

Choosing Your Exit Strategy

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Perhaps the most important piece of the initial business plan that is commonly overlooked by entrepreneurs **is their exit strategy**. It probably seems silly to spend much time thinking about how to liquidate your future interest in a business that doesn't yet exist. Yet, your exit strategy impacts many directions that you might choose in growing your business. Not considering your exit strategy early may indeed limit your options in the future. Remember: It is not a matter of if you will sell, or otherwise dispose of, your interest in this business. **Your only decisions are when and how.**

OK, you say: So why do I need to plan my exit strategy early? Here are just a few reasons:

First, it is very important that your founding operating partners and investors agree on your exit strategy. If you later decide you would like to give your shares to your heirs, for example, your angel investors will not be pleased and may choose an exit strategy that does not complement your future plans. If you wish to sell the business in five years, but your operating partner wants to own and manage the business with you for fifteen years, you have a problem. If you suggest to key employees that you have no plans to exit the company and then sell the company in two years, they will likely be quite dissatisfied and could disrupt the sale.

Second, if you wish to share equity with your employees or with your heirs, it is important that you start early, when the company valuation (and share price) is low. U.S. tax laws severely limit gifts to heirs; hence, it will take many years to pass the business on to children. Assuming the company experiences consistent growth, sharing equity with employees can be rewarding at any stage in the business cycle. However, transferring total ownership to the employees, including the sale of your shares, is more easily accomplished by starting early, when the company valuation is low.

Third, if you choose to fund the early growth of your company using venture capital (VC), you are usually setting on a course which will lead to an initial public offering, or IPO, or to the sale of the company. Before seeking VC funding, it is mandatory that the entrepreneur contemplate the management and control issues that accompany VC funding and

eventual public ownership.

Finally, if you plan to seek a business partner and/or outside financing from angel investors, banks or venture capitalists, I can assure you that someone will ask about your long-term plans regarding the business, and specifically, how long you plan to be with it. You need to have a thoughtful response.

The liquidation of ownership in your business is a very personal decision, and, as the entrepreneur, it is yours to make. I have heard entrepreneurs say that creating a business and selling it within a few years is a travesty to the employees who helped build it. Others have said they couldn't possibly go public, because a "big brother" would constantly be looking over their shoulders. From my perspective, there is no incorrect exit strategy. You, your partners, your investors, and your employees are building a business. Your exit strategy is simply a very important part of your business plan. Entrepreneurs generally have four choices for liquidating the equity in their businesses. What follows is a description of each.

Selling the Business

Selling your business to another individual or independent business is a huge decision **and generally one that is difficult to make.** One day you own the business, and the next day you do not. To optimize the terms of the sale, the new owner will insist you continue to operate the business for an agreed-upon period of time. From another perspective, then, you move from controlling owner to employee in one quick step.

The proceeds from the sale of a private company are usually for cash, for shares of a public company, for shares of a private company, or for a combination of the above. This is generally a move toward greater liquidity in your personal estate. You are selling illiquid shares of your private company for cash and/or shares of a public company that will eventually become liquid.

This allows the successful entrepreneur, who often has nearly 100 percent of his or her assets tied up in the business, the option of diversifying his or her portfolio of investments. Some entrepreneurs sell to other private companies and achieve asset diversification by becoming part of the larger, merged business. While immediate liquidation may not be their primary driver, entrepreneurs who take this course usually move closer to a liquidation opportunity.

The disadvantages of selling your business are also obvious. You have sold your "baby". You are no longer in control. You may have passed up the opportunity to grow the business (and the value of your shares) in the future.

When do you sell? It may be time to begin working on selling your business when you are losing sleep (or your hair) because you realize the

following:

1. Your business is a very valuable asset, and
2. Ownership represents nearly 100 percent of your net worth, and
3. Some power outside your control (competitor, government, act of God, etc.) could take that away from you.

