William Blair

Private
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Understanding the Business Sale and Dividend Recapitalization Processes

What do family business owners need to know about their options for generating liquidity and managing the wealth created by liquidity events?

For owners of family businesses and other closely held companies, the opportunity to be acquired or to generate liquidity through a dividend recapitalization can be both exciting and overwhelming. In most cases, these liquidity events are once-in-a-lifetime occurrences. As a result, the stakes are high—from both a financial and an emotional standpoint—for the owners.

The founders, and any ensuing owners, undertake a great deal of risk and pour their time, energy, and financial resources into growing the business. A sale or a dividend recapitalization represents an opportunity for the owners to realize a financial return on their efforts, and in many cases, transition the business to the next phase of its life cycle.

Having a clear understanding of the process for completing a sale or a dividend recapitalization can help business owners accurately evaluate their options and fully capitalize on the opportunities they have created for themselves and their families.

The most critical decisions in a sale or recapitalization process are the ones made well before any potential buyers, investors, or lenders have been contacted.

Concerns about running an efficient process and maximizing the after-tax value of the proceeds are secondary to questions about what you are ultimately trying to accomplish for the company, yourself, and your family.

The answers to these questions are vital in determining whether a transaction makes sense for you and your family, and, if so, the type of transaction that will help you achieve your goals.

For businesses with multiple owners, it is important that all owners think through these questions. The answers likely will vary among the owners, especially when ownership is spread across multiple generations. By understanding each party's goals and identifying potential conflicts, the owners and their advisors can create a strategy for achieving an optimal outcome.

Business owners need to carefully consider the following questions before they initiate a sale or recapitalization process:

- What is my motivation for pursuing a transaction? What am I looking to accomplish?
- What are my goals from a wealth planning perspective, in terms of retirement, transferring money to younger generations, and philanthropy? What level of assets and liquidity will I need to achieve those goals?
- When am I looking to generate liquidity?
- What are my goals for the future of the company?
- Where is the company in terms of its lifecycle and future growth opportunities?
- How will the transaction impact our employees and our community?
- Do I want to stay involved in running the company after the transaction? Do my family members and younger generations want to be involved in the company going forward?
- How much longer do I want to be involved in managing the company? Are there potential successors in the family or in the company?
- Am I emotionally prepared to transfer some or all control of the business to an outside equity partner? If so, what characteristics am I looking for in a potential investor or partner?

Business owners have a range of options for generating liquidity, but these options can generally be grouped into two main categories: sale or dividend recapitalization.

Sale
A sale, also known as a merger or acquisition, involves selling all or a portion of the company's shares to a strategic buyer or a private equity firm (also referred to as a financial sponsor). Strategic buyers could be larger companies in your industry, similarly sized competitors, or companies in adjacent industries. The acquirer typically gains full ownership control of the company, but a sale does not necessarily mean that the sellers will no longer be involved in the business after the transaction.

Often, the new owners—especially when it is a private equity firm—may request, or even require, that some of the previous owners stay involved in the business, either in a management or advisory role. Also, the new owners may require the sellers to "roll over" a portion of the sale proceeds as an equity stake in the acquiring company. In some cases, there may be an "earn-out" component to the sellers' compensation, where a portion of the sale proceeds are paid up front, and the remainder is paid when/if the company meets certain performance or timing goals after the transaction.

Dividend Recapitalization
A recapitalization involves borrowing money or selling a minority share of the company's equity, and using the proceeds to pay a one-time dividend to the owners. A recapitalization can be an effective way for owners to "take some chips off the table" while retaining control of the company. With a debt recapitalization, the owners of the company retain 100% of the equity ownership, and with an equity recapitalization, which may also be referred to as a minority sale, the owner's equity gets reduced by the amount sold to outside investors.

Not every company is a candidate for a debt recapitalization because taking on the additional debt could hurt the company's future performance. Often, the debt will contain covenants that could limit the company's operating flexibility or restrictions on the shareholders' activities. But for companies that have relatively low levels of debt to begin with, have a history of consistent profits and cash flows, and operate in industries with low cyclicality, a debt recapitalization may be an appealing option for the owners. This is particularly true in an environment of low interest rates and lenders who are willing to underwrite debt with borrower-friendly terms.

