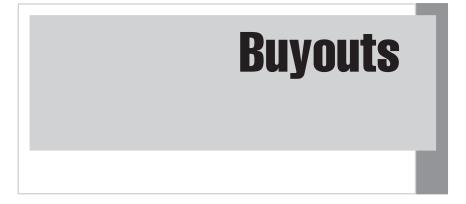


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Success for Owners, Management, PEGs, Families, ESOPs, and Mergers and Acquisitions

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SCOTT MILLER



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SCOTT D. MILLER



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To my wife, Jayne, and my children, Melinda and Mark

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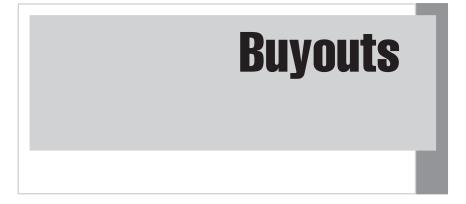
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Dream no little dreams. They have no magic to move men's souls. —Jeremy Bentham



The New Reality for Business Owners in 2012

First things first, but not necessarily in that order. —Anonymous

istorically during the past 10 to 15 years business owners had little to fear about the failure to sell their businesses to third parties. There was the perception that there were many buyers waiting for the opportunity to acquire a business, bank resources were generally available to finance such transactions, and capital gain taxes were at historic lows. This thinking is not reflective of today's business environment. There are several important forces at work in our current economy, and the confluence of their impact has broad and far ranging significance for business owners that challenge the too comfortable thinking of the past. Circumstances for business owners have unalterably changed, and this book will help you make decisions in the upcoming uncertain future.

First, we passed a significant milestone with the financial meltdown of Wall Street in the fall of 2008. Within just a few weeks the entire face of the financial industry was systemically changed as one whole segment of investment banking capabilities was irrevocably altered. Linked to the implosion of the housing market and the subsequent torrent of bad debt, the banking industry shifted to preserving capital and avoiding most lending activities with any significant risk attached to it. Suddenly, commercial credit for middle market firms literally disappeared or was significantly reduced.

Second, there is a wave of "boomers" coming of retirement age. The oldest of the baby boom generation (1946–1964) are turning 65 in 2011. While many refuse to face reality regarding aging and reaching retirement,

the fact is that an estimated 80 million of them will be retiring in unprecedented numbers during the next 10–15 years. Much of the wealth of the boomer generation is committed to equity in closely held businesses, and releasing those resources for retirement purposes will have a telling impact on our economy. It is estimated that there will likely be far more sellers of businesses than buyers as the torrent of boomers seeks to ease into retirement.

Third, there is an almost certain material increase in taxes coming by January 1, 2013. The tax increase legislation has already been passed and signed into law. The increases are the direct result of "sunset" provisions in the tax cuts passed in the early 2000s often referred to as the Bush Tax Cuts. Tax rates such as the capital gain and ordinary income taxes will reset to the comparable rates in 2001. For example, at the Federal level, capital gain taxes will increase from 15% to 20%. Additionally, the new Patient Protection and Affordable Care Act passed in 2009 will impose surtaxes on certain capital gain and ordinary income taxes. State and local taxes on the sale of a business combined with Federal obligations will have a substantial impact on the net proceeds realized by a business owner.

In summary, there will be far fewer buyers with cash waiting to acquire companies. Business owners are well advised to be proactive and begin today to consider options that do not involve third-party buyers. There is a whole range of candidate buyers for the business including managers, key employees, family members, Employee Stock Ownership Plans (ESOPs), and private equity firms in concert with management. Selling to one or a combination of these buyers often results in a desirable outcome, but such a positive conclusion takes careful planning and above all, time. This book will demystify and provide a detailed look into the complex world of inside buyouts.

THE MIDDLE MARKET

This book is addressed to the stakeholders in middle market companies. The stakeholders include a wide range of interests including business owners, their families, key employees, professional advisors, communities, suppliers, and customers. The list is almost endless.

