, in volatile markets, it may not be desirable.

Selling to Your Employees

Employee ownership can be very rewarding and can take several forms. Most of us are familiar with Employee Stock Ownership Plans, or ESOPs, which are managed like a

pension plan with all company contributions used to buy company stock. But, an ESOP is only one arrow in the equity-compensation quiver.

Motivated employees can be given appropriate incentives through other forms of equity, such as stock options, stock-purchase plans and performance-based stock bonuses. These plans generally allow the founder to maintain control of the company as his or her shares are diluted by those shares made available to the employees. Equity compensation as part of a corporate culture fosters a great working environment conducive to a high-growth business.

Under certain conditions, it is possible for the founder to sell shares back to the company, or to the ESOP. However, the legal ramifications of this strategy are many and should be explored well in advance.

Passing Control to Your Heirs

Transferring ownership to the founder’s heirs is more common than most entrepreneurs might imagine, although tax laws in the United States limit this option. It requires patience and endurance. Gifts by a single U.S. citizen to each heir, without paying gift tax, are limited to \$10,000 a year, and the tax implications of passing a business to your heirs through your estate are daunting. It’s best to take action early in the life of the business, when the share price is low and the entrepreneur has many years to give some of it away.

For high-tech entrepreneurs, this option may not be feasible, because high-tech products may have limited life spans. However, there are plenty of entrepreneurs building significant businesses outside of the high-technology arena. The long-term prospects for a well-run commodities business, for example, justify planning to pass ownership along to the following generation.

If you haven’t done so already, I suggest you develop your exit strategy now. Get a good understanding of your options. Then, talk to your spouse, parents, friends and business advisors. Use all these insights to develop a strategy that meets your needs. Once you have developed your plan, think about structuring your company to meet those needs.

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