Creating Shareholder Liquidity in Your Closely-held Company

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Doorways to the ***Future***

ABSTRACT

Over the next 15 years, the average age in the United States is projected to increase to the point that the available pool of buyers (35- to 54-year-olds) in the industry will shrink dramatically relative to the pool of sellers (55 and older). This will likely tip the scales to buyers in terms of purchasing power, which is likely to adversely affect the value of the shares of a retiring shareholder. All other factors being equal, a very profitable and growing company could face significant discount to its value. Shareholder liquidity is one of the single largest factors affecting value in a closely held company. Taking steps to maintain and create shareholder liquidity is paramount to protecting the value of your investment. We will share ideas that can be implemented today to create shareholder liquidity in the future.

SPEAKER

MICHAEL O'BRIEN, a principal in the Washington, DC, office of ZweigWhite, directs all corporate financial advisory services, including business valuation, fairness and solvency opinions, mergers and acquisitions, litigation support, internal ownership transition consulting, ESOPs, and strategic planning. Mr. O'Brien formerly served as a vice president in the Los Angeles office of Houlihan Lokey Howard & Zukin. Drawing on over 12 years of investment banking experience, including business valuation, corporate finance, mergers and acquisitions, and strategic financial advisory, Mr. O'Brien has consulted with over 500 companies from many industries and testified on matters of valuation disputes. Prior to that, Mr. O'Brien was with T.D. Capital recommending mezzanine and equity investments in second and third stage start-up companies and assisted in managing a $300 million investment portfolio of companies in the telecommunications industry. Mr. O'Brien received his MBA from the Cornell University Johnson Graduate School of Management and BS in business administration with a concentration in finance and real estate from California State University, Northridge.

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Liquidity is defined as the ability to buy or sell an asset quickly without substantially affecting the asset's price. The liquidity of an investment in a closely held company is a factor that typically has the largest impact on value. Despite how well you manage your business and all of the profits your company may generate, if you do not create, maintain, or ensure the liquidity of your shares, you risk diluting the value of your investment.