For my purposes the middle market is loosely defined as closely held companies with an overall value between \$1 million and \$250 million. There are thousands of companies with modest valuations under \$1 million. Those businesses typically have few employees, little management beyond the owner and operate from a single location. These are the companies we find on "Main Street." Those companies are briefly addressed in Chapter 18. The succession options for them are often limited due to size and a restricted market presence. Companies with a value over \$250 million are typically divisions of public companies or public companies themselves. They have market dynamics beyond the scope of this book.

Middle market companies, as defined here, represent closely held businesses that most often have been founded by one or a few individuals with a vision of doing things better. With vision, hard work, and a positive attitude it is just possible such attributes will lead to the evolution of a successful company. According to the Middle Market Investment Banking Association it is estimated there are over 20 million privately held companies with sales under \$1 million, and most of those businesses have no employees. There are approximately 1.2 million companies that meet the arbitrary definition of middle market companies as defined herein. Many of those companies are owned by aging baby boomers. As a generation, every day that passes thousands of boomers turn 65. The end of the working career is approaching rapidly for many.

This book will be of value to business owners and the employees in those companies. The book will also be of assistance to professional advisors to privately held businesses. Too often outside advisors assume the company has to be sold to outsiders if there is no logical family member to assume the mantle of leadership. As you read the book, it will be shown that business owners have many attractive options, but they must recognize that the options involving the transition involving insiders will take time to complete.

NOT ANOTHER MERGERS AND ACQUISITIONS BOOK

This book is focused on *buyouts*. Most significantly, the emphasis is on inside generated buyouts, typically not the sale of the company to a third party. First I examine common attributes with all business transactions such as the state of the economy, financing resources, valuation insights, the consideration of professional advisors, and how to minimize taxes.

There is a tidal wave of retirements coming as the boomers begin to exit the workplace. It is likely to be a buyer's market for many years. The face of acquisition financing has changed, as banks become more risk averse in the post 2008 Wall Street debacle. Strategic business thinkers will recognize the forces at play and will work to optimize options. Those few exceedingly successful companies with strong growth and demonstrated profitability will always attract buyer attention. There are fewer of those companies. There are a vast number of attractive, profitable, closely-held companies that will likely be under the radar screen of outside buyers. This book addresses one option often not recognized by business owners; the inside buyout. The reason business owners often do not consider such an option is that there is the perception that "insiders" do not have the financial wherewithal to acquire the company. It is true that such buyers cannot typically write a check for the business. After 2008 fewer outside buyers can do the same thing. I suggest that many business owners take a deep breath and think about exiting the business over time. With a longer time horizon, inside initiated options are now far more likely. The benefit to inside buyouts is that the seller is dealing typically with employees and people that have been known for many years.

CHAPTER ORGANIZATION

There are a series of chapters that consider inside initiated buyouts from many perspectives. Beginning with Chapter 9, I look at management (or key employee) buyouts. The management buyout is considered from the perspective of overall advantages and common cautions or issues that need to be addressed. Valuation considerations are part of the analysis followed by observations on the viewpoint of the seller and buyer. The analysis considers professional advisors and a risk analysis that could threaten the transaction. Finally, technical matters impacting the structure of the proposed transaction are considered. All the succeeding chapters follow a similar outline.

Buyouts involving the assistance of private equity firms, or private equity groups (PEG) are considered in Chapters 10 and 11. The distinction is made between PEGS where management has been instrumental in the selection of the PEG (Chapter 10), and where the seller has been instrumental in the selection of the PEG (Chapter 11). ESOPs are addressed in Chapter 12 where the ESOP is one of perhaps many investors; and the case where the ESOP is the 100% shareholder. A special 100% ESOP in Chapter 13 is included because of the extraordinary tax benefits and operating environment of such a capital structure.

Professional service firms, including engineering firms, public accounting firms and management consultants, are addressed in Chapter 14. Many of those professional service firms embrace broad based employee participation. The use of "parallel companies" is considered in Chapter 15, a strategy employed when the underlying company is subject to high revenue volatility or cyclical results typically found in construction companies.

