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Exit Considerations

There are several critical dimensions to an exit of a private company. The following are some of the key considerations to any exit:

1. Client's motivation for partial/complete divestment **(Why?)**
2. Scope of the divestment **(What?)**
3. Target acquirer/investors **(Who?)**
4. Possible divestment transaction approaches **(How?)**

Scancorp considers each dimension in order to tailor a divestment process for its clients.

Motivation for divestment

In order to structure the most appropriate divestment arrangement, it is critical that the client's motivations for divestment are thoroughly understood. While there is a potentially limitless range of reasons for divestment, some of the most common reasons for complete or partial divestment include:

- **Owner grows out of their business or their business grows out of the owner:** in many high-performing private companies, the owner may have developed the business to a point where it now requires a higher level of expertise, business network or energy to expand the business further. Where an owner has succeeded in growing the business rapidly, they are often reluctant to see the business growth stall and would prefer to sell the business (in part or full) to parties who can better exploit its potential.
- **Wealth diversification:** where an owner has established a business over several years, much of their personal wealth may be invested within their business. A lack of diversification across a portfolio of investments may represent a risk to their personal and family wealth.
- **Requirement for expansion capital:** an owner that seeks to expand their business may be reluctant to invest more of their own funds or may be unable to secure further debt finance. In such cases, the owner may seek to bring on equity investors who acquire shares in the company.
- **Changing personal circumstances:** aging, degrading health or changing marital circumstances may create a requirement to exit a family-owned business.

Scope of divestment

Depending on the owner's motivations for exit, the scope of divestment must be clearly established. It is not always the case that an exit will or must lead to a sale of 100% of the assets of a business. The scope of divestment could include:

- **Sale of company shares:** this may include partial or complete sale of the shares of the company. A company share sale may be appropriate where the company has substantial contracts with current clients. Where shares of a private company are sold, appropriate due-diligence is required to assess potential warranty claims and liabilities associated with prior contracts.
- **Sale of business assets:** this may be the preferred approach where a company does not hold significant long-term contracts. It may also be necessary where the business assets are held by an entity other than a private company (such as a discretionary trust).
- **Sale of a license or franchise to exploit geographic territory:** where a business currently or potentially operates across a broad geographical area (such as a national retailer), an owner may elect to sell the right to operate the business within a specific location. This may be achieved via a formal franchise arrangement, a license or other agreement.
- **Sale of a specific product or service offering:** an owner of a business that provides multiple products or services may elect to divest of a specific product or service line. For example, due to recent regulation many combined accounting/financial planning practices have been separated to enable one or more of the separate businesses to be sold.

Target acquirer/investors

Once the owner's motivations have been established and the scope of the divestment is understood, target acquirers and investors can be identified. Some of the key targets include:

- **Strategic acquisition by customer/supplier:** in many cases target acquirers can be identified within the divesting company's supply chain. For example, if a component manufacturer dominates its niche, customers may seek to secure their critical component supplies by acquiring some or all of the target company.
- **Strategic acquisition by an "adjacent player":** it is important to consider strategic sale opportunities to companies that operate within an adjacent industry. This may be highly attractive to potential acquirers who are seeking to expand their current offerings and/or who would benefit by having access to the customer base of the target company. For example, a PR company may be an attractive acquisition for a corporate advisory practice which could expand its offerings and up-sell to the clients of the PR business.
- **Trade sale to a competitor:** a business may be attractive to a competitor particularly where the target has successfully eroded the potential acquirer's margins and where the target's products and services can be operated independently or successfully integrated. While competitors may be an obvious source of potential buyer great care must be taken in qualifying their intentions.
- **Management buy-out (MBO):** where a business has a strong management team in place, the owner may seek to sell some/all of the equity within the business to current employees. The owner may offer the employees an element of vendor finance and/or the employees may seek to re-leverage the business in order to pay the current owner.
- **Parties seeking to acquire an income stream:** smaller businesses may be attractive to individuals or families who wish to secure an income stream. Individuals and families seeking to work within the business are the most common buyers of small businesses - especially those with enterprise value less than $2 million.
- **Migrants:** foreign families and individuals seeking residence in Australia may elect to purchase a business in order to enhance their eligibility to emigrate.
- **Investors:** due to their lack of scale and liquidity, private companies generally offer a significantly higher return than publicly listed companies. Some investors seek to take a passive or partially active investment role in a private company by buying equity in a company that is operated under management.
- **Private Equity:** private equity firms may be attracted to larger private companies that offer consistent earnings, strong management and potential upside growth. The private equity fund may seek to increase the performance of the companies it acquires and may divest its interest in the company via a future trade sale or IPO. In many cases the owner will retain some equity within the company.

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Transaction considerations

The transaction that effects the divestment must be engineered to satisfy the objectives of the owner and the target acquirer/investor. There are as many deal structures as there are individual divestments; however some of the common approaches are outlined below. Note that these are not mutually exclusive as several may apply to a particular transaction:

- **Vendor finance:** to supplement bank lending, the owner may offer to provide debt finance to the buyers at an agreed interest rate.
- **Earn-out:** an owner may agree to defer payments subject to future performance of the business. Earn-outs are relatively common in businesses which have a high goodwill component.
- **Syndicates:** investors may be attracted to large privately held businesses that are operated under experienced management. These investors may acquire their interest in the business via a structured investment syndicate.
- **Leveraged recapitalisations:** leveraged recapitalisations occur when the acquiring party uses debt finance raised by leveraging the business' balance sheet to fund part of the acquisition. The acquirer then uses cashflow generated by the business to repay the debt. Leveraged recapitalisations are common in some private equity markets and in MBOs.
- **IPO and reverse mergers:** while many business owners aspire to exit via an Initial Public offering (IPO) on a stock exchange, it may be more feasible to gain listing status via a reverse merger (RM). A reverse merger or "backdoor listing" involves the acquisition of a small publicly listed company by a larger private company. The reverse merger may coincide with a capital raising to fund the acquisition of the private company and enable the owner to effectively sell part of their company through the publicly listed markets.