Deciding which approach makes the most sense for a company depends on many factors. For a company whose owner is getting ready to retire with no likely successor in place, an outright sale may be preferable. But for a company whose owner wants to run the company for an extended period and believes that the company has significant growth opportunities over the next several years, a dividend recapitalization would allow the owners to cash out some of their equity and still participate in a sale down the road (i.e., "take a second bite of the apple"). Dividend recapitalizations can also work well in situations where some family members want to retain ownership of the company while others want to liquidate their positions.

Conditions for mergers and acquisitions and dividend recapitalizations have been very favorable for sellers over the past several years. These markets have also become increasingly sophisticated with an expanding array of alternatives for business owners. This increases the importance of working with advisors to help you evaluate your options.

Sales Versus Recaps – Tools for Generating Liquidity

Sales and dividend recapitalizations are the two primary tools that business owners can use to generate liquidity from their companies. Either approach carries a unique set of pros and cons for the business owners.

	Sale	Dividend Recapitalization	
		Debt	**Equity**
Typical timeframe for completion (after investment bank has been engaged)	12-24 months	2-3 months	2-4 months
Limiting factor for amount of capital that can be raised	Buyer's valuation of the company	Company's ability to take on additional debt and lenders' willingness to lend	Owners' willingness to give up equity and investors' valuation of the company
Impact on management control	Control transfers to buyer	Current owners retain control	Current owners typically retain control, but investors usually have voting rights and receive board seats
Opportunity to participate in future growth	Limited to rollover equity	100% retained by owners	Retained by owners but reduced by the amount of equity sold
Timing of liquidity	Majority received upon closing, less earn-outs, rollovers, and vesting provisions	Received upon closing	Received upon closing
Impact on succession planning	May negate the need for finding a successor	No impact	Investors may be interested in expanding ownership stake and taking management control
Impact on company's future performance	Depends on buyer's plans for the company	Debt payments may make company more vulnerable to business downturns; covenants may limit the company's operating flexibility	Limited impact

For companies considering a sale, it is important to understand the various steps of a sale process. Although timing can vary significantly, it often takes 12-24 months from when an advisor is hired to when a transaction is completed.

1. Advisor Selection: Building Your Team of Trusted Advisors
Selling a business can be a complicated process, and the potential buyers on the other side of the bargaining table usually are very sophisticated. Therefore, it is important to have a team of trusted advisors with extensive experience managing these processes and representing companies in your industry.

In most cases, an investment bank should be selected first, as the investment bankers will lead the process, serving as the "quarterback" of the team of other advisors, which may include attorneys, accountants, insurance specialists, and analysts who perform quality of earnings reports and market assessments. The investment bankers can guide the sellers through the process of deciding 1) which type of transaction will be the most effective and 2) the timeline for pursuing a sale.

2. Preparation: Gathering Information for Potential Buyers
Once the advisors have been selected, the focus turns to preparing for the launch of the formal sale process, or marketing the company to potential buyers. At a formal kickoff meeting between the investment bankers and the owners, the team will start brainstorming about which type of buyers will have the most interest, when to launch the marketing process, how to position the company for maximum value, and what questions or concerns will come up during due diligence.

Then, the investment bankers will begin drafting the slide decks, financial models, confidential information memorandum, and other marketing materials that will be used to tell the company's story to the universe of potential buyers. The investment bankers will begin creating the data room, which is a repository of financial statements, contracts, and other important documents that potential buyers who have signed non-disclosure agreements will be given access to in the due diligence phase. A third-party firm will begin creating a quality of earnings report, which is a forward-looking analysis that attempts to strip out irregularities related to taxes, currency movements, and one-time events, and measure the company's ability to generate sustainable profit.

