How to Cash Out Some Equity, But Stay Partly in Game

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JOHN BUSH

How to cash out some equity, but stay partly in game

IF YOU ARE A TYPICAL entrepreneur, your largest investment is your business.

This is a natural phenomenon, since we initially perceive that our best chance of controlling our destiny is through managing our own business. Then we continue to up the ante, reinvesting our earnings and letting them ride to fund growth.

So we take the risks (including personal guarantees on business debt) with most of our personal resources being "in the game" every day of our business lives.

There comes a time, however, when prudence dictates that we balance our estates and take some chips off the table. This can be done in a variety of ways, including recapitalizations that allow us to reduce risks yet stay in the game. Here's a rundown:

Ultimate exit

Traditionally, the ultimate exit strategy was to sell the business and cash in. This strategy has always required some planning, and some good fortune, to time the exit so as to maximize the proceeds from a sale.

Many businesses have followed the general trend of the economy in recent years and have experienced some temporary downturns in business. And, while most are now starting to return to normal growth in sales and profitability, a business sold before a full recovery might not command its full value in the marketplace. So it seems that an entrepreneur is forced to wait a little longer and continue taking large risks with the lion's share of personal wealth.

However, if you are interested in decreasing the risks of holding a business through uncertain times, and therefore are willing to consider a sale, there are several current considerations that you should take into account:

U.S. income tax rates. There is a very attractive window open today for the sale of a business. Dividend rates are only 15 percent (for those with C corps), and more importantly, your personal capital gain tax is generally 15 percent.

There appears to be considerable risk that these rates will return to pre-Bush levels, generally 25 percent for capital gains and about 38 percent

[tips]

1 | If you believe interest rates will rise any time soon, there is a good chance the value of a financed business will decrease.

2 | Likewise, if you believe personal capital gain and dividend taxes will increase after the next election, now may be the time to sell.

3 | Many private equity funds today are willing to acquire a minority interest, and invest in smaller companies than before.

for dividends. There is even some risk that capital gain rates could exceed the 25 percent rates.

If you were to sell your business now at a $1 million gain your federal tax rate would be at 15 percent. To net the same amount in the future with a 25 percent rate, you would need to sell for a gain of $1.135 million. Risks of the alternative minimum tax would apply in either case. If you agree that rates will increase after the coming election, these matters are very compelling to you.

Interest rates. Generally, there is a relationship between the cost of capital for a business acquisition and the price that can be paid. If rates are higher, debt service is higher and net cash flow is lower, therefore the price would normally be lower. Interest rates are currently very low. If you believe they will rise any time soon, there is a good chance the value of a financed business will decrease.

Market values. There are many forces working on market values for businesses. Capitalization rates (the rate of return demanded by buyers) are very important. Cap rates are generally affected most by interest rates as mentioned above. Demand is also a critical determinant of price. There is a great deal of money chasing very few deals today, creating demand for businesses far in excess of supply, which tends to increase prices and improve terms for sellers.

Tax deferral. Installment sales have been available for most business sales (with certain limitations such as recapture). However, installment reporting means you are financing the debt. Providing financing can be good based on the fact you receive returns on pretax income, possibly pay lower taxes when you do pay, and you can often receive an interest rate superior to alternative investment opportunities.

However, you are generally risking that you won't get paid. Historically you would not be able to use installment reporting if money was escrowed or otherwise available to you, because it was considered "constructively received." There is currently an opportunity to use a hybrid tool, a guaranteed structured installment sale, which will guarantee that you get your money but you will not be taxed until it is received (normal exposure to constructive receipt issues are eliminated).

Recapitalization. The term "recapitalization" is often used in general contexts. In fact, an initial public offering, an outright sale, and a debt refinancing might all be called recaps. However, consider specifically the use of private equity funds that participate in changing the capital structure of your company. There are many of these funds and they have substantial capital that they very much want to invest.

[quote]

"There is no need for you to live in a 'hold 'em or fold 'em' environment with your business. It is quite possible that now is the most prudent time to take all or some of your chips off the table and remain a winner."

— Michael Hannon, Lingate Financial Group

These funds in the past have mostly been available only to larger transactions, often with minimum investments of $10 million. Today the funds are willing to invest in smaller companies, buying a percentage of ownership and bringing new senior debt to the table (eliminating the personal guarantees of the current shareholders).

Patient debt

Many funds are willing to acquire a minority interest. In some cases, the fund will design a program involving part equity and part "patient debt." The huge benefit available through this mechanism is the opportunity to withdraw some but not all of your capital from your business. You can therefore better define part of your estate, diversify prudently and yet stay involved personally and financially in your business without risking all your business net worth and personal guarantees.

There is no need for you to live in a "hold 'em or fold 'em" environment with your business. In the event you expect your business to improve dramatically in the near future, but you don't want to stay fully at risk until that happens, a recap could be the perfect prescription for you.

If it is time for you to limit the risks of having your worth depend entirely on the continued success of your business, you don't necessarily have to wait for a total economic rebound to take action. It is quite possible that now is the most prudent time to take all or some of your chips off the table and remain a winner.

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