Understanding and Evaluating Equity Transfer Options

Introduction

The objective of this document is to share with you the various options about how you can make a successful exit from your business. We will review seven exit options, explain what each of these mean and share the pro's and con's with that option.

There are have two general categories for private ownership transition. The first is the internal transition, which includes intergenerational transfer, management buyouts or MBOs, sale to existing partners and sales to employees, which might be an ESOP or another form of employee transfer.

On the external side or the outside, there is a sale to a third party, which could include either financial or strategic buyers, recapitalizations of the balance sheet of the company that could be done through debt or equity, a combination of the two. The last option may be an orderly liquidation.

Of course, you have the opportunity to publicly list (IPO) your business however this requires extensive research and content, which is best left to my friends at the National Stock Exchange (NSX). Our focus is upon the private capital markets, which do of course have their own set of rules.

Surveys undertaken by representatives of the Exit Planning Institute have asked the question "Are you familiar with all of your transition options?" Interesting the responses typically show yes, to be 35%, "not sure" at about 37%; and "no" at around 29%. So this would indicate that two-thirds of business owners are not sure about their options to exit. This is one of the reasons so many owners do not have exit plans, as they simply don't know what is available to them.

Interestingly of those that responded yes they may not in fact have a full understanding of what all the available options are. So hopefully this document will make all this clear to you.

These surveys also asked the question "what best describes how you're planning on transitioning" Of those that nominated an internal transfer (about 36% overall)

- 58% said they were going to transfer via their family (or intergenerational),
- 35% to management/employees, and
- 7% said to their existing partners.

Option 1 - intergenerational transfer.

This involves the transfer of the business stock, possibly the assets, to the next generation, and that's usually children. Studies show that about 50% of business owners really want to exercise this kind of option. But, in reality, only about 30% actually get it done. There are some reasons for that outlined below.

Pro's

The most important pro here is probably business legacy preservation. At least that's where owners typically start the conversation, whether that's the right pro or not for them.

Con's

Predominantly the main issue is the complexity of family dynamics. My experience to date with family business transfers is that there are a lot of different opinions and attitudes to the business and the existing leaders that can have a big impact on creating agreement amongst all the family members. Typically the nature of the relationships generates increased emotion when seeking to make major changes, particularly when people's financial future is going to be impacted.

Option 2 - Management buyout

This is where the owner sells all or part of the business to the company's management team. The management team is then typically going to use the assets of the business to finance a significant portion of the purchase price.

In many cases it is difficult for management to come up with the money to do this kind of thing, so it tends to be a complex financial structure that relies a lot on seller financing.

Pro's

Business continuity, because obviously the management has been deeply involved in the business, probably for a long period of time before they actually take it on. Then such investment by management may be combined with private equity access to have additional capital and resources for growth in the business. There are a lot of private equity groups out there that will back good management teams in a buyout of the business, so it's not necessary in all cases for management to come up with the entire stack of capital, and it's not necessarily the owner's responsibility to finance the acquisition through a seller note.

Con's

Firstly, you're almost always going to get a lower price and there may be some unattractive deal terms for the seller. However the heavy seller financing that may be required to close the deal is probably less risky than some of the other exit options that require seller financing, because you're dealing with a management team that is experienced with the business. There will generally be dependence on the future performance of the company to get the proceeds of the sale into the pocket of the seller.

Quite frankly, managers are not always good entrepreneurs. That's not what they were hired to do. And so, they may lack the entrepreneurial skill to carry the business forward, or they may just not be the kinds of folks that think that way, so a careful evaluation of whether the management team is really well prepared to take over the business, I think, is an important part of the process.

Option 3 - Sale to existing partners

Success in this particular case is going to be closely linked to the existence and quality of the buy/sell agreement is quite rare. A buy/sell agreement, is a much more complex and detailed document in many cases than what has been created in a shareholder agreement.

It's just the case, I think, that many owners who have been in business for a long time, especially if they have partners, have just not reviewed it and tested it against the current realities of the business or even market value of the business. Then, of course, this exit option is not available to a single owner business, which there are a lot of.

Pro’s

On the pro side, this is much less disruptive exit option, and I think it's also a pretty well controlled process as long as a buy/sell agreement is in place and, most importantly, properly funded, probably through an insurance instrument.

Con’s

On the con side, I think the most important are probably competency gaps, which may occur when a partner or a group of partners exit the business. Typically partners, over the years, have settled into specific roles, and they fulfill the needs of the business through those roles. If you withdraw a partner, or more than one partner, without proper preparation and over a period of time that makes sense, you may find that you just have naturally created a competency gap. The question is who is going to fill it with the same entrepreneurial incentive as the previous partners.