Succession within family businesses is the topic for Chapter 16. There is currently an enhanced opportunity to transfer family company ownership to the next generation of family members because of newly enacted gift tax legislation. Employee cooperatives are a little known option due to restrictive state laws, but when properly applied as discussed in Chapter 17 they may be an exciting option to explore. The last chapter on buyouts addresses the smallest privately held companies, Chapter 18.

The comparison between inside buyouts and selling to a third party is considered in Chapter 19. This is a summary chapter on options for the business owner and his advisors to consider.

CHAPTER 1

Buyout Examples

Opportunity is missed by most people because it is dressed in overalls and looks like work.

-Thomas Edison

Throughout this book I reference many case studies of real companies that have gone through the buyout process. Additionally, there are many illustrations of buyout principles without naming specific companies for confidentiality reasons. Years of speaking and consulting have me concluding that the reference to appropriate case studies is a time honored and preferred means to communicate key concepts. Case studies with real life applications are so much more viable than dry technical narrative.

This first chapter is intended to introduce you to a select number of thought leaders, visionary thinkers, and hands-on business entrepreneurs that illustrate how to roll up your sleeves and work toward accomplishing extraordinary results. In order of presentation we will explore SRC Holdings Corporation in Missouri; SSG Financial Services a public accounting and consulting firm in Ohio; and Quality Assembly and Logistics, LLC in Wisconsin. The last case study is Jumbo Heater and Manufacturing Company, Inc. in Cleveland with some personal lessons learned.

CASE STUDY—SRC HOLDINGS, CORPORATION

Perhaps one of the most celebrated management buyouts of a business is the case of the International Harvester's ReNew Center Repair Division which was started in 1974. The Division became known as Springfield ReManufacturing. Mr. Jack Stack joined the company in 1979 and played an integral part in the buyout from Harvester. As part of International Harvester's Construction Group in Woodfield, Illinois, the unit focused on remanufacturing engines and components used as replacement parts in Harvester equipment. In 1981 International Harvester itself was realizing financial difficulties and that stress was making its way throughout the entire organization. A recession was gripping the country and Springfield ReManufacturing was already experiencing a wage freeze.

Jack Stack, General Manager for Springfield ReManufacturing, was thinking of ways to save jobs at the plant. The Springfield ReManufacturing Division was still profitable even as the fortunes of the parent Harvester were deteriorating. The thought of buying the operation from Harvester was broached, but Harvester was having so many of its own problems at the corporate level the proposed buyout was delayed. After a succession of new Harvester managers in a short period of time, the management proposal was lost in the increasing mountain of Harvester problems. Compounding the stress, Harvester placed the Construction Group on the sale block and one large international company was bidding on the bundle of operations. At the darkest hour, Jack was convinced that the plant would be sold to a third party.

The proposed sale kept getting delayed. Jack was aware that negotiations were very complex. Suddenly in the middle of negotiations, Jack received a call from a lead Harvester negotiator stating that talks were at an impasse, and some of the issues involved Springfield ReManufacturing. In reference to an earlier purchase inquiry from the management, the Harvester negotiator said they could have the plant for an additional million over the preliminary offer of \$6 million. Jack was "tapped out" for financial resources at \$6 million. Virtually all that amount was debt, and finding another \$1 million seemed impossible. With his creativity hat on, Jack proposed the extra million be in the form of an unsecured one year note from Harvester to Springfield ReManufacturing. On paper it is an extra million with "terms." Nothing like some delayed payments to overcome lack of cash today. Harvester was Springfield ReManufacturing's largest customer and they could see that repayment on the note was likely. The deal was accepted.

Management succeeded against impossible odds to acquire the business unit and in 1982 SRC Holdings Corporation (SRC) was formed. The structure of the transaction still is haunting today. Management, numbering 13 individuals, in 1983 was able to raise \$100,000 in equity between them toward the eventual purchase price of approximately \$9 million. When we look at the math SRC was leveraged approximately 89:1 debt to equity. In an era when financial institutions like to see debt to equity ratios of 2:1