CHAPTER

4 *What Are the Exit Options for your Business?*

Choosing the optimum exit option for your business is a vital part of exit strategy planning. In this chapter we:

- examine briefly the various exit options available to the owner of a private business so that you are able to form some initial views on the options that could be relevant to your business
- show you what to look for in your business to establish, in principle, whether it is suitable for the option being considered
- look briefly at some of the market and investor requirements for a business to qualify for various options.

Do you know how to exit your business?

Many private business owners are not aware of the various ways in which they can dispose of their businesses. Those with families will have considered family succession planning, even if they are unsure of exactly how to do it. Others will think that their only option is to sell to a third party, in what is often called a 'trade sale'. Some will be aware of the opportunities afforded through a management buyout and, perhaps, a few of you will have considered a flotation, or even franchising.

This chapter gives an outline of the many options that could be available to you to dispose of your business so that you can maximize your sale price and your personal satisfaction. After studying this and the following chapter it will be easier for you to make a preliminary shortlist of the disposal options best suited to your business. In the appendices that follow a more detailed account of each exit strategy option is given. You should study the specific appendices that cover the options on your shortlist and this should enable you to make a final decision. Before making your final decision you might wish to get further advice on your choice of option from an appropriate professional adviser.

Choice of option could be crucial

Importantly the choice of the correct option could make the difference between disposing of the business for a fair price and not being able to dispose of it at all. With the choice of the right option you could be creating a market for your equity that did not exist previously. An example of this could be to groom a manager to buy your business and to assist him or her with the purchase funding, where no other party is interested in purchasing it.

What are the exit options?

There are at least eight main ways in which you can dispose of your business. There are also various variations on the main ways. One example of a variation is where in a trade sale you sell part only of your shares rather than all of them. Another is where in a management buy-out an outside chief executive officer (CEO) is brought in to assist the internal management, making it partly a buyout and partly a buy-in.

The main exit options available to a private business are as follows:

1. Transferring it to a family member (known as a family succession).
2. Sale to internal management or employees (known as a management buy out or 'MBO').
3. Sale to outside management (known as a management buy-in, or ' MBI').
4. A public listing (or flotation) on the stock exchange.
5. Franchising your business operations (and, as an optional second stage, selling the franchisor business).
6. Sale to a third party (also known as a 'trade sale').
7. Merger of sole traders, or smaller businesses in the same industry.
8. Ceasing to trade and ultimate liquidation, or close down.

Many of the variations on the basic exit methods mentioned above are packaged and promoted by financiers or business consulting firms, but the differences are usually only in the way transactions are structured: the principles of the exit process remain the same.

The exit options explained in brief

To make even an initial shortlist of optimum exit options it helps if you understand how they work. Below we provide a brief review of the options from the aspect of how they might suit you and your business. Fuller explanations of the processes involved in each option and of how you would implement an exit strategy utilizing each option are given in the relevant appendices.

FAMILY SUCCESSION

A family succession involves passing on your business to a family member, such as a child. Most private business owners with children, or who have a close relationship with a younger relative, usually are favourably inclined to this exit choice where it is practicable. Unfortunately, even those with close relatives such as children, often find that their heirs are not interested in, or capable of, taking over the running of the family business. For these people, and for those without a family heir, the family succession option is, obviously, not applicable.

Although desirable from the point of view of personal satisfaction for the owner, family succession can be the most difficult exit strategy of all. The greatest problems are that family and business goals and cultures often clash, objectivity is often absent and emotion rather than business practicality takes over.

We cover this option more fully in Appendix 4, and if you are considering family succession as a disposal option you should read this appendix carefully.

MANAGEMENT (AND/OR EMPLOYEE) BUYOUTS

What is an MBO?

Contrary to common belief, exit through an MBO is available to any private business and not just the larger ones; nor are venture capitalists (VCs), or corporate finance specialists, or bankers necessary to organize them. An MBO is simply a business sale where the buyers are the management and/or employees of the business. It is true, of course, that financiers do get involved in most MBOs by arranging the financing and taking an equity stake in the business, but this is not a prerequisite for an MBO.

