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Harvesting your wealth

Optimizing shareholder liquidity

EXPLORE THE ARTICLE

Executive summary

Realizing an attractive investment return is an aspiration shared by most private business owners. A healthy return on investment (ROI) is the payoff for years of hard work, sacrifice, and financial risk. Capturing that value is likely to require many of the same attributes that helped you along the way, including experience, commitment, discipline, and timing.

But assigning a value to your business may be challenging. The process involves a systematic evaluation of transaction alternatives based on an objective assessment of the value of capital deployed and invested over time, as well your "sweat equity" in the company's success. Such an assessment should also consider your company's achievements, its expectations, and the depth and breadth of potential capital market interest. The analysis should be conducted with the understanding that nonfinancial and qualitative objectives can often significantly influence transaction alternatives.

This paper offers information and insights from investment bankers at Deloitte Corporate Finance LLC and professionals who assist entrepreneurs and business owners as they explore strategic liquidity alternatives. The paper begins with a discussion of transaction timing, transaction drivers, and the current capital markets environment. We then delve into specific liquidity alternatives that you can potentially pursue, and we explore how these opportunities can affect liquidity and ownership. Finally, we outline six tax planning concepts that you may want to consider as you prepare to exit or reduce your involvement in the business.

Key points include:

- Perspectives on current economic factors and capital market conditions, including factors that may make this year a favorable time for private company liquidity events.
- An essential planning tool: a framework for analyzing, preparing for, and executing a liquidity transaction, as well as a summary presentation of the array of available transaction alternatives.

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EXPLORE OUR TOPICS

Why transaction timing is imperative

A concept in the wealth-harvesting process is that transaction timing, more than any other single factor, will likely drive the increase in a private business owner's wealth from a shareholder liquidity event. Support for this dynamic is found in consistent market evidence regarding company pricing levels, credit market conditions, and legislative and tax policies, informed by years of Deloitte transaction experience.

Both macroeconomic and microeconomic factors that affect enterprise value and private company shareholder ownership can influence timing (Figure 1).

