by **Joy James** | The Joy James Group

Finding 'Black Gold': Exit Strategies for Remanufacturers, Part 2

Editor's Note: This article is the second in a three-part series.

The first article in this series explored the pros and cons of a public mechanism, and looked inside one the biggest transactions to hit the aftermarket — Teckn-O-Laser's decision to become public by participating in a reverse acquisition with Adsero Corp. (Nasdaq: ADSO).

Becoming a publicly owned company is a high-risk, high-reward strategy. Success often stems from the management team's ability to execute the business plan and to grow the company's revenues and profits. Going public as a long-term exit strategy favors very large businesses because of the high cost structure associated with being public.

This second installment provides options for large-scale remanufacturers interested in selling into the private equity market, strategic buyers, or employees who complete an employee stock ownership plan (ESOP). We will discuss the pros and cons of each option shown in Figure 1. In the final installment next month, we will explore selling your business to individual buyers, including some innovative options for smaller operations with less than $1 million in annual revenue.

Exit Options for Sellers by Businesses Size

	Private Equity Group (PEG)	ESOP	Strategic Buyer
Typical Size	Annual sales more than $20 million	Annual sales more than $20 million	Annual sales more than $5 million
Pros	Offers immediate liquidity and access to capital.	Tax advantages.	Liquidity.
	Access to experienced, strategic thinkers.	Acquisitions can potentially be made using tax deductible dollars.	Business model 'fit' creates value which often equates to a higher sales price .
	Relatively quick transaction.	Can retain organizatonal control.	Deal terms are often controlled by the seller.
	Existing management team can participate.	Aligns employee focus with organizational objectives.	Access to experienced managers and other
Cons	3-7 year window before a secondary exit strategy.	Very complicated. Difficult to administer.	Loss of control.
	High performance level required.	Must have a significant payroll.	Strategic growth opportunities.
	New outside directors.	Can be a hard sell to unspohisticated employees.	Cultures may clash between organizations.
	High debt load.	Ongoing maintanence cost.	Fate of existing employees is unknown.
Why choose this option?	Owners choose a PEG as an interim exit strategy to create value through growth, operating performance, and leverage.	Owners choose ESOP for an exit strategy that favors employees.	Owners seek a strategic buyer to create synergistic opportunities and maximize value.
Aftermarket Example	Clarity Imaging Technologies (2003), Quality Imaging Products (2001)	GRC (1995)	Summit Laser & Graphic Technologies (2004), Golden Imaging/Turbon Group (1999), Future Graphics/NuKote (1993)

Figure 1: Exit options for sellers by business size.

Shhh … It's Private

Due to the very nature of PEGs being private, they generally try to maintain a low profile, especially in attractive industries. Several PEGs have agreed to be interviewed for this article under the condition of anonymity. For purposes of a case study we will use the information collected to construct a typical deal using a hypothetical company.

Selling Today

Business owners are selling. As the industry continues to mature, owners are exiting for both personal and strategic reasons. Some owners have reached a point in their lives where they're seeking less responsibility. Other owners are cognizant of the resources it will take to bring the company to the next level and are not able or willing to provide these resources. Finally, some business owners are selling to capture the value of the company that they've built.

Market environments also affect ownership transitions. Chris Schenkenberg, a senior manager in the federal tax practice of Grant Thornton LLP's Chicago office, believes the market is opening up for sellers today.

"There is more private equity capital looking for deals, more senior debt and more high-yield debt. This makes it an attractive

market for a seller because premiums will be higher," Schenkenberg said.

This combination of an attractive market environment and motivated ownership has sparked increased aftermarket transactions. Because of more available capital and easier debt financing, private equity group funding (PEG) has become increasingly popular today.

PEGs

PEGs provide equity capital to established companies in connection with a change in ownership or growth capital transaction. These third-party investment groups often have long-term relationships with banks and other investors, as well as the ability to provide professional management that can step in to take over or help manage the business. About 17 percent of the companies that comprise Inc. Magazine's "Inc. 500" list use PEGs as a source of capital for continued growth.