An MBO is also a widely used exit strategy by public companies wishing to dispose of subsidiaries that are considered not to be core group operations.

Could an MBO be suitable for your business?

You will need to distinguish initially between an MBO that is not funded by institutional investors and those that are. The main difference is one of size of the transaction: VCs are unlikely to be interested in a deal in which they are investing less than £500,000. Otherwise, the general prerequisites of MBOs are the same.

If you have suitably talented management in your business that you believe would be interested in an MBO, you should seriously consider an MBO, because your management and employees (who we will collectively call 'management') could be the perfect buyers of your business. There are many reasons why this could be the case, namely:

1. Management should be aware of the potential of the business and, because they understand its operations better than any outside buyer, they should have sensible ideas of how to achieve this potential.
2. Management is familiar with the business clients, suppliers, financiers and employees.
3. As an owner, you know your managers and their capabilities intimately and, hopefully, you trust them.
4. With a sale to a group of people you know well you are more likely to be able to structure the sale to suit your retirement planning needs (including your possible future involvement in the business) than in other disposal options.
5. There is a great deal of personal satisfaction in seeing people you have taught, worked with, know and like, purchase your business.
6. Management is often driven by personal and emotional reasons to buy your business, making them keener to buy than most outside buyers and, perhaps, to pay you more for it.

MBO requirements

We have looked at the potential advantages to you and your management of an MBO, but you now need to look at aspects of your business and its management that need to be in place before an MBO is likely to be successful. There are two aspects that need to be present, namely a strong cash flow and management expertise.

Cash flow Employed managers are not usually wealthy and, consequently, they will need to borrow a large portion of the purchase price if they are to undertake a successful buyout. This will result in a substantial interest bill and the business will need to have a steady, positive cash flow to meet its repayments schedule. The business will, of course, have other needs for cash, not least being reasonable salaries for the managers themselves. If the managers are put

under too much financial pressure the business itself could be in danger of collapse. If you as vendor are part of the financing arrangements through providing vendor finance, this will, of course, put your own position in danger also.

Management expertise It is usual for an MBO to be a team effort, with line managers, a CEO and financiers making up the team. At the head of the team should be an effective, experienced CEO who has the right leadership qualities and good relations with the rest of the team. The management team should include members who have a wide range of business skills. Where the MBO is being financed from outside, the managers must have the confidence of the financiers and the ability to 'talk their language'.

Generally speaking the management should have the following attributes:

- experience in the essential operational functions of the business
- strong financial management skills
- involvement in the day-to-day running of the business in a hands-on way
- the ability to produce well thought out strategic and business plans, with accurate financial forecasts.

Where outside management is brought into the team, the transaction becomes a management buy-in, which we discuss next.

MANAGEMENT BUY-INS

An MBI is an MBO in which outside management (usually an individual with particular talents) puts a team together to purchase a business from a private business owner or a public company. Where an individual is brought in by the financiers to bolster a management team that has perceived management weaknesses, this is a hybrid transaction called a MBI/MBO or 'BIMBO'. A further variation on this is where an institution initiates and drives the buyout (called an 'IBO').

As a business owner if you feel that your business is suitable for a management buyout but that there are weaknesses in the current management team, you could try to find a suitable outside party as the potential CEO to lead a buyout team. On the other hand, potential CEOs from outside the business could recognize an opportunity in your business and themselves initiate a buy-in.

(For a more detailed description on the MBO process you should refer to Appendix 5.)

PUBLIC LISTING, OR FLOTATION

Most private businesses do not make enough profit (nor have the profit potential) and are not big enough in terms of capital to be attractive to investors, or to qualify for the minimum requirements of either the London Stock Exchange's (LSE) Main or Alternative boards. But although this appears to rule out the listing option for most private companies, the rules are not hard and fast.