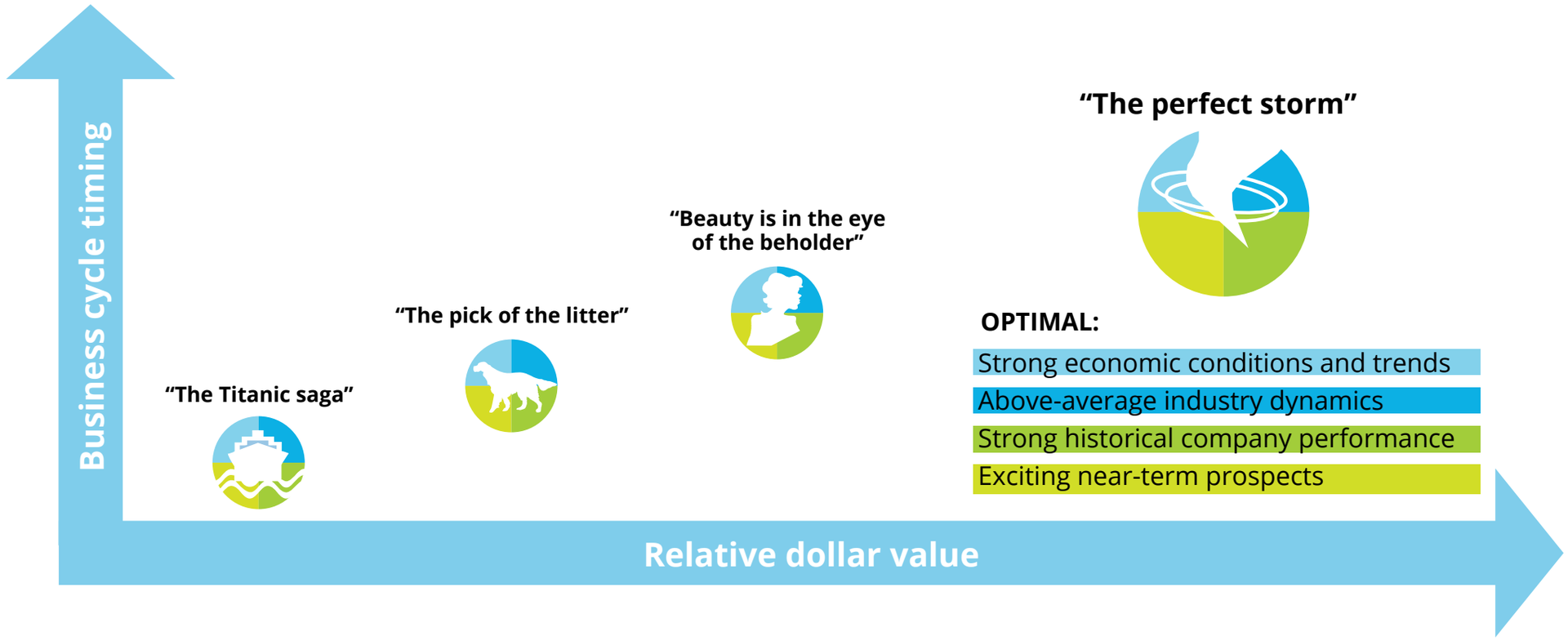


Figure 1: Enterprise value timing grid

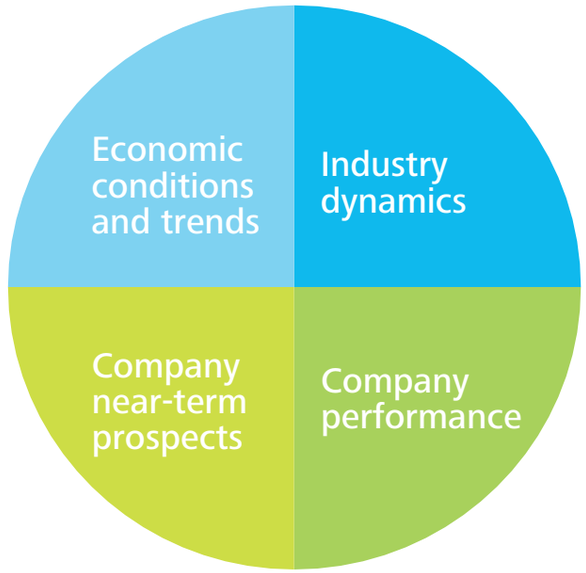
Why transaction timing is imperative (cont.)

Macroeconomic factors are both economic and political, such as global and domestic economic conditions, industry and market dynamics, and legislative and tax policies. These drivers frame the assessment of enterprise value and the relative worth of the financial assets that make up private company ownership.

Microeconomic factors that may significantly affect enterprise value include the company's operating performance, financial condition, near-term expectations, management depth, and business succession plans. In addition, qualitative shareholder considerations, such as the company's legacy, family ownership continuity, employee and community loyalty, and investment risk tolerance, can make wealth harvesting even more challenging.

Amid all these factors, the process of determining which shareholder liquidity alternatives may yield the most advantageous results for private business owners typically requires experience, commitment, discipline, and favorable timing. A closer look at current macroeconomic factors and capital market conditions should be a helpful starting point.

Enterprise value timing factors



Economic influences: A brightening picture

From a macroeconomic standpoint, resumption of growth in developed economies has significantly improved the global economic outlook (Figure 2). Modest tightening in US monetary policy is shifting the flow of capital away from emerging economies, causing a slowdown in these markets.[1]