The other material issue is that the realization of the proceeds from the sale is often quite long, and it may be at a lower level than you would get through other exit options. Typically, the sale to the existing partners is the value a partner is prepared to pay is going is going to be at the lower end. It's going to be down in the same vicinity as intergenerational transfers and management buyouts.

Option 4 - Sale to employees

If you're going to sell the business to your employees, which in my experience almost always comes up as a high priority for a lot of business owners that are thinking that they are going to exit within the next five or so years, they really want to take care of their employees. In an ESOP structure, at least, which is obviously the most tax advantaged way to exit a business by far, then the company typically uses borrowed funds to do it.

Employee equity can be provided under a number of methods and structures. These may involve such things as option contracts or unit trust structures, which are appropriate for the circumstances of the particular employer organisation and its employees.

In order to create the necessary structure for effective delivery of equity benefits, it is important to recognise the three (3) pre-requisites of an employee share option plan. These are:

- Determination of the type of equity (e.g. shares or options);
- Valuation of the equity; and
- Utilisation of a plan trustee for the implementations, administration, and marketing of the employees' equity.

There's a high level of regulatory oversight here and a lot of tests that you have to meet if you're going to do an ESOP structure. The ATO defines an employee share scheme (ESS) is a scheme under which shares, stapled securities, or rights to acquire them (ESS interests) in a company are provided to an employee or their associate in relation to the employee's employment. The tax law contains specific rules about how tax applies to employee share scheme (ESS) interests.

Well designed employee share plans that secure income tax concessions for employers and employees fall into two categories. (These are sometimes called 'qualifying plans'.)

a. Exempt Plans With these sorts of plans, businesses may grant employees up to $1,000 of free shares each year without the employee incurring tax on these shares. "Buy one-get one free" is an example of a plan that makes use of this sort of concession.

b. Deferred Plans. Under "deferred plans" shares may be issued at a discount to the market price, and the taxation of the discount may be deferred for up to ten years.

   There are also other plans that may be tailored to meet the specific requirements of a particular business. These are called non-qualifying plans.

Pro's

On the pro side, the most significant benefit is that an ESOP will generally motivate and encourage the employees to think and act like owners, because they in fact become part owners.

ESOP companies have improved performance, higher profits and better staff retention than other businesses. The ability to attract, retain and motivate people to peak performance means being able to attract and retain business – and it is a major source of competitive advantage.

> *"Employee ownership is a different way of thinking about business. It targets long-term sustainability by recognising that employee/owners are more committed to developing innovative products and processes. The result is competitive advantage and lasting success – in good times and bad."*
>
> - Sir Stuart Hampson, former Chair of the John Lewis Partnership

Here's what the research says:

- ESOPs appear to increase sales, employment and sales per employee. *(Drs. Joseph R. Blasi and Doulas L. Kruse, School of Management and Labor Relations, Rutgers University).*
- ESOP companies that combine employee ownership with a participative management style grow 8-11 percent per year faster than they otherwise would have been expected to grow based on pre-ESOP performance. (*National Center for Employee Ownership. Harvard Business Review. September/October 1987).*
- Compared to 500 private non-ESOP companies, ESOP companies paid better benefits, had twice the retirement income for employees, and paid higher wages than their non-ESOP counterparts. *("Wealth and Income Consequences of Employee Ownership: A Comparative Study from Washington State." Kardas, Peter A., Scharft, Adria L., Keogh, Jim. November 1998).*
- Studies between ESOPs and productivity growth have found greater productivity and profitability in the first few years after a company adopts an ESOP. *(Dr. Doulas L. Kruse, School of Management and Labor Relations, Rutgers University. 1995).*

The other major advantage to implementing an ESOP is the possibility of gaining some tax advantages through a properly structured ESOP arrangement. Refer the Appendix on ESOP's for details on the various ESOP options.

Con's

The transition from being a closely held business or a family owned business to being an employee owned business for management, and even the existing owners if they're involved in management, can be very jarring because they're not used to managing a business that may have a lot of shareholders in it, and they're not used to treating employees as owners. You really have to spend some time preparing the management team and the owners for what that's going to look like and giving them the skills to be successful.

On the con side, is that it can be fairly complicated, and can be relatively expensive. Plans range from simple plans, with benefits that are easy to explain to all the employees in the business, to relatively complex plans. These complex plans are often restricted to key executives. It's best to engage an expert in this field to ensure it is done correctly and at a budget that is within your means.