In certain phases of the economic cycle investor requirements are more biased towards entrepreneurial enterprises, and profit potential could be enough to attract investor support for a flotation. Also, the LSE rules for the Alternative Investment Market (AIM) are not as strict as for the main board, and alternative opportunities with less structured rules, such as OFEX, exist for smaller companies.

A flotation of your company is best considered as a multistaged exit strategy, that is an initial sale of your equity to the public followed by the opportunity to sell further tranches of equity into a much more liquid market and at, hopefully, ever-increasing prices. A flotation can be a high reward strategy and if you have a profitable business with strong growth potential you should give it serious consideration.

To be listed on the LSE, either on the AIM or the Main Board, or on OFEX, a company needs to meet certain minimum requirements. These are detailed in Appendix 6, which you should study in detail if you believe a listing might be a viable exit option for your business.

FRANCHISING

Like a flotation, franchising your business could be a multistaged exit strategy. The first stage would be to establish a franchise business by selling off part of your current business operations. Next you could sell further franchise outlets and eventually you could dispose of the franchisor business itself.

If you are thinking about franchising your business as an exit option, you should check initially whether your business might be suitable. The following characteristics are usually necessary for a business to be successfully franchised:

- It must have a strong brand recognition, or be able to build one.
- It must have a unique or new way of conducting business (that is, a unique operating system), or an aspect of its business that is unique, such as a formula.
- The business system must be relatively simple and be able to be taught to others, so that suitable franchisees can be found.
- It must be able to duplicate its operations outside its current geographical areas of operations.
- There must be sufficient gross margin in the business for the franchisee to pay the franchise fees and still make a reasonable net profit.
- The business must have financial and operational systems in place that can keep track of the franchisees operations and ensure that the franchisor gets paid.

From your personal point of you as an owner (or franchisor), you must be capable of managing a group of independently minded business people who will make up your franchisees.

(A fuller explanation of franchising is given in Appendix 7.)

TRADE SALES

A sale to a third party on the open market (known as a 'trade sale') is the method of disposal most private business owners think of when they consider disposing of their businesses, and it is still the way most private businesses are sold. Most businesses in most industry sectors are suitable for a trade sale and there are usually no special attributes you or your business need if you are to dispose of it through this route. The key question that an owner should ask when considering a trade sale is the following: 'Is this the best way for me to maximize my financial return (and, perhaps, my personal satisfaction) when exiting my business, or should I be thinking of different options?' An understanding of the other options (which are described in some detail in the appendices) will obviously help you to

answer this question with any authority. If, having studied the appendices, you still believe that a trade sale is the optimum exit option for your business, then all you need to understand are the procedures and the pitfalls of this disposal route, which are covered in detail in Appendix 8.

As most businesses are suitable for a trade sale, the issues that need considering are often more to do with your own financial position than the position of your business. Some of these issues are discussed below.

Selling the business yourself

You can sell your business through an agent or company broker, or you could decide to handle the sale yourself. If you decide to handle the sale yourself, you should address the following questions:

- Am I able to establish a fair market price for my business?
- Am I able to find someone who wishes to buy my business?
- Am I able to negotiate the best price on my own?
- How do I best structure the sale transaction?
- Am I in a position to provide some of the funding?
- How do I arrange a suitable handover and how long should this be for?
- If I want to continue to be involved in the business after sale (perhaps as a consultant), how do I go about this?

Funding

It is sometimes difficult for purchasers of a small business to borrow money to finance a purchase (particularly where goodwill value is a major part of the price), unless they can provide security outside the business, such as a house that is not already heavily mortgaged.

One way of overcoming this difficulty would be to provide vendor finance, so you need to consider if you are prepared, in principle, to do so. To help your deliberations, you should ask yourself the following questions:

- How badly do I need the sale to go through at the price I am asking?
- Do I need all the cash proceeds of the sale now and how urgently do I need them?
- How confident am I of the financial viability of the business in the purchaser's hands? (*Note*: your old business is likely to be the security provided for the purchaser's borrowings.)