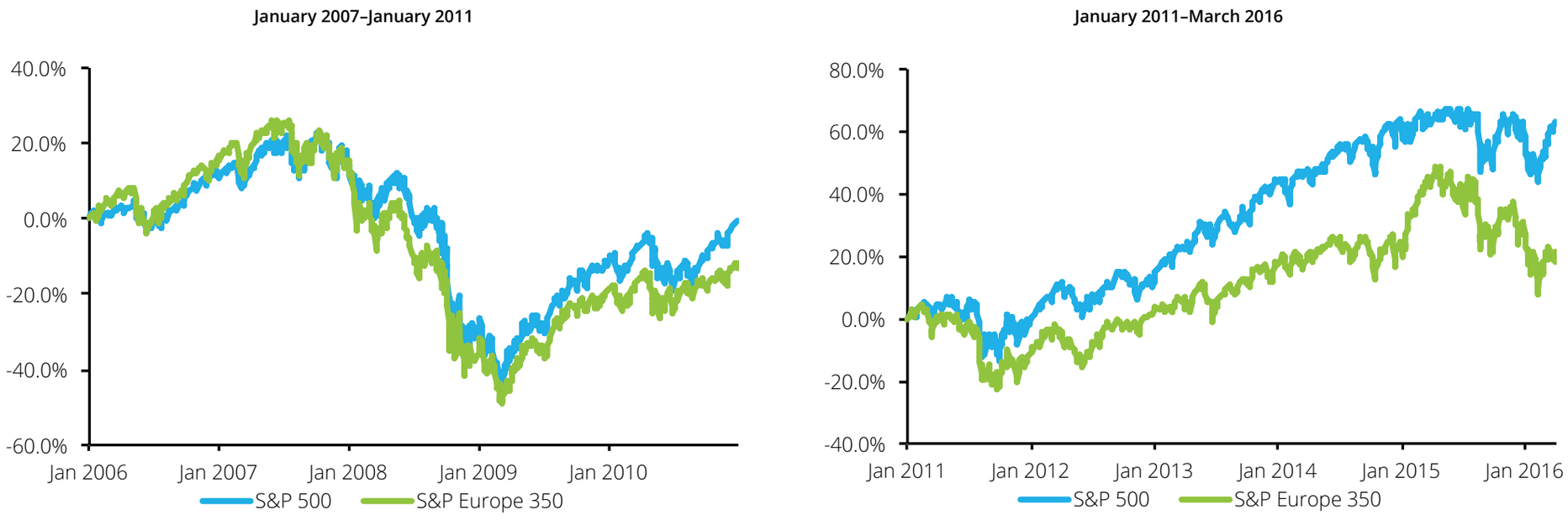


Figure 2: Domestic and European economic environment
Source: CapIQ.

[1] International Monetary Fund, "Understanding the Slowdown in Capital Flows to Emerging Markets" in *World Economic Outlook: Too Slow for Too Long*, April 2016

Economic influences: A brightening picture (cont.)

Recovery has finally begun in the Eurozone. Many investors, however, maintain mixed perspectives on growth prospects and sustainability in some countries (e.g., Spain, Italy, Greece, and Ireland) as the European Central Bank strategy continues to evolve in response to market dynamics. Asian economies, meanwhile, continue to seek a balance of promoting growth while curbing inflation. Africa is the fastest-growing continent, with real incomes increasing 30 percent in the past 10 years and gross domestic product (GDP) expected to rise six percent per year over the next decade.[2]

In the United States, macroeconomic conditions seem to be slightly improving despite uncertainty created by both lawmakers and broader global issues. Domestic businesses have performed moderately over the past year, with the S&P 500 Index losing less than one percent in 2015. Many investors are looking to the new Federal Reserve Board leadership for clues regarding how the central bank will transition to a more traditional stance without causing the economy to revert to a slow-growth path.

Strong corporate performance has begun to improve economic conditions for some individuals, as employment levels approach pre-recession peaks. With the Federal Reserve continuing its accommodative stance, the improvements in US economic fundamentals have the country potentially positioned for stronger growth going forward.

[2] McKinsey & Company, "What's Driving Africa's Growth?," June 2010

The upshot

Developed countries are driving current economic growth amid relatively strong investor confidence and increasing corporate profits.

Current economic environment

More than one-third of respondents predicted **growth in excess of 3.5%**

Almost 3/4 of survey respondents indicated their companies generate revenue outside the United States

"The three greatest obstacles to my company's growth in the next 12 months are..."