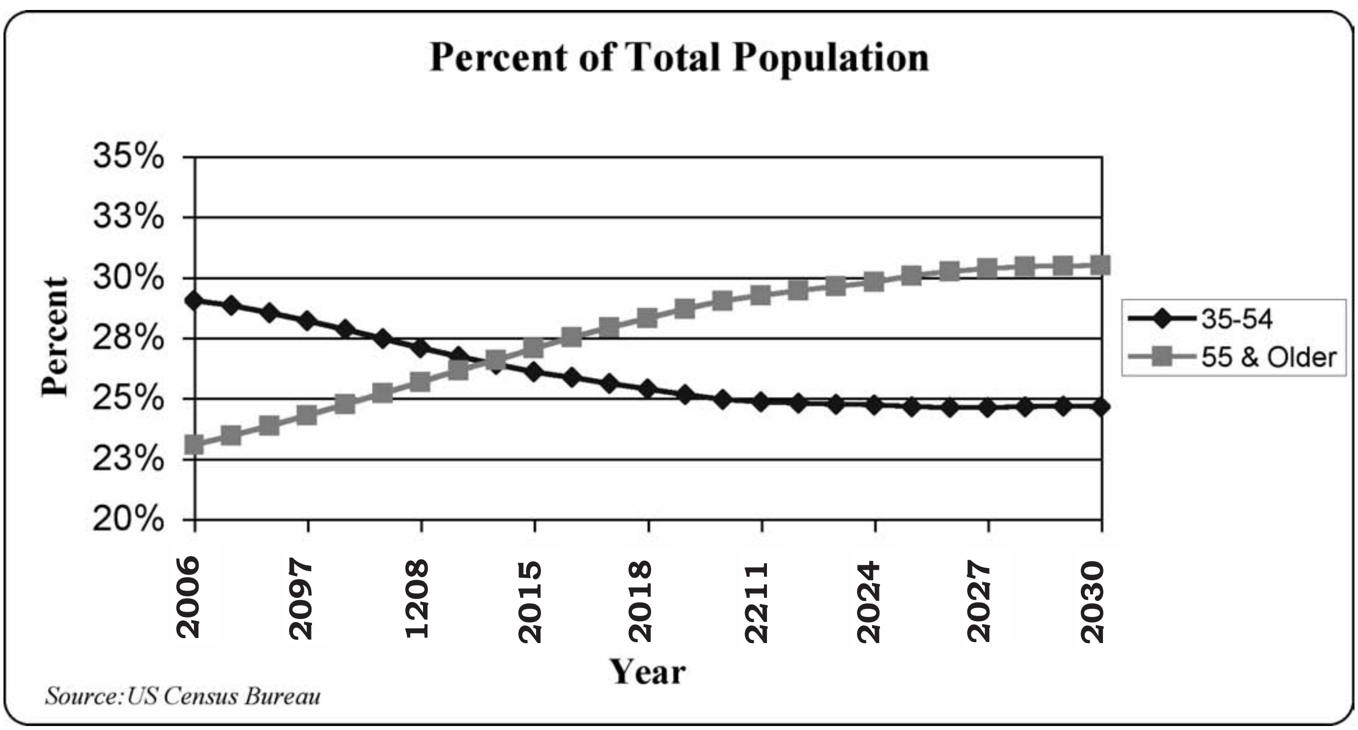
Trend

Over the next 25 years, the median age in the United States is projected to increase from approximately 36.4 years in 2006 to 39.0 years in 2030. After World War II, the United States experienced the largest population boom in history in what became known as the Baby Boomer generation, which is now approaching retirement age. According to the U.S. Census Bureau, it is estimated that there were more than 68 million Americans aged 55 and older and more than 86 million Americans aged 35 to 54 years in July 2006.

By 2030, the number of people aged 55 and older is projected to increase 61%, while the population of 35-to-54-year-olds will increase 4% during the same period. In absolute terms, the population of 55 and older will begin to exceed the population of 35- to 54-year-olds by 2014 and the gap continues to widen through 2030.

If we assume that those in the 35- to 54-year-old demographic are likely “buyers” of shares and those in the 55 and older demographic are “sellers” of shares, then the shift in demographics is likely to affect the supply and demand for shares of closely held companies in the future, which may also affect companies’ fair market values. The shift in demographics may tip the scales of supply and demand equilibrium in favor of buyers, as the demand for shares will decrease because of the decline of the pool of potential purchasers of shares and the increasing number of sellers entering retirement.

“Fair market value” is defined as the price at which the capital stock would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts. This definition is essential to understanding how value is derived. Along with many other factors, the availability of buyers willing to purchase shares in a company



influences the price a seller may get for his shares. If an owner of a company does not have any employees willing to buy shares in her company, then the value that she may receive for those shares could be negatively impacted. Extending this line of thinking one step further, if an owner does not have enough buyers, then the price for those shares could be negatively impacted.

Shareholder Liquidity

As previously mentioned, arguably the discount for lack of marketability is likely to have the greatest impact on the valuation of your shares. Whenever an appraiser conducts a valuation of a closely held company, he will take into consideration the earnings capacity of the company, the growth prospects, the risks associated with the generation of that earnings stream, and other salient factors associated with the generating of the expected future cash flow.

Marketability discounts are used to capture the difference in value based on the liquidity of stock traded on the public markets versus the value of holding an ownership interest in a private firm with no ready liquid market in which to transact shares. To determine an appropriate marketability discount, there are several studies on the subject of liquidity of non-marketable securities. An SEC study of the purchases of common stock subject to investment restrictions showed an average discount from the freely traded price of 32.7% for companies in a sales range of $1 million to $5 million.

In a second study, the prices paid by certain mutual funds for stock subject to restrictions as compared to identical but freely traded stock were shown to be an average of 35% higher. John D. Emory has performed eight studies of private placement stock transactions and subsequent initial public offerings of the same stock. All eight studies were done under very diverse market conditions, yet the results were not dissimilar: from the 1980-1981 study, where the prime rate of interest went up to 20%, through the 1987-1989 study, which included the October 1987 market crash. The median discount for sales transactions from all eight studies was 43%. The value of your shares can be reduced by an order of magnitude of up to 40%.

