



# WHITE PAPER: SELLING YOUR COMPANY

*How Selling Your Company to Management Can be a Smart Exit Strategy*

**Abstract:** Selling Your Company: How Selling Your Company To Management Can be a Smart Exit Strategy  
Business owners often overlook selling their company to management as a possible exit strategy. But for solid companies with good cash flows, selling your company to management may yield a higher financial value for the owner and a much brighter future for the business, management, and the seller. This white paper discusses the benefits of the strategy of selling to management, and illustrates it with an example of a company that successfully completed a leveraged management buyout after proactively pursuing other alternatives.



## A SMART FINANCIAL MOVE

OWNERS SELL BUSINESSES NOT ONLY FOR FINANCIAL GAIN BUT TO GET AWAY FROM THE STRESS OF DAY-TO-DAY OPERATIONS. UNFORTUNATELY, SOON AFTER SELLING, SOME OWNERS FEEL REMORSE OR BOREDOM. SELLING TO MANAGEMENT ALLOWS OWNERS TO GET UPFRONT CAPITAL AND STAY INVOLVED IN THE BUSINESS AND DO ONLY THE THINGS THEY WANT TO DO.

## SELLING YOUR COMPANY TO MANAGEMENT

Business owners often overlook selling their company to management as a possible exit strategy. But for solid companies with good cash flows, selling the company to management may yield a higher financial value for the owner, and a much brighter future for the business, management, and the seller. This white paper discusses the benefits of this strategy, and illustrates it with an example of a company that completed a successful leveraged management buyout after proactively pursuing other alternatives.

### COMPANY EXAMPLE

About a year ago, we helped an owner “sell” 80% of his business to management for \$27 million through a

leveraged buyout. The owner chose this exit strategy after years of exploring different alternatives, because it provided him four key benefits:

1. He sold at a higher value than was offered by private equity firms
2. He received significant cash proceeds at the closing.
3. He sold to the group most qualified to successfully run his business-his own team.
4. He got to stay involved in the business on his terms.



This company example and the reasoning behind each of these benefits are explained further below.

### **SELL AT A HIGHER VALUATION**

Prior to working with us, our client hired an investment bank to sell their company to another business or private equity firm through a 'sponsored' management buyout. After contacting numerous prospective buyers, they received proposals from a couple of the private equity firms. Most of those proposals stated the purchase price in terms of a multiple of cash flow, or EBITDA (earnings before interest, taxes, and depreciation). The formula most commonly used was five (5) times last year's cash flow (EBITDA) minus outstanding debt, plus company cash. Based on that calculation and the company's cash flows at the time, the purchase price was about \$25 million. In addition to paying the owner, the private equity firms offered to grant management a 5% ownership stake in the business and provide them the opportunity to acquire another 5% through future bonuses or future investments.

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Ultimately, the owner rejected all the offers because he wasn't overly excited by the purchase price and also thought the private equity firms would likely change the direction of the company once they controlled it.

The owner then decided to sell the company directly to management through a leveraged buyout. However, instead of selling the business for 5 times cash flow, he offered it to management for 6 times cash flow (also less debt plus cash.) By selling the company to management directly, this valued the company at \$32 million, or about \$7 million more than his previous offers.

#### **REASONING**

It may seem counter-intuitive, but selling the company to management can often be done at a higher valuation simply because the seller (not the buyer) determines the price. The buyers (i.e. management) are willing to pay a higher price, because they can obtain a much higher ownership interest (plus job security) than they would if the Company were sold to another company or a private equity firm.

While determining a company's valuation and 'right' sales price can be 'half art, half science', many private companies below \$100 million in value, often get valued around 5 times (X) EBITDA less company debt plus cash. This valuation (5 X EBITDA less debt plus cash) is particularly common when the buyer is a private equity firm.