Uncertain economic outlook
38%

Weak market demand
35%

Cost of raw materials and other inputs
27%

Nearly two-thirds of respondents say they have noticed **an increase in voluntary staff departures**

Source: Deloitte Mid-Market Perspectives: 2015 report on America's economic engine.

Capital market signals: Broad advances and continuing opportunity

Competition to complete deals has remained strong over the last several quarters, leading to strong valuations among both financial and strategic acquirors. Financial sponsors are increasingly bidding up valuations as they seek returns for large amounts of capital they have raised. In the fourth quarter of 2015, the median purchase multiples for strategic buyers and financial sponsors were 12.0x and 13.6x EBITDA for the latest 12 months reported earnings before interest, depreciation, and tax expense, respectively.

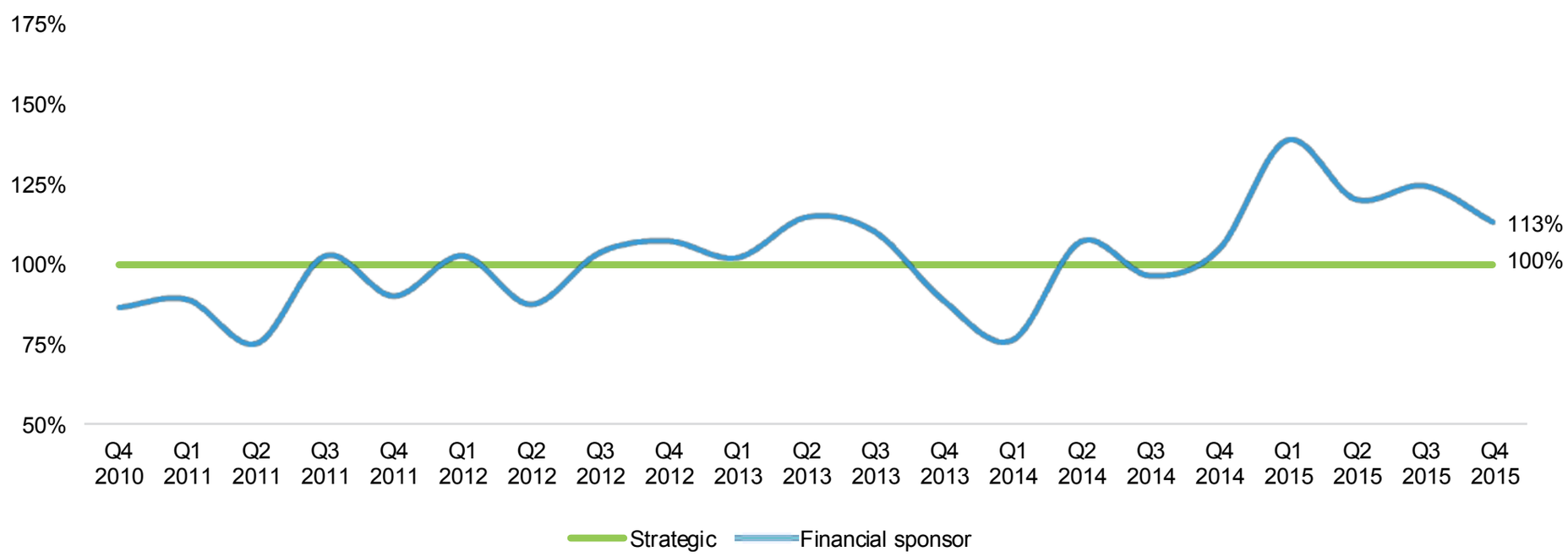


Figure 3: Median acquisition multiples for strategic versus financial buyers

Source: Capital IQ.

Capital market signals: Broad advances and continuing opportunity (cont.)

Credit markets can exert considerable influence on equity securities pricing. Generally, as credit becomes more accessible and is available at lower cost to companies, stockholders can expect to achieve a higher equity value. According to Thomson One, debt capital is more accessible today than in any time since 2008.[3] Middle-market debt multiples continued to expand through 2015 (Figure 4). Capitalization of leveraged buyouts relied on more conventional debt over the same period, with both metrics declining slightly during 2012. It is no coincidence that middle-market debt multiples are trending with small-cap stock pricing. Access to lower-cost debt often enables equity owners to enhance investment return through effective use of financial leverage.