Figure 2 illustrates the basic private equity formula for value creation: make investments in the right company and in the right industry. The correct execution is essential in order to create long-term value. PEGs invest in private markets to create value and achieve a superior return on their investments.

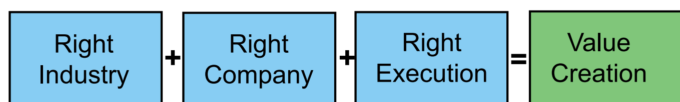


Figure 2: Basic private equity formula for value creation.

In addition, the management team is a critical part of the deal, and most PEGs prefer to see the owner stay on to run the company. Generally speaking, an owner increases the business' stability and reduces overall risk. "We wouldn't be making this investment unless we were happy with the management team," said a member of a PEG who is currently in the process of closing a growth equity investment in the aftermarket.*

PEG investments can be broadly categorized into three types, as detailed in Figure 3. These options are based on a) the owner's needs b) the PEG investment philosophy and c) the dynamics of the business.

PEGs prefer to handle established companies with more than $20 million in annual revenue, and about $2 million in earnings before interest, taxes, depreciation and amortization (EBITDA). (For more information on EBITDA refer to Part One of this series in last month's Recharger). This size preference is due mainly to the high transaction cost associated with a PEG investment.

Because private markets are inherently riskier than other investments, the average PEG return is quite attractive, as illustrated in Figure 4.

	1 Year	3 Year	5 Year	10 Year
All Venture Funds	9.6%	32.2%	26.7%	16.8%
Buyout $0-$250MM	9.0%	18.5%	19.7%	19.7%
All Buyout Funds	16.4%	18.1%	19.1%	17.0%
All Private Equity	14.3%	22.4%	21.7%	16.9%

Figure 4: Average Private Equity Returns, 1989 – 1999.

A Typical Leveraged Buyout (LBO)

Private equity groups have been able to achieve solid returns over the past two decades; hence the popularity of LBO funds in mature capital markets. Therefore, a value-creating LBO will effectively: 1) identify industries with opportunities, 2) screen companies within this industry for suitable investment targets, and, following the investment/ acquisition, 3) execute effectively.

Execution involves both the determination of a proper strategy and a disciplined approach to following through on that strategy. Typically, PEGs will look for both sales growth and improvements in operations. Oddly enough, manufacturing companies with low operating margins present a good opportunity for PEGs. The characteristic of low margins presents both risks and opportunities. The potential risk is that failure to rapidly respond to a downturn in volume, with appropriate reductions in fixed costs, can quickly lead to cash flow shortfalls. The attractive opportunity, however, is the potential to dramatically improve earnings. A highly simplified hypothetical income statement (as a percentage of revenue) of a company

Types of Investments PEGs Make			
	Growth Equity Investment	**Recapitalization**	**Owner Exit**
Characteristics	Limited liquidity to owner. Investment sticks mostly to the business to accelerate growth.	Shareholders receive cash through a combination of new debt and new equity into the business.	PEG must have an executive looking to get into the industry or has experience in the industry.
	New directors added.	Control of the company may go to investors.	After a transition period the owner will exit the business completely.
	Management team is supplemented with PEG managers.	The business becomes leveraged with debt.	May get a lower multiple. The risk is higher because the owner is leaving.
Why choose this option?	This option is right for an owner who wants to stay in his business and take it to the next level by bringing in equity.	Owners choose this option when they want to receive cash in exchange for a portion of the business.	Owners who seek to fully exit their businesses and do not have a strategic buyer opportunity.
Aftermarket Example	Clarity Imaging Technologies Inc. (2003)	N/A	Quality Imaging Products (2001)

Figure 3: Three different PEG investments.

with Unfocused Operations is contrasted against a company with Focused Operations, as shown in Figure 5:

In these two scenarios, there exists only a 5 percent difference in costs, yet the resulting impact on EBITDA is almost 50 percent. Since manufacturing companies tend to trade at valuations based on a multiple of EBITDA, this improvement in earnings will translate to an equivalent increase in the value of the company. A similar analysis shows that an 11 percent reduction in costs would double the value of the company.