For some owners this rule of thumb is helpful, while other owners want to test the market by approaching other possible strategic buyers and private equity firms. In fact, it's not uncommon for owners to run a dual track of offering the company to management while considering outside buyers. This 'dual shopping' process can be an effective way to arrive at a fair price – that is where owner's don't leave money on the table and managers don't grossly overpay. In many cases, management buyouts offer a unique opportunity for both buyer and seller to get the best possible deal.

#### **SIGNIFICANT CASH AT CLOSING**

Another attractive part of our client's buyout transaction was that the owner received significant cash proceeds upon closing the buyout. Like many owners, our client wasn't interested to 'self-fund' his own buyout by providing a large seller note that the Company paid back

to him over time. Instead, he wanted cash at closing without a personal guarantee back to him. This would give him true liquidity.

To help him accomplish that, we helped the company obtain debt financing offers from several financial institutions. Ultimately, the company secured \$24 million of debt financing, \$23 million of which was paid to the owner upon closing. The difference between the owner's cash proceeds (\$23 million) and the total company valuation (\$32 million) was divided between a remaining equity stake of 20% for the owner and a subordinated note owed to the owner for \$4 million.

#### REASONING

Probably the biggest reason owners don't consider selling their company to management is that they don't see their management as qualified buyers, because managers don't have significant capital on hand to buy a business (that's why they work for a living!). But when it comes to leveraged buyouts, it's not the net worth of the buyer that matters as much as the net worth (or cash flows) of the company. In fact, when private equity firms buy companies, they rarely use all their own money. Instead, they borrow funds based on the underlying cash flows of the business they are buying. In fact, some private equity firms are able to acquire a controlling interest in a company (50% or more) solely by borrowing from the bank or lending institution (and without committing any of their own capital).

Our client applied the same concept. The debt financing that could be raised on the company was paid directly to the owner. However, instead of selling 80% or more of the equity to a private equity firm, all the equity was shared between the owner and the management team. In a way, the company acted as its own private equity firm and positioned themselves to generate much greater returns than they would have if they sold to another company or private equity firm.

#### SELL TO PROVEN MANAGERS

In our client's management buyout, four members of management purchased 80% of the ownership of the company. This was a huge difference from the 5-10% ownership offered by private equity firms. Not only did this ownership opportunity radically motivate management, it also left the company in the best hands



of the group most qualified to run it – the existing management team.

#### REASONING

Even though private equity firms and new owners often like to shake things up, good performing companies are often best left in the hands of the existing managers. In fact, companies occasionally experience dramatic growth after a buyout, because talented managers are given more incentives and control. A great example of this can be found in the book, "Breakthrough Company" by Keith McFarland. In the book, the author profiles Polaris, the industry's industry leading manufacturer of ATVs and snowmobiles. Today, Polaris' generates over \$1.5 billion in annual sales. More interesting is that Polaris' growth got its kick-start after management bought the company from its parent company, Textron, for the princely sum of \$350,000(!) back in 1981.

#### TO ESOP OR NOT TO ESOP

One question that always comes up when doing a buyout directly to management is whether or not to do

an ESOP. In our client's case, an ESOP had a significant limitation. The company was required to include all employees in the ESOP plan and company ownership. Based on the ESOP requirements and the number of employees in the business, key management was going to have a relatively small ownership position.

However, the company was able to utilize a special election available to s-corporations called a 338 (h) 10 election to get a more favorable tax treatment on the assets sold and thus increase the after tax proceeds to the owner. This election also enabled the company to deduct depreciation and amortization that increased the after tax cash flows available for debt service. This enabled the company to pay down debt faster. In the end, this election provided significant tax benefits without the limitations posed by the ESOP.

### OWNER GETS TO STAY INVOLVED

After going through a sales process a few years earlier, our client realized he didn't want to walk away completely. He liked coming to work and worked three to four days a week. By doing the management buyout on his terms, he retained a 20% interest in the business and maintained control until all the debt financing is repaid. Now our client focuses on new business



opportunities and the other areas of the business that are interesting to him.