Option 5 - Selling to a third party:

This refers to a sale to a strategic buyer or financial buyer. This could be a private equity group or a competitor. It's a negotiated sell, a controlled auction, or an unsolicited offer.

Pro's

There are some definite pros to this. The most material advantage is that typically you'll get a higher price for the company.

The other advantages, is the business refresh. There is an injection, in most cases, of growth and fresh energy into the company. That's primarily because, especially if you get a private equity group involved, they're going to bring some talent to the table at maybe the governance level. There's going to be strong support for management and, in many cases, they'll provide additional capital for growth or acquisitions that the company just didn't have before. Then, often in a family business, it can break the deadlock, if there is one, at that management level if the family is involved in the management.

Con's

On the con side, it's typically a long process. It could take 9 to 12 months. During that period, I think there's a potential of a real distraction for the owners and their management teams, and that may cause a lack of focus. Then I think it's emotional for the owner to think about potentially the legacy of the business and the legacy of the family ending in the way that they've been used to.

Option 6 - Recapitalizations or refinance,

This is about finding new ways to fund the company's balance sheet, so this may be a situation where, to give you an example, a private equity group or lender comes it. A private equity group comes in and invests in a minority position in the company, or a lender comes in and provides additional capital so that you have a debt partner in the business that could take a lot of different forms in terms of structuring.

Pro's

The pros of that are that, you access some growth capital, potentially, and the owner gets a second bite at the apple, typically on the basis that you have sold a portion of the business. If you're bringing in an equity partner, you're going to sell a portion of the business at step one. That's probably going to provide you with some growth and advantages in the market, and then you're going to get a chance to sell another portion of the business or maybe the remainder of the business at a higher valuation down the line.

Con's

The con, there's continuing accountability almost in all cases, obviously to the partners in the process. The equity partners and the debt partners, so it's not a clean break, and that may not be attractive to some owners.
This process can also be expensive, potentially, relative to the benefit. By expensive we mean that the cost of capital can be quite high.

Option 7 - Orderly liquidation,

This is different to what we might call a fire sale, a disorderly liquidation. It is a planned liquidation in which the business just decides that the best option is to shut down through a simple and a quick process. I think it makes sense if the asset values on the balance sheet exceed the ability of the business to produce income. The assets may be worth more than the going concern.

A good example of that might be a trucking company that has a lot of assets, a lot of heavy, capital intensive assets sitting on the balance sheet that are worth something in the marketplace. That business really may be better off liquidating. Of course, there's a legacy impact, but from the owner's point of view that may be the only option that they favor. It's a good option for some businesses when the sum of the parts are greater than the whole, so when the asset division produces real value in the market.

The cons are pretty complex here. It's uncertain. There's really no guarantee that you can get adequate capital out of the deal. You don't get any dollars for goodwill. For a lot of businesses, that's an issue. It is emotional for owners, and I think part of that is they go back into the community and, having been a business owner, presumably of a successful business, and then the business liquidates, it could be misinterpreted in the community, and that can impact what they view as their standing as a successful business owner. Then it definitely damages employees' jobs. It has a trickle down and kind of radiating effect in many ways.

Those are some of the pros and cons of the seven potential exits available for business owners. You will probably find that the best way to consider which option is right for you is to have a conversation with a properly qualified adviser.

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Appendix - Employee Share Plans as a Succession tool

The most important asset of any business is its people. The management and motivation of staff is one of the biggest challenges a manager or employer will face in the course of business. To be able to attract, motivate and retain top personnel is the single advantage which will provide a single competitive advantage against your competitors.

Employee Participation Planning

Prerequisites for Effective Employee Participation Plans

In order to create the necessary structure for effective delivery of equity benefits, it is important to recognise the three (3) pre-requisites of an employee share option plan. These are:

1. Determination of the type of equity (e.g. shares or options);
2. Valuation of the equity; and
3. Utlisation of a plan trustee for the implementations, administration, and marketing of the employees' equity.

Employee equity can be provided under a number of methods and structures. These may involve such things as option contracts or unit trust structures, which are appropriate for the circumstances of the particular employer organisation and its employees.

It is important that employees are secure in the knowledge that their participation delivers a fair share in the capital growth and profitability of the company, without jeopardising their base pay entitlements, nor exposing them or their families to unnecessary downside risk of the value of shares, being the subject of the options happens to fall.

Which ESOP plan is most suitable?

If you are planning to introduce an employee share plan, there are a number of questions that you must answer before you decide what sort of plan suits you best.