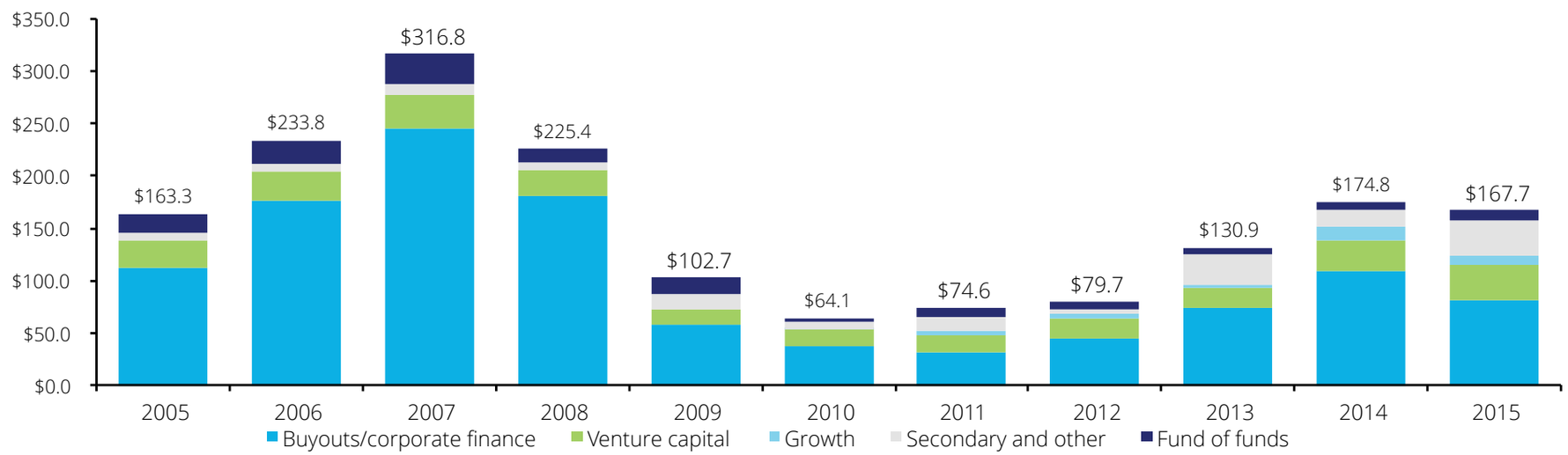


Figure 4: US financial sponsor fundraising ($ in billions)

Source: Dow Jones Private Equity Analyst, Preqin Research.
[3] Thomson One Research.

Capital market signals: Broad advances and continuing opportunity (cont.)

As credit access becomes more widespread, relative equity values will likely increase. Also, the cost and terms for securing debt capital may impact the value of shareholder equity in a private middle-market company. The pricing of business acquisitions typically moves in tandem with credit markets (Figure 5). This relationship can be observed in a capital-cost context. When financing leverage is reasonably accessible and available at lower historical costs, the price paid for majority equity investments tends to increase. That is because a larger percentage of the overall purchase price can be paid with low-cost debt capital. The current health of the credit markets suggests a strong outlook for M&A pricing.