What Can You Do?

For many years we have touted the importance of planning for ownership transition early to gain the most out of your investment. Much to our frustration, many firms still wait too late to begin their ownership-planning process. With the changing demographics, planning early for ownership transition will likely become more vital if a transition is to yield full value and be successful.

An essential element to a successful transition is mitigating the burden on the buyers and allowing the sellers a fair rate of return for their investment. In order to mitigate the burden on buyers, allow for more time to ensure a successful transition plan. The fewer shares that must be transferred at any one time, the better. Selling down some of your ownership interest in stages prior to your date of retirement is an effective method of managing the ownership transition program.

An equally feasible alternative to internal transition is an outright sale to a third party, which may yield a higher value for your company. However, with the changing demographics, more companies may consider the third-party alternative in order to create liquidity for their shares. The likelihood of an increased supply of AEC companies available for sale may put downward pressure on the multiple of earnings that investors are willing to pay. Again, it's the supply-and-demand issue. The greater the supply of companies available for sale, the more of a buyers' market it becomes.

Like any investment, there are risks. However, unsystematic risks can be managed if action is taken early on. Planning for an ownership transition program now doesn't mean you have to give up control or have to sell down your position today. Planning means identifying who, what, and when to execute your ownership transition. Knowing your firm's value today may help you understand the magnitude of the ownership transition risk you need to manage five to ten years from now.

Increase Liquidity of Your Company's Shares

1. Let current and future investors know what they get in return for holding an investment in your company. Make sure that you are not only providing long-term returns on investments, but current returns in the form of distributions.
2. Enable shareholders to "put" some of their shares back into the company – only if it does not impair the financial condition of the company. "Put" right is a right to sell shares back to the company at any time. This right alone increases the inherent liquidity of your shares.
3. Increase the size of potential purchasers. Many firms only let principals own an interest in the company. If your firm has 50 employees and only four principals, you are limiting your potential pool of purchasers to only

three people (you are selling). Many firms have broadened the ownership base by allowing project managers, key non-professionals (finance, account ing, and HR personnel), and other key employees to purchase ownership in the company. Having a pool of 10 to 15 people is much better than a pool of four.

4. Grow. Increasing the size of your firm will not only reduce the risks associated with size, it will also reduce marketability discounts as larger companies are looked upon more favorably from an investment point of view from internal and external buyers. Furthermore, the larger the company, the greater the likelihood of a greater number of shareholders.
5. Make sure you have a Buy/Sell Agreement that specifically describes how shares are bought and sold and how the shares will be valued and when. Shareholder agreements should provide detailed information on the rights and privileges of the shares so that the investor knows what she is purchasing.
6. Transparency – make sure that the company is forthcoming with all relevant information as it relates to understanding the financial performance and condition of the company. Don't keep your investors in the dark with respect to information about the history and nature of the company, recent performance (good or bad), and business strategy.
7. Key-man insurance is an insurance policy with a view to providing liquidity, financial strength, and indemnity to your company in the case of losses on account of death or disability. This mitigates against liquidity issues from loss of business and the requirement of redeeming shares from the departed shareholder.

Exit Strategies

Planning for the liquidity of your investment is often the most overlooked action item that companies fail to implement. Careful planning can increase your options for creating an effective exit strategy that will improve your chances for a successful liquidity event. All of these options are not mutually exclusive. Many companies will implement plans for several options knowing that only one may actually get executed.

Initial Public Offering

Initial public offering is the most widely recognized form of creating shareholder liquidity. Many investors believe that this is the most lucrative and easiest way of creating liquidity for their investments. In reality, much like the probability of an athlete making it to the professional level, the odds are long against a company going public.

A company must demonstrate it is ready to go public; generating revenues less than a $100 million will likely receive a cool reception from the public market. Furthermore, companies must contend with a volatile window for going public. Management must be able to make quick decisions and take action on their decisions effectively. Often, public companies are lead by management teams that have demonstrated business leadership and decision-making skills.

When your company goes public, not all of the shares are sold and you will likely be subject to restrictions to selling your shares on the open market for a period of six to 18 months.