By the preparation stage, the owners should have begun discussions with their wealth advisors about strategies that may be used to minimize the taxes related to the sale and to achieve the owner's long-term financial goals. These discussions should include a review of the owner's estate planning documents, and should cover topics such as cash-flow planning, risk management, and converting the proceeds of the sale into a diversified portfolio.

3. Marketing: Contacting Potential Buyers
This is when the advisor will begin reaching out to potential buyers to let them know that the company is available for sale and to gauge their level of interest. Rather than reaching out to the entire universe of potential buyers at once, the investment bankers may decide to stagger the timing of when companies are contacted. This strategy, which is based on the investment bankers' knowledge of individual buyers' aggressiveness and past behavior in deal processes, can be helpful in creating a dynamic where the most interested buyers are able to stay involved until the final stages.

Interested parties will sign a non-disclosure agreement (NDA) and then receive the marketing materials. The NDA is used to ensure that any trade secrets in the marketing materials are not used to adversely affect the sellers' business. The interested parties will then submit an indication of interest (IOI), which outlines the range of prices that they would be willing to pay for the business and the assumptions they used to arrive at those prices.

4. Due Diligence: Getting to Know Potential Buyers and Answering Their Questions

Upon reviewing the IOIs, the investment bankers will work with the buyers to determine which bidders will be invited to conduct their due diligence on the company. It is important to note that the potential buyers who are invited to the next round will not necessarily be the ones with the highest initial bids. An experienced investment banker will have insight into which potential buyers are most likely to make it to the finish line with a final offer at the higher end of their IOI range.

Two of the main elements of the due diligence process are hosting management presentations and granting access to the data rooms. During the management presentations, potential buyers will meet with executives of the selling company to ask questions about the business and get to know the leadership team better. Then, the potential buyers will be given access to the data room, allowing them to review details of employment contracts; customer, supplier, and vendor contracts; insurance policies, and other documents that contain important details about the company's operations, legal obligations, and financial background. It is likely that the potential buyers will ask to hold follow-up meetings with the executives to go over any questions that arise when reviewing the data room.

5. Best and Final: Choosing the Right Partner

After the potential buyers have completed their due diligence, bidders will be asked to present their best and final offers. In addition to giving a specific purchase price, the final offer will include a purchase agreement that stipulates details, such as how the purchase payments will be structured and financed, whether members of the seller's management team and other key employees will be required to remain with the company, and whether the sellers will be able to participate in the continued growth of the company via rollover equity contribution.

At this point, the owners and their team of advisors will be able to determine which bidder will make the best partner for the company. While price is certainly a major consideration, it is just one of many factors that need to be evaluated. Whether the bidder is a good fit culturally can make an enormous impact on the success of the company after the acquisition. The owners will also want to understand the bidder's plans for the company and how those could affect the company's employees. Other important non-price considerations include the timing of the closing and the degree of certainty that the bidder will make it to the finish line. The owners' wealth advisors should review the purchase agreements to determine the tax consequences of the payments.

6. Signing and closing: Finalizing the transaction

Once the final agreement has been negotiated and signed, it becomes a binding contract. Typically, there is a 15- to 30-day delay before the funds transfer. During this period, larger transactions will be reviewed by the Federal Trade Commission for compliance with antitrust laws, and the buyer may be completing its financing arrangements.

Staying Focused on Running the Business

It is important that the owners remain focused on running the business throughout the sale or recap process. If the business performance suffers, this could reduce the value of the company or jeopardize the transaction altogether. The investment bankers' and wealth advisors' roles are to help the owners and management team navigate the decisions, freeing up more of their time to spend running the business. At the outset of a sale process, the owners should work with the advisors to develop a schedule that accounts for any conferences, client meetings, product rollouts, or other events that need the owners' full attention.

Considerations at Each Step of the Process

While business owners are going through the process of selling their business or completing a dividend recapitalization, they should be working with their wealth advisors to develop a plan for managing the wealth generated by a liquidity event.