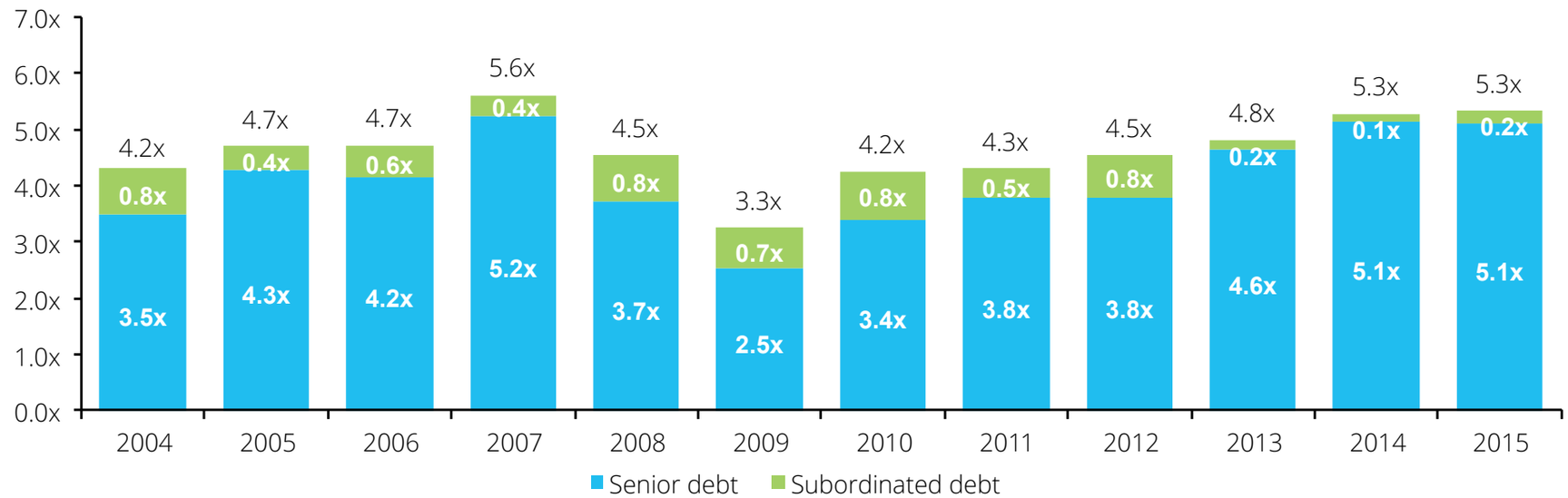


Figure 5: Leverage multiples

Source: Standard & Poor's Leveraged Commentary and Data.

Capital market signals: Broad advances, some caution, and continuing opportunity

M&A activity and credit market trends suggest that the capital markets are favorable for companies seeking to raise capital (Figure 6).

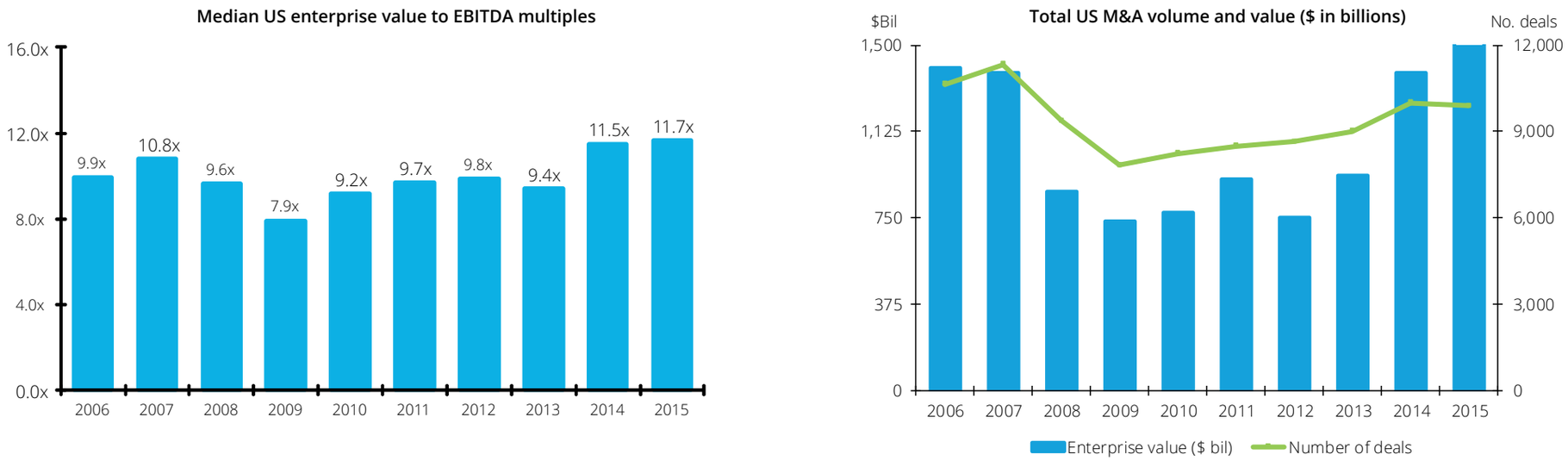


Figure 6: M&A market trends

Source: Thomson Financial.