Some of these questions are as follows:

1. What does the business want to achieve with its plan?

2. Who will take part in the plan?

3. Does the company want to use real shares or options in its plan?

4. Over what period does the company want the plan to operate?

5. How will the company tell its employees about the plan?

6. Will the costs of the plan be tax deductible to the company?

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ESOP Option 1: THE EMPLOYEE INVESTMENT TRUST

The concept involves the establishment of a special purpose Employee Investment Trust (EIT). The EIT receives (deductible or non-deductible) contributions or loans from Employer and purchases approved investments (for example, listed ASX shares). Those approved investments are to be held for the benefit of participating employees. Employees are in turn issued with units in the trust (investment units), the deed and the particular terms of issue of the Investment Units govern their entitlements to the investment benefits.

STRATEGY

- Retention Strategy.
- Deferred Bonus.

ADVANTAGES

- The plan is flexible and enabling – that is, it suits a wide range of strategic remuneration applications.
- Investment choice may be as flexible as allowed by the employer.
- Vesting **if applicable** is controlled by Terms of Issue of Investment Units as instructed by the Employer.
- Funding is made by the employer as contributions or loans.
- The plan provides a controlled downside risk protection for Participating Employees.
- Termination not necessarily a trigger for benefit payments.
- Concessional post Ralph CGT provisions apply to profits made on disposal of assets.
- No FBT payable by Employer.
- Fully outsourced administration.

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ESOP Option 2: EMPLOYEE SHARE OPTION PLAN

The concept involves the establishment of an Employee Share Option Plan (ESOP). The Employer makes tax deductible contributions to the Plan Trustee to enable the Trustee to purchase the options from the Employer at their value determined by the through an agreed valuation method The ESOP options are purchased by the Trustee and allocated to participating Employees, on the instructions of the Employer on the basis of terms of issue stipulated by the Employer's Board of Directors.

STRATEGY

- Retention Strategy.
- Succession Planning Strategy.
- Wealth Creation.

ADVANTAGES

- The plan is flexible and enabling – that is, it suits a wide range of strategic remuneration applications.
- Rights to shares controlled by Terms of Issue of Share Options as instructed by the Employer.
- Funding by the Employer is made as fully expensed contributions and cancellations payments, which meet the new AASB2 Accounting Standards.
- Termination not necessarily a trigger for benefit payments.
- Fully outsourced administration.

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ESOP Option 3: THE KEY EMPLOYEE OPTION PLAN

The concept involves the establishment of a special purpose employee option contract (KEOP). The Employer makes tax deductible contributions to the Plan Trustee to enable the Trustee to purchase the options from the Employer at their value determined through an agreed valuation method. The KEOP options are purchased by the Trustee and allocated to participating Employees, on the instructions of the Employer on the basis of terms of issue stipulated by the Employer's Board of Directors. The plan is especially suited to unlisted companies wished to extend equity to its Employees.

STRATEGY

- Retention Strategy.
- Succession Planning Strategy.
- Wealth Creation.

ADVANTAGES

- The plan is flexible and enabling – that is, it suits a wide range of strategic remuneration applications.
- Designed for Key Employees.
- Rights to shares controlled by Terms of Issue of Share Options as instructed by the Employer.
- Funding by the employer is made as fully expensed contributions and cancellations payments, which meet the new AASB2 Accounting Standards.
- Termination not necessarily a trigger for benefit payments.
- Fully outsourced administration.

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ESOP Option 4: THE EMPLOYEE SHARE TRUST

The concept involves the establishment of a special purpose Employee Share Trust (EST). The EST receives contributions and purchases shares in the Employer Company. Those shares are to be held for the benefit of Participating Employees. Employees are in turn issued with units in the trust, the deed and the particular terms of issue of the Share Units govern their entitlements to the share benefits.
Share Units may or may not be issued with vesting conditions, based on time and/or performance measures. These terms of issue should be consistent with the Employer's particular remuneration strategies, underpinning the offer of participation in the EST.

STRATEGY

- Retention Strategy.
- Effective Share acquisition.
- Deferred Bonus.
- Succession Planning.

ADVANTAGES

- Allows controlled access to share benefits to meet incentive/remuneration criteria.
- Funding is made by the Employer as contributions or loans expensed in its accounts.
- Allows shares to be bundled and warehoused in the EST.
- Distributes franked dividend income (if any).
- Controls Employee downside risk exposure.
- Provides owner/shareholder full control over who participates, for how much and for how long.
- Fully outsourced administration.