Strategies for Maximizing Exit Value

Tom Hiatt
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I think if I were to begin my career all over again, I would purchase a middle market business.

I mean that. The owners of growing businesses that I have met over the years have impressed me with their industry, their intelligence and their commitment. From my perspective, few other opportunities allow a person to leverage one’s knowledge and hard work to generate often dramatic financial results. Business owners enjoy exciting challenges, and, for the most part, set their own hours. I realize, of course, that it takes an enormous amount of hard work over many years to build a good team, relationships with customers, and establish a consistently profitable business. I simply mean to say that the lives of most of the business owners I meet strike me as being interesting and fulfilling.

Now I know that the grass always looks greener on the other side of the proverbial fence, and some of you might be thinking, “If I had it to do all over again, I would come back as a manager of a private equity fund, because it is pretty obvious that all those folks do is leverage other people’s money, and skate by on a thin amount of industry knowledge.”

But if that’s the case, you need to keep in mind that those of us in the private equity industry are perhaps the only professionals held in lower esteem than lawyers, or these days, members of Congress.

In fact you probably heard that the Post Office had to recall its series of stamps depicting famous private equity managers after Mitt Romney’s campaign. Apparently people were confused about which side to spit on.

A number of you manage solid growing businesses and have achieved considerable independence and financial success. Some of you, I am confident, already have a timetable and detailed plans for exiting your business in the years ahead.

My remarks today are directed to business owners and advisors who are not quite that far along. Owners who are so busy addressing the challenges of managing a growing business that they haven’t yet had much time to think about when, or how, they are going to exit their business, let alone how they are going to maximize the value of their firm between now and then.

At Centerfield we evaluate about a thousand investment opportunities in middle market businesses each year, anticipating that perhaps we will find four to six well managed companies which line up with our investment criteria. To date we have invested in forty companies across the United States, of which approximately one-quarter were based in Indiana at the time of our investment. We have invested in companies which manufacture products, both here and
abroad, firms which provide business and consumer services and firms which are value added distributors.

Which businesses earn our immediate attention?

- Businesses with thoughtful, dynamic CEOs who lead experienced, motivated and complete management teams;
- Businesses with a obvious future successor in place, particularly if the CEO is thinking about leaving in the near future;
- Companies with strong and consistent earnings—typically our portfolio companies have EBITDA margins between 10 and 20%;
- Companies with strong balance sheets;
- Management teams who have developed defensible market positions and have outlined a strategy for continued growth;
- Companies who make good use outside advisors; and
- Companies that have sound internal management systems, complete records and a strong planning process.

Which businesses do we “ding”?

- Companies with consistently low margins, as well as firms in markets characterized by many competitors and low barriers to entry;
- Businesses with an incomplete or subpar leadership team;
- Companies with multiple family members with dubious qualifications in senior management positions or on the board; and
- Companies that have had significant swings in their bottom lines, either because they are in highly cyclical industries, have long or “lumpy” sales cycles, or significant customer concentration issues.

If you are among those who are wondering what steps you might take to maximize the value of your firm to prepare it for an eventual “liquidity event”, you might consider one or more of these suggestions:

**ONE:** *Recruit the best and the brightest*. Motivate your leadership team with incentive based compensation plans. Fill any holes in your leadership team, and include the team in key decisions. Provide them the information and authority they need to help you build and improve the business. Identify a potential successor, and establish a succession plan.

**TWO:** *Focus on margins and the quality of earnings*. “Quality of earnings” simply means earnings that are stable and predictable. Strong consistent earnings are much more important to most investors and buyers than top line growth, and will help you garner a higher valuation for your company.

**THREE:** *Put strong reporting systems and controls in place.*
FOUR: Diversify your product line and, if necessary, your customer base. To smooth earnings, develop a line of products and services that includes a steady flow of new entries. Consider tuck-in acquisitions, even small ones, to achieve these objectives.

FIVE: Engage outside advisors for specific assignments. If your problems are too much inventory, a clunky CRM system, an outdated website, or a less than efficient shop floor, and you and your team have not found time to make these changes despite your best intentions, hire experienced outsiders to get these tasks done.

SIX: Establish an independent board. Identify and interview CEO’s who have built similar businesses, ideally in the same industry and who would welcome the opportunity to pass on what they have learned. At Centerfield, we often hire niche search firms to find just the right board member in particular industries, and in our experience, these outside advisors pay for themselves many times over. Outside board members have helped our CEOs land major new customers, consummate acquisitions which appeared otherwise impossible, and even identified buyers when the company was ready to be sold. Strong knowledgeable outside directors are literally worth their weight in gold.

AND SEVEN: Develop relationships with investment bankers and business advisors, including private equity investors, who can brainstorm with you on matters relating to exit planning.