	Investment Banking Considerations	Wealth Management Considerations
1. **Advisor Selection** *Building a team of trusted advisors*	• Investment bankers • Attorneys • Accountants • Consultants for quality of earnings reports and market assessments	Find an advisor with experience guiding business owners through liquidity events and structuring transactions in a tax-efficient manner
2. **Preparation** *Gathering information for potential buyers*	• Determine outreach strategy and timing • Draft offering memorandums, pitch books, and financial models • Begin creating data room	• Identify goals and priorities related to new wealth • Begin assessing tax consequences of potential transactions • Identify opportunities to minimize transaction proceeds' tax exposure • Review estate planning documents • Implement wealth transfer strategies to take advantage of valuation discounts and to avoid assignment of income
3. **Marketing** *Contacting potential buyers*	• Send marketing materials to universe of potential buyers • Collect non-disclosure agreements • Review initial indications of interest	
4. **Due Diligence** *Answering buyers' questions*	• Determine which bidders are invited to next round • Conduct management presentations • Give access to data rooms	
5. **Best and Final** *Choosing the right partner*	• Review final offers and purchase agreements • Determine which offer is the most attractive in terms of price, certainty of close, and cultural fit	• Analyze final offers in terms of tax consequences, earn-outs, rollovers, vesting, and timing • Implement comprehensive wealth management plan, covering cash-flow, wealth transfer, risk management, and portfolio diversification and management
6. **Signing and Closing** *Finalizing the transaction*	• Sign final documents • Clear anti-trust review • Transfer funds	

Compared with selling a company, completing a dividend recapitalization has many similar elements, but is typically a quicker process. A recapitalization usually involves the following steps:

1. Determine the amount of capital the owners are looking to raise and whether a debt or equity recapitalization is most appropriate
There are several elements to these decisions. First, you must determine how much liquidity the owners need to fund their personal goals. Then, you must also think about how much, if any, control and upside participation the owners are willing to give up, as well as how much leverage lenders are willing to offer and how much debt the company management is comfortable taking on. The answers to these questions will determine whether raising the funds via debt or a minority equity sale makes the most sense.

2. Distribute the offering memorandum and marketing materials
An offering memorandum and marketing materials, which describe the details of the proposed transaction and provide in-depth information about the company, are distributed to potential lenders or investors. Interested parties will respond with their initial indications of interest. For debt transactions, the universe of lenders may include banks, private credit funds, and specialty lenders. For equity transactions, the universe of potential investors includes private equity funds, family offices, pension funds, and other institutional investors.

3. Identify the best potential lenders or investors
The next step is to evaluate the offers from the interested parties and determine which ones are the best fit for the company's goals. With a debt transaction, the terms to consider include interest rate, covenants, repayment restrictions, and the length of the loan. With a sale of minority equity, terms to consider include the valuation, the type of equity, voting rights, and board seats. With an equity transaction, the owners will also want to consider whether the investor can bring valuable management expertise to the company.

4. Negotiate final terms and select the winning partner
Once the selected lenders or investors have completed their due diligence, the advisors will negotiate with them to secure their best and final offers. At this point, a winning bid will be selected.

5. Close the transaction
Once the transaction closes and the final documents are signed, the funds will be distributed to the company and then to the owners in the form of a special dividend or share purchase, depending on the owners' objectives.

As with a sale, in a dividend recapitalization the investment bankers' role is to facilitate an efficient process, clear the market by identifying all of the most interested potential lenders or investors, and secure the most favorable terms possible for the business owners.

When it comes to structuring the proceeds of a transaction and managing the wealth created by the sale of a business or a dividend recapitalization, the earlier you begin planning the better.

How a transaction is structured can have a significant impact on the after-tax wealth generated for the owners. It is important to work with advisors who have experience helping owners structure transactions in a way that limits the proceeds' exposure to income taxes and eventually estate taxes.