Sale of Company

Sale of a company provides an immediate liquidity for all shareholders of the company and is likely to achieve the highest value. Transactions will fall into two types of sales: stock and assets. Stock sale is when the shareholders sell his or her shares to the purchaser of the company and the purchaser assumes all liabilities – explicit and contingent – of the company. While this is the most tax-effective transaction from a seller's perspective because the sellers will be able to recognize capital gains taxes, most transactions in the professional services industries are found to be asset transactions. Buyers are very concerned with contingent liabilities as they relate to professional services companies, because it is very difficult to quantify the liabilities. An asset sale transaction is the sale of identified assets (excluding liabilities) and will subject the sellers to ordinary income tax on the proceeds from the sale.

Private Equity

Private equity funds are limited partnerships that are controlled by the private equity firm that acts as the general partner. The fund obtains commitments from pension funds, financial institutions, and wealthy individuals to invest a specified amount. These investors become passive limited partners in the fund partnership and at such time as the general partner identifies an appropriate investment opportunity, it is entitled to "call" the required equity capital, at which time each limited partner funds a pro rata portion of its commitment. All investment decisions are made by the General Partner, which also manages the fund's investments (commonly referred to as the "portfolio"). Over the life of a fund, which often extends up to ten years, the fund will typically make between 15 and 25 separate investments. Private equity firms will hold an investment for five to seven years.

Since the 1990s, the private equity market has increased its role in creating opportunities for companies seeking capital to fund their growth strategies. Nearly $200 billion was invested by private equity firms in 2005, which bolstered the trend in M&A. More recently, we have seen increasing trends of private equity firms investing in the architecture, engineering, construction, and environmental consulting arena. The benefits of partnering with private equity firms include: access to capital, management expertise, and support structure for acquisition strategies, among others. However, as a result of increasing investments from private equity firms, the demand began to outpace the supply of quality investments. Private equity firms began to allow shareholders to liquidate some of their investments along with additional capital being invested in the companies to fund growth strategies.

Employee Stock Ownership Plan

An employee stock ownership plan ("ESOP") is a qualified retirement savings plan under the Internal Revenue Code 401(a) that can only hold common or common equivalent equity securities of the sponsoring company. One of the benefits of an ESOP is the tax advantage to the sponsoring company, selling shareholders, and employees of the company.

If the company elects a "C" corporation tax status, the selling shareholders (subject to requirements), may be able to defer their gains on sale if they invest the proceeds into a qualified replacement security. Additionally, the sponsoring company will benefit from any contributions to the ESOP trust, which proceeds are most often used to repay any debt obligations owed by the trust. This enables the sponsoring company to use pre-tax dollars to pay off debt obligations owed for purchasing shares from selling shareholders. An ESOP can accumulate cash through contribution to the trust, which is tax deductible. The ability to create a sinking fund to future redemption of shares that does not create a tax burden on the company has made this vehicle very favorable for closely held companies.

According to a 2000 study by Douglas Kruse and Joseph Blasi of Rutgers University, it was found that company performance of ESOP-sponsored companies was higher than non-ESOP companies. Many sponsoring companies use ESOP as a benefit plan as well as a vehicle for creating and maintaining shareholder liquidity.

Costs associated with the implementation and operation of ESOPs can be high. It is our experience that most firms do not consider implementing an ESOP until they have at least 75 employees. Typical costs associated with the implementation include legal for filing appropriate documents with various government agencies, benefits administration, business appraisal, and in some cases, financing costs.

Conclusion

Shifting demographics are forcing companies to take action now before it is too late. For many years, creating shareholder liquidity came naturally as the size of the next generation exceeded the preceding generation. With the aging Baby Boomer generation, that is all about to change. Planning for your liquidity will become more critical as you will need to maintain your company's options to exercising the best liquidity option when your time comes to retiring.

Footnotes

1. SEC Institutional Investor Study, U.S. 92nd Congress, 1st Session House, 1971.
2. J. Michael Maher, "Discounts for lack of Marketability for Closely Held Business Interests," *Taxes – The Tax Magazine,* pp. 562-571, September, 1976.
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4. The National Center for Employee Ownership (NCEO).