Retentions

In a trade sale of a small business it is not unusual for a purchaser to keep back a specified portion of the purchase price (especially where the price consists mainly of goodwill) until it is proved that the business can retain its customers or clients, (that is, its turnover or sales levels). The withheld portion (or retention) will usually be held in trust until the trial period has expired. When the performance conditions are met the retention is paid to the vendor. You need to consider whether this is likely to happen in your business and whether you can cope with this if it does.

Earn outs

This refers to the circumstance where a portion of the ultimate purchase consideration is based on a multiple of future earnings of the business sold. This is not uncommon practice where a large amount of the purchase price is goodwill (for example, in many service

industries where there are few hard assets in the business). Total ownership of the business will pass on completion and the payment of the first tranche of capital, and the final payment will be conditional on trading results. The main difference between a retention and an earn out is that in the former the amount held back is specified, while in the latter it will vary depending on the extent of the profit achieved.

You will need to consider whether either a retention or an earn out is likely to be asked for by the purchaser and what your reaction will be if it is. Your response is likely to turn on your immediate need for the entire sale proceeds.

(All these issues are covered in more detail in Appendix 8.)

SOLE TRADER MERGERS

The mergers we are considering here are those between smaller private businesses and professional practices who are, typically, sole traders. This exit option allows a retiring business owner to plan an exit strategy at an early stage through an arrangement with another owner, who is keen to expand his business. For the retiring owner this can be a relatively low-risk option and allows some latitude in working out your retirement at a reduced level of intensity in the newly merged business.

The sole trader merger can be a three-staged exit strategy. Stage 1 involves the merger of two businesses (with perhaps an initial purchase of equity). Stage 2 involves the buy out of the older owner' s interest (or the balance of his interests) in the merged business by the younger owner, while stage 3 could involve the retiring owner working out a retirement period as an employee.

To consider exiting through this method you would be, typically, a sole trader and you would need to find a younger sole trader in the same industry with a similar working philosophy as yourself.

(This exit option is dealt with in more detail in Appendix 9.)

CEASING TO TRADE

If 'going concern' status is not maintained, most businesses will lose a large part of their value. Experience shows that assets such as plant and equipment, or stock, which are sold in auctions (or in fire sales) seldom fetch their so-called 'market value' and often sell for less than their written-down value. Even real property can fail to reach market value when there is a forced sale. Just as damaging will be the fact that a business, which is not a going concern, will usually have no goodwill value.

To close down your business and attempt to sell off its assets is, therefore, usually the worst of all exit options for you. However, there are circumstances where the value of the business as a going concern is no greater than the value of its assets and, indeed, when the value of the assets could exceed the going concern business value. It is in these circumstances that an orderly disposal of a solvent company's assets (followed by liquidation of the company) could make financial sense and we discuss these circumstances in some detail in Appendix 10.

Sometimes, the close down of your business will be not of your choosing. If you are forced through insolvency to liquidate your company, then planning an exit is out of your hands. A detailed examination of this area of business life is outside the scope of this book, although we deal briefly with some aspects of insolvency in Appendix 10.

How to choose the right option?

In summary, the steps you should follow in choosing the exit strategy that is best for you and your business are as follows:

1. You should analyse the reasons why and when you wish to quit.
2. You should consider which option is the one you would prefer for personal as well as business reasons.
3. You should understand your disposal choices in general terms from reading this chapter.
4. You should then read Chapter 5 and make a shortlist of what appear to be the best options by going through the options elimination worksheet in Figure 5.2.
5. You should study your choices more closely in the appropriate appendices at the back of this book.
6. You can now make your final choice or, if you feel it is necessary, you could obtain professional advice to help you make your final choice.

Conclusion: choosing the best option

Now that you have had an opportunity to consider these options in brief, we show you in the next chapter how to approach the choice of the best probable exit options for your business.