Capital market conditions

Important considerations for private business owners include:

- Continued broad advances in public market equities over the past several months indicate investor confidence and willingness to incur some risk for a potentially higher investment return.
- Recent M&A activity has remained steady among smaller private companies.
- Credit availability and debt costs are currently favorable for privately held, middle-market company transactions.

The upshot

Stock market confidence, credit availability, and M&A activity bode well for private business owners who are considering liquidity alternatives.

A framework for assessing and executing a shareholder liquidity transaction

The preceding review of key macroeconomic factors and other transaction-timing issues that affect enterprise value serves as a basis for assessing your alternatives for strategic shareholder liquidity. Building on that foundation, the high-level "Strategic Alternatives Framework" below offers insights into numerous decisions and milestones you may encounter along the path to harvesting wealth. The framework begins with a timing assessment and then evolves into a broader, disciplined process. This multifaceted approach, which is analogous to creating a successful business enterprise, has three stages: vision, strategy and objectives, and game plan and execution.

Stage 1: Vision

This is a preparatory phase. Market intelligence, empirical evidence, and detailed analysis provide a platform for lining up relevant liquidity alternatives and making informed decisions.

Stage 1 actions can include:

- Defining and prioritizing financial and qualitative objectives.
- Assessing macro factors, including current geopolitical, capital market, and industry conditions, and determining a near-term direction.
- Analyzing company performance and financial condition and formulating a supportable estimate of the company's near-term prospects.
- Establishing an optimal "net proceeds basis" tax position for shareholders.

Stage 2: Strategy and objectives

In many private company transactions, this stage is a matter of applying market and industry knowledge, transaction creativity, and financial engineering. Armed with Stage 1 information and analysis, your corporate finance adviser can inject experience and ideas into the process.

Stage 2 actions can include:

- Arraying potential liquidity alternatives that are aligned with Stage 1 actions.
- Discerning the benefits and considerations for each alternative in relation to stated objectives.
- Analyzing the alternatives on a financial "apples-to-apples" basis to reduce decision-making complexity.
- Articulating a game plan to execute the alternative(s) most desired by the shareholders.

Valuation estimates for the relevant strategic alternatives are typically shaped by market forces. Since the capital markets are generally considered to be highly efficient, the present value of net proceeds estimates for liquidity alternatives often fall within a predictable range. Because of this, factors such as transaction risk, governance concerns, and other nonfinancial objectives take on added significance as the choice of a shareholder liquidity path nears.

Stage 3: Game plan and execution

A clear picture of transaction alternatives should emerge at the conclusion of Stage 2: which transactions are financially attractive; how each provides for the objectives originally identified; and the likelihood that the transaction will close or the shareholder liquidity event will be consummated. In Stage 3, your corporate finance adviser can apply collected information, client feedback, and market experience to help fashion a transaction marketing strategy and execution timeline.

Stage 3 actions can include:

- Assembling an experienced transaction team that can tackle the breadth of transaction marketing and execution processes.
- Maintaining transaction momentum.
- Retaining transaction flexibility to effectively respond to market feedback.
- Communicating milestones in a timely manner to board decision makers and shareholders.
- Creating an efficient negotiating process to retain, leverage, and properly document deal terms.

Understanding the array of available transaction alternatives

The dichotomy between achieving various levels of liquidity (cash at close) and retaining control and maintaining corporate governance stability produces creative tensions among the array of strategic alternatives. Figure 7 describes some relevant strategic alternatives, in ascending order of their capacity to provide cash at close.