### REASONING

Owners sell businesses not only for financial gain but to get away from the stress of day-to-day operations. Unfortunately, soon after selling, some owners feel remorse or boredom because they don't know what to do next or don't feel needed by the new owners. Selling to management allows owners the opportunity to stay involved in the business and do only the things they want to do.



### SUMMARY

From an owner's perspective exiting through a leveraged buyout may seem counter intuitive or even unorthodox, but as the example above illustrates it has the potential to be more attractive than other, better known exit strategies. For those interested to learn more about selling a company to management or doing a management buyout, please visit our

website [www.lanternadvisors.com](http://www.lanternadvisors.com). We also have several white papers published at CFO.com that discuss financing for buyouts in greater detail.

### ABOUT LANTERN CAPITAL ADVISORS

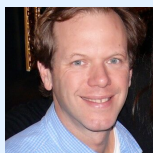
Lantern Capital Advisors is a corporate financial consulting firm for growing companies. As corporate financial consultants, we help established, profitable companies secure capital in order to fund faster growth, perform management buyouts or leveraged buyouts, achieve acquisition financing, or refinance corporate debt. As corporate financial consultants, we specialize in finding financing alternatives that allow owners and

managers to maintain control of their company and preserve equity.

We deliver our corporate financial consulting services using an hourly based engagement process that gives clients great value, peace of mind, and consistent results while at a cost that is a fraction of our (investment banking) competition.

Beyond raising capital, we also offer corporate financial planning services, serve as a corporate financial advisor, create professional comprehensive business plans, and monitor financial performance in order to help our clients use finance to realize their Company's unique potential.



**ABOUT THE AUTHOR:****CHRIS RISEY**

Chris Risey is the founder and president of Lantern Capital Advisors, an Atlanta-based corporate financial consulting firm specializing in helping successful entrepreneurial companies finance growth, acquisitions and buyouts. Lantern Capital Advisors has helped clients develop strategies and access capital to fund their Company in a way that best suits their unique needs and growth potential.

Mr. Risey is a frequent writer and speaker to financial executives and entrepreneurs through out the country interested to learn more about corporate financial planning and how to use it to build greater value in today's financial markets. Mr. Risey began his career as a CPA with Arthur Andersen. Mr. Risey is a magna cum laude graduate of the University of South Florida. He was twice named Academic All-American (Men' Basketball) and is a former Rotary International Ambassadorial Scholar.



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**MANY CLIENTS HAVE LIMITED PRIOR EXPERIENCE IN THE CAPITAL MARKETS AND WANT TO GAIN THE BENEFIT OF AN EXPERIENCED ADVISOR TO SOURCE FUNDING ALTERNATIVES AND GIVE ADVICE THAT IS IN THEIR BEST INTEREST. LANTERN CAPITAL ADVISORS HOURLY BASED CONSULTATIVE APPROACH UNIQUELY POSITIONS US TO DO JUST THAT. OUR PROFESSIONALS HAVE BEEN ENGAGED IN A BROAD ARRAY OF LARGE AND SMALL ASSIGNMENTS ACROSS VARIOUS INDUSTRIES ACROSS THE UNITED STATES. COMMON CLIENT ENGAGEMENTS AND ACTIVITIES INCLUDE ONE OR MORE OF THE FOLLOWING:**

- ❖ **EVALUATE GROWTH AND VALUATION ALTERNATIVES**
- ❖ **SECURE CAPITAL FOR GROWTH OR LIQUIDITY**
- ❖ **COORDINATE MERGERS/ACQUISITIONS**
- ❖ **COORDINATE MANAGEMENT BUYOUTS**
- ❖ **PREPARE QUALITY BUSINESS PLANS**
- ❖ **REPLACE CURRENT LENDERS OR INVESTORS**
- ❖ **REMOVE PERSONAL DEBT GUARANTEES**
- ❖ **SOLICIT UNDERWRITERS FOR SECURITIES OFFERINGS**