What are my personal preferences regarding the exit strategies of businesses I have started or assisted with funding during the start-up phase? I prefer investing in niche or boutique businesses in which:

1. the investment required to achieve break-even in cash flow is less than \$500,000;
2. the annual revenue potential within the first five to ten years is \$5 million to \$20 million; and
3. the likelihood that a large public company might be interested in purchasing the company is significant.

(In other words, I like small, well-run companies positioned to be "discovered" by an attractive buyer.) The agreed-upon exit strategy at the start-up of these businesses has been to sell to an attractive public company as the business approaches a preset valuation.

Were we able to execute this exit strategy? For those two businesses that crashed and burned with no survivors, of course not! **But, it has worked nicely with others.** For my first business, Solid State Dielectrics, Inc., we managed to be discovered by DuPont and were very pleased with the specifics of the sale of the business. The business is now approximately 15 times larger than it was when we sold it in 1982.

We are pleased that the business has thrived for the new owners, and we have never looked back. As angel investors, we have subsequently implemented this exit strategy with two additional businesses, which continue to operate successfully, and we are positioned to carry out this strategy with a third. In all cases, the exit strategy was agreed upon early in the development of the businesses by all involved principals.

Going Public

Offering shares of your company to the public markets is viewed by some as an exit strategy. **In my opinion, it is not.** Initial public offerings, or IPOs, involve the issuance of new shares for cash, at a time when the business is challenged with an opportunity to grow, which would be facilitated with an infusion of cash. However, going public generally limits your exit options and, by default, defines your exit strategy. Once the shares trade in public markets, significant employee ownership (that is, more than 50 percent), or control by your heirs, is unlikely.

Selling ownership to public markets generally provides the cash for growth, while offering the principals of the company the promise of some future liquidity of their shares. Liquidation by the entrepreneur

can be accomplished, but it is likely to require many years, unless, of course, the entire company is subsequently sold. Control of the company by founders is generally possible, but the company acquires a new set of investors with a short-term perspective on defining success. Dealing with the demands of the market makers and the Securities and Exchange Commission, or SEC, will become a reality.

Selling to Your Employees

As Bob Beyster explained in an earlier article (EntreWorld, April, 1997), **employee owned employee ownership can be very rewarding and can take several forms.** Most of us are familiar with Employee Stock Ownership Plans, or ESOPs, which are managed like a pension plan with all company contributions used to buy company stock.

But, as Beyster explained, **an ESOP is only one arrow in the equity-compensation quiver.** Motivated employees can be provided with appropriate incentives through many forms of equity, such as stock options, stock purchase plans, and performance-based stock bonuses. These plans generally allow the founder to maintain control of the company as his or her shares are diluted by those shares made available to the employees. Under certain conditions, it is possible for the founder to sell his or her shares back to the company, or to the ESOP. However, the legal ramifications of this strategy are many. Equity compensation as part of a corporate culture fosters a great working environment conducive to a high-growth business.

Passing Control to Your Heirs

The transfer of ownership to the heirs of the founder is more common than most entrepreneurs might imagine, although tax laws in the U.S. limit this form of ownership change to entrepreneurs with patience and endurance. Gifts by a single U.S. citizen to each heir are limited to \$10,000 a year, and the tax implications of passing a business to your heirs through your estate are daunting. Accomplishing the transfer of a business from one generation to the next requires action early in the life of the business, when the share price is low and the entrepreneur has many years to accomplish this mission.

For high-tech entrepreneurs, **this option probably is not feasible, because high-tech products may have limited life spans.** However, I think we all realize that there are many more entrepreneurs building significant businesses outside of the high-technology arena than in this more visible sector. The long-term prospects for a well-run commodities business, for example, justify planning for ownership of the business by the following generation.

If you haven't done so already, I suggest you develop your exit strategy now. Develop a good understanding of your options. Then, talk

to your spouse, your parents, your friends, and your business advisors. Use all these insights to develop a strategy that meets your needs. Once you have developed your plan, look at structuring your company to meet those needs. And be prepared to provide a concise answer to the question:

What is **YOUR** exit strategy?

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