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Separating the Investment From the Job

Planning for a future sale adds value to the business.

by Mike Dannenberg

As long-term advisors to privately held companies, each largely born out of an entrepreneurial founder's vision, we have a courtside seat to two of the toughest decisions an entrepreneur will face – what to do with my "baby," and when is it time to move on? Making the decisions even harder, many founders equate ownership in their business with their personal career horizon. If there is a natural hand off through generational lines or all the stars are aligned (i.e., the performance of the company, the macroeconomic environment, and the drivers of the specific industry are favorable during the window of expected retirement), this might work, but in every other situation, timing retirement with a sale of the business is decidedly to the owner's detriment.

TAKE ACTION TO INCREASE VALUE

Succession, timing, and the alignment of personal and professional goals require consideration of two independent decisions, an investment decision and a career decision, and the optimal timing for each is likely different.

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Rather than wait for the two paths to converge, we encourage owners to take deliberate actions that will increase the value of the business, better position it in the market, and give themselves more flexibility to choose the correct timing for a sale. One of those deliberate actions is to expand the management team and delegate responsibility to a handpicked successor well in advance of an ownership transition event.

In a significant portion of lower middle market businesses, the founder is the management team. He or she is not only the leader, but occupies the de facto chairs of several leadership positions within the company. Often, they are the sole person responsible for corporate governance and strategic direction, and they alone hold an outsized portion of the intellectual and human capital. While this structure can be effective during the entrepreneurial phase of the company's life cycle, it is not scalable and is not the ideal position from which to launch a sale of the business.

EXPAND THE MANAGEMENT TEAM

Buyers, at the most basic level, are acquiring a stream of cash flows, discounted for an appropriate level of risk. Perhaps the biggest risk, and one that can't be easily quantified, is the quality of the management team expected to execute on a plan. In cases where the management team is essentially the selling owner, this creates an obstacle. The new owner will need to operate the business without any break in business performance and often will ascribe more aggressive growth targets. Rarely will the new owner take on this challenge without a management team familiar with the business and one that has enough runway to execute the plan. For this reason, the majority of private equity firms in the lower middle market are unwilling to consider a purchase without an embedded management team. Even strategic buyers will expect a significant level of leadership involvement post-acquisition. To the extent that an owner is unwilling to stay with the business through the hold period for a private equity firm or until a successful integration is complete, the buyer universe is significantly reduced, and those who remain interested will be so at a price that reflects the added risk.

DELEGATE RESPONSIBILITY

Expanding the management team before a sale can also provide flexibility to an owner on a personal level by allowing them to enjoy some of the benefits of retirement without giving up their "baby." Most of our clients have spent the majority of their working lives leading their companies, and the thought of an immediate retirement is not always ideal. While it is never easy to give up control, in cases where there is mutual trust between an owner and an executive capable of leading the company into the future, the owner can get the best of both worlds. This is also advantageous to the sale process as it allows the owner to time the future sale based on the optimal time for the company and not a forced timeline due to health, age or desire to step back

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from day-to-day management. We often see this dynamic play out in negotiations with older clients when the buyer knows that retirement is imminent and there is no succession plan. Fatigue can set in and owners accept less than ideal terms because their alternatives become limited. If the company has management with a longer time horizon and a clear vision, negotiating leverage swings to the company's favor, as the owner can always walk away, continue to benefit from profits, and choose another buyer or another time.

PREPARING THE BUSINESS FOR SALE

In addition to broadening the investor universe, and providing flexibility to an owner, strengthening the management team provides substantial benefits in preparing the business for sale and managing the due diligence process. In our three-part series on preparing a business for sale (Part I: Data Matters, Part II: Understand the Problem, and Part III: Plotting the Course), we discuss at length the types of actions, analyses, and processes that enhance a competitive sale process. This preparation does not happen without concerted effort, and many of our clients do not go through with these suggestions because they do not personally have the bandwidth. Hiring a successor who drives the preparation, and serves as an additional voice of the company, greatly improves

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the process and the odds of maximizing valuation, achieving stated objectives, and completing due diligence.

Striking the perfect balance between retirement goals, the legacy of the company, and receiving the maximum price for the value created is difficult. One solution is to separate the job decision from the investment decision by making a deliberate effort to expand the management team and delegate responsibility. Done correctly, the founder can extend his or her personal timeline, eliminate management successor risk, expand the universe of potential buyers, and capture value for themselves rather than for a future ownership group. **ZS**

Zachary Scott
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1200 Fifth Avenue, Suite 1500
Seattle, Washington 98101
www.ZacharyScott.com

ABOUT ZACHARY SCOTT

Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities, and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott, go to **ZacharyScott.com.**

Frank Buhler
206.224.7383
fbuhler@zacharyscott.com

Doug Cooper
206.224.7388
dcooper@zacharyscott.com

Mike Dannenberg
206.838.5531
mdannenberg@zacharyscott.com

William Hanneman
206.224.7381
bhanneman@zacharyscott.com

Derrik Larsen
206.838.5527
dlarsen@zacharyscott.com

David Petrisor
206.838.5529
dpetrisor@zacharyscott.com

Ray Rezab
206.224.7386
rrezab@zacharyscott.com

Jay Schembs
206.838.5524
jschembs@zacharyscott.com

Mark Working
206.224.7382
mworking@zacharyscott.com