Figure 7: Strategic alternatives array: Dichotomy of share ownership and liquidity

Anticipating the dynamics of shareholder liquidity transactions

After determining which strategic liquidity alternative is an appropriate fit, you can work with corporate finance advisers to execute actions in pursuit of your goals. In many instances, creating broad investor interest and competition for the right to participate will increase the value and results of a shareholder liquidity transaction.

The corporate finance advisor can contribute to this result by helping prepare your company for market and soliciting investment interest from an array of potential investors and buyers.

Steps in this process include:

- Identifying capital market and strategic buyer candidates thought to be interested in the company, including subordinated debt, mezzanine capital, private equity, and strategic partners.
- Developing an information memorandum that highlights the company's investment attributes.
- Conducting a "market test" to gauge preliminary pricing and terms for the minority recapitalization, majority recapitalization, and company sale alternatives.
- Delivering preliminary market test results for the board's consideration.

Maintaining flexibility

Maintaining transaction flexibility throughout the liquidity process can increase investment competitiveness. An example of this is preserving the board's ability to transition to internal liquidity strategies, frequently referred to as "hedge strategies," such as debt recapitalization or an ESOP transaction.

While typically providing less liquidity, these strategies do not require a change of control or material corporate governance alterations. The hedge is derived by maintaining the ability to effectively execute a material liquidity event (dividend distribution or tax-advantaged ESOP transaction) if the board is underwhelmed with the market test response.

Typical capital sources for hedge strategies are excess corporate cash, senior-based asset and cash-flow lenders, and subordinate debt and mezzanine providers. When executing a market test/hedge strategy, the ability to seamlessly transition to a transaction alternative without losing deal momentum can reduce the risk of an aborted shareholder liquidity event.

Anticipating the dynamics of shareholder liquidity transactions (cont.)

Elements of this strategy include:

- Defining and prioritizing shareholder financial and qualitative objectives.
- Establishing optimal shareholder tax positioning on realized transaction proceeds.
- Testing the capital and strategic markets for pricing and terms related to a change of control transaction.
- Advancing dividend distribution and ESOP transaction financial metrics, while concurrently pursuing market test alternatives.
- Comparing market test-solicited pricing and transaction terms with the economics and governance terms of the hedge strategies.
- Selecting the transaction alternative for the shareholder liquidity event that appears to achieve the most favorable results.
- Focusing adviser resources on effectively consummating the selected transaction.

The upshot

Shareholder liquidity transactions can be life-changing events. It's essential to approach the process strategically—to understand the many alternatives available and what factors affect their potential risks and rewards. A defined structure for assessing, analyzing, and making decisions related to a transaction can be a defining difference in the outcome you experience.

Conclusion

Now may be the time to begin harvesting your wealth

Macroeconomic and capital market conditions in 2016 appear to be favorable with respect to a critical ingredient that private company owners look for when considering a shareholder liquidity transaction: transaction timing. If you decide to explore the many alternatives available to you for such a transaction, prepare yourself for an exciting but demanding process.

At the same time, if you leverage a disciplined transaction approach, along with the experience and resources of a well-regarded corporate financial adviser, you can address many of the risks that lead to surprises and disappointment. Such an approach can help you gain a clear understanding of what to anticipate from a liquidity event, choose a path that's likely to produce the ROI you expect, and gain insights into important decisions and milestones you are likely to face on your path forward.

Contacts

About Deloitte Corporate Finance LLC

Deloitte Corporate Finance LLC (DCF) provides strategic advisory services and M&A advice that help corporate, entrepreneurial and private equity clients create and act upon opportunities for liquidity, growth and long-term advantage. With an in-depth understanding of the marketplace and access to a global network of investment bankers, we help clients confidently pursue strategic transactions in both domestic and global markets. DCF, together with the Corporate Finance Advisory practices within the Deloitte Touche Tohmatsu Limited network of member firms, include in excess of 1,900 professionals, who work collaboratively across 150 international locations. With our significant experience providing investment banking services across key industries, we are able to offer our clients solutions that help them to achieve their strategic objectives. For more information, visit www.investmentbanking.deloitte.com.

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