There are several wealth management strategies that are most effective when implemented months before the transaction is finalized. For example, if the owner is looking to transfer wealth to younger generations and believes that the company will sell for more than its current valuation, the owner may want to transfer those shares to a trust for children or grandchildren well before the agreement is finalized. Taking advantage of the pre-transaction valuation discount effectively increases the amount that can be passed to younger generations without being subject to gift or estate tax. Also, being proactive in implementing wealth-transfer or charitable strategies can help avoid running afoul of assignment of income principles that, if violated, could cause the owner to pay income tax on the contributed shares.

Other proceeds structuring and wealth management considerations for business owners preparing for a liquidity event include:

- *Identify goals and priorities:* For most business owners, a sale or dividend recapitalization will elevate them to a new level of liquid or financial wealth and open a wide array of new possibilities. Before developing a plan for managing this wealth, owners should identify what their priorities are and what they would most like to achieve in light of these new opportunities.
- *Optimize for tax efficiency:* The owners' wealth advisors should be closely involved in a sale process to structure the transaction in a tax-efficient manner. The advisors also will help the owners understand how much they will receive after taxes and when that wealth will be available. From a tax perspective, the most important analysis is determining how much of the sale will be treated as long-term capital gains versus ordinary income. The top federal long-term capital gains rate is 20% plus likely exposure to a 3.8% tax on investment income. In contrast, the top federal rate for ordinary income is 39.6%. The character of the income from a transaction (long-term gain versus ordinary income) will have a significant impact on the overall tax exposure for the owners. Wealth advisors also can help the owners understand elements of a purchase agreement that affect the ultimate value and the timing of the liquidity, such as rollovers, vesting, and earn-outs.

- *Addressing philanthropic goals:* Business owners considering a sale should discuss any long-term philanthropic goals they have with their wealth advisors. The proceeds from the sale can be used to fund charitable vehicles, such as donor-advised funds, private foundations, charitable trusts, or outright gifts of stock that generate a tax deduction for the donor. There may also be an opportunity to establish charitable vehicles ahead of a business sale or transaction that can avoid or reduce exposure to capital gains tax. Accelerating the donations into the year of the sale can help offset the taxable income generated by the sale of the company.
- *Reassess estate planning documents:* A liquidity event often creates opportunities to pass wealth on to younger generations, so business owners should work with their wealth advisors to evaluate whether the current estate plan will adequately handle the new wealth created by the transaction.
- *Develop and implement a comprehensive plan:* The owners should work with their wealth advisors to create a comprehensive plan for the myriad aspects of managing the wealth created by a business sale or dividend recapitalization. From a cash-flow perspective, the plan should address any large one-time purchases that the owner would like to make, such as a house or a boat, and create a "paycheck" to make up for any income lost by having a reduced role in the business, while taking into account the potential value of any equity rollovers and earn-outs. In some cases, the goal may be to create a sustainable income stream that is inflation-adjusted and tax-efficient throughout the owner's lifetime, assuming no further earned income. The plan should also address the owner's estate planning and philanthropic goals, risk management strategies, and investment portfolio diversification and management.

The Importance of Proceeds-Management Advisory Experience

While most business owners already are working with a financial advisor who focuses on retirement planning and investment management, a business sale or dividend recapitalization may necessitate working with advisors who have experience structuring these transactions in a tax-efficient way and managing the proceeds of the transaction. Liquidity events of this magnitude may create opportunities for business owners to participate in more institutional-level asset classes and may require more sophisticated levels of tax planning and diversification.

The process of selling a business or completing a dividend recapitalization should be a very rewarding and exciting time for business owners and their families. But the complexity of these processes and the gravity of the decisions that are involved raise a number of questions for the owners.

Low interest rates and the abundance of cash that private equity firms and strategic buyers are looking to deploy have created a market environment that is very favorable for business owners. The investment banking landscape, meanwhile, has become increasingly sophisticated in recent years, providing business owners a diverse array of options for generating liquidity.

At William Blair, for more than 80 years we have been committed to helping business owners evaluate their options and capitalize on the opportunities created by the success of their companies. As a privately-owned global asset management and investment banking firm, we are uniquely positioned to guide business owners through the investment banking and wealth planning aspects of selling a business or completing a dividend recapitalization.