As all of you know better than I, family held businesses often reinvest free cash flow back into their companies over time. As a result, business owners and other shareholders often find that a majority of their personal net worth is tied up in the business. For many years, the only avenue open to shareholders of smaller businesses to realize liquidity was to sell the entire business. While a shareholder seeking liquidity may consider selling his or her equity to other existing shareholders or perhaps the management team, rarely do either of these groups have the assets to finance the purchase of some or all of the company.

In the last dozen years or so, the capital markets have “discovered” the lower middle market—i.e., businesses with $10 to $200 million in revenue—and today the sector is swarming with investors seeking to put capital to work. Middle market lending is now viewed as an accepted asset class for many yield-seeking investors who have historically shied away from financing middle market companies. The broad availability of capital provides today’s business owners more options than they have ever had before.

It is increasingly common for business owners to elect to sell a portion of their business, either a minority or a majority stake, as they may prefer, to free up some money and take some chips off the table while still running the business. If an owner sells a minority stake, often through a process called a “minority recap”, he or she can set aside cash to ensure his or her retirement fund is protected from business risk, while still participating in the company’s future earnings and profits and retaining operating control of the firm.

Mezzanine financing can be an effective way to fund a one-time dividend, providing liquidity for the business owner, as well as accomplishing other objectives, including purchasing the interests of other smaller shareholders and providing capital for acquisitions. Unlike buyout funds, providers of mezzanine funding, like Centerfield Capital, are typically minority investors; i.e., they usually do not purchase control positions in the firms in which they invest. Centerfield’s
average equity stake in companies varies widely, but averages around 20% of a company’s equity.

Transactions like these are fairly straightforward:

1. The owner agrees to sell a portion of the business to an outside investor, to other family members, or the management team;
2. The company borrows a combination of bank debt and mezzanine capital;
3. The capital borrowed is used to buy out the selling shareholders at fair market value, leaving the active shareholders or the management team as the company’s controlling shareholders.

In addition to enabling the business owner to stay involved, and, if he or she wishes, enjoy a “second bite of the apple” several years down the road when the company has further increased in size, these type of transactions are attractive for several other compelling reasons. Mezzanine debt, which is sometimes also called “junior” debt, since it is subordinate to the bank debt in terms of payment priority, is less dilutive and less expensive than selling equity. And once mezzanine debt has been introduced as part of the capital structure, banks often accept the junior capital as an equity-like security, often making a personal guarantee for debt no longer necessary.

While bank debt usually has a highly structured pay down schedule over a two or three year period, most junior capital has interest only payments, with the principal paid at maturity in five to seven years. Because mezzanine financing does not require repayment of principal during the term of the debt, companies are able to use the increased cash flow to pay down bank debt, invest in working capital or product development, or accumulate the cash on the balance sheet to take advantage of other opportunities.

I would like to conclude by providing several examples of firms we have worked with here in the Midwest to give you a good idea of the owners’ objectives and what they accomplished:

- **We are currently working with a young woman entrepreneur, who started a manufacturing business in her home which has achieved extraordinary growth. When she and her husband decided to bring in outside investors to help them take their business to the next level, they were able to tuck away millions in their bank account. This dynamic CEO, who has more than 400 other women working for her, continues to own a significant stake in the firm she started which continues to grow almost exponentially. She is surrounded by experienced, top notch advisors and remains fully in charge of daily operations.**

- **We assisted the owner of an Indianapolis-based distributor. He also wished to take a little capital out of his business and, in this case, buy out a long term partner who wished to retire. After the transaction, working closely with the CEO, we evaluated many potential acquisitions and eventually decided together to merge the Indianapolis firm into a much larger distributor in the same industry, tripling revenue and EBITDA and significantly increasing the value of everyone’s ownership stake. The firm subsequently acquired two other smaller firms and has moved from a business focused mostly on opportunities within Indiana to a large regional operation.**
• We helped the management team of the nation’s largest manufacturer of scaffolding, based in Ohio, purchase the company the team at worked at for many years, without ever owning stock. As new owners, the management team introduced new products, recruited an outside board member, reorganized the factory floor and introduced new reporting systems. During the period of our investment, revenue grew at an annual rate of 19% and EBITDA grew 29% annually. When they sold the company approximately six years later, each member of the team realized a return of more than thirty times the amount of capital he had invested.

Although perhaps it may be hard for you to tell, the owners of well managed lower middle market businesses are in the catbird seat today. Not only do business owners have access to more financing alternatives and more capital, at a lower cost, than ever before, but solid and strong middle market businesses are selling at valuations that are at or near an all time high.

I would now like to turn to Ed Wetzel, whose accounting and business advisory practice is based in Noblesville. Ed has advised a number of middle market business owners over the years, including the owners of Standard Locknut, a family owned firm in Westfield in which Centerfield invested back in 2007.

Ed has served as Chief Financial Officer of Standard Locknut, and is going to provide his perspective of what it is like to work with a private equity partner.