Figure 6 illustrates sample scenarios for increasing the value of the business. In the first scenario, the revenues in the first year are $10 million and costs of goods sold (COGS) are $8 million, which results in a gross margin of $2 million. Selling, general and administrative expenses (SGA) costs are $1 million, so the EBITDA (cash flow) is roughly $1 million. The scenario assumes a value multiple of 5X, so the value of the business is $5 million.

Unfocused Operations	
Revenue	100.0%
Cost of Goods	65.0%
Gross Margin	35.0%
S,G, & A	25.0%
EBITDA	100%

Focused Operations	
Revenue	100.0%
Cost of Goods	61.7%
Gross Margin	38.3%
S,G, & A	23.8%
EBITDA	14.5%

Figure 5: The financial significance of low operating margins.

Each year, the business is assumed to grow at 30 percent, so revenues in year two are $13 million, $16.9 million in year three and $28.56 million in the fifth year. Costs and SGA expenses are assumed to remain constant, and the purchase multiple is also assumed to remain constant at 5X. At the end of five years, the business is now valued at $14.28 million (5 x $2.86 million EBITDA). The equity appreciation per year is 23 percent.

In the second scenario, the business grows at the same rate, but the management team also improves the margins each year both on cost of goods sold and SGA. As a result, the EBITDA increases at a faster pace.

So, in year one, just like in the earlier example, revenues are $10 million, costs of goods sold are $8 million, which results in a gross margin of $2 million. SGA costs are $1 million, so the EBITDA (cash flow) is roughly $1 million. The scenario assumes a value multiple of 5X, so the value of the business in year one is $5 million.

Again, like the first scenario, each year the business is assumed to grow at 30 percent, so revenues in year two are $13 million, $16.9 million in year three and $28.56 million in year five. As mentioned, costs and SGA expenses are assumed to decrease by 1 percent of revenues per year, so by year five the EBITDA is $5.14 million. Assuming a 5X EBITDA value, the company is now valued at $25.70 million. In this scenario, the equity appreciation is 39 percent.

The third scenario below assumes, like the second scenario, strong revenue growth and increased margins. In addition, the third scenario assumes the company is purchased at a low value and sold at a high value and that debt is also used to finance the pur-

Scenario 1 — Strong Revenue Growth, Constant Margins

	Year 1	Year 2	Year 3	Year 4	Year 5	Assumptions
Revenues	$10.00	$13.00	$16.90	$21.97	$28.56	30% yearly growth
COGS	$8.00	$10.40	$13.52	$17.58	$22.85	Constant
Gross Profit	$2.00	$2.60	$3.38	$4.39	$5.71	
SGA	$1.00	$1.30	$1.69	$2.20	$2.86	Constant
EBITDA	$1.00	$1.30	$1.69	$2.20	$2.86	
Multiple	5	5	5	5	5	
Value	$5.00	$6.50	$8.45	$10.99	$14.28	23% ← Return

Scenario 2 — 30 Percent Revenue Growth, Increased Margins

	Year 1	Year 2	Year 3	Year 4	Year 5	Assumptions
Revenues	$10.00	$13.00	$16.90	$21.97	$28.56	30% yearly growth
COGS	$8.00	$10.27	$13.18	$16.92	$21.71	1% of sales per year
Gross Profit	$2.00	$2.73	$3.72	$5.05	$6.85	
SGA	$1.00	$1.17	$1.35	$1.54	$1.71	1% of sales decrease per year
EBITDA	$1.00	$1.56	$2.37	$3.52	$5.14	
Multiple	5	5	5	5	5	
Value	$5.00	$7.80	$11.83	$17.58	$25.70	39%

Scenario 3 — Strong Revenue Growth, Increased Margins, Buy Low, Sell High, Reduce Leverage

	Year 1	Year 2	Year 3	Year 4	Year 5	Assumptions
Revenues	$10.00	$13.00	$16.90	$21.97	$28.56	30% yearly growth
COGS	$8.00	$10.27	$13.18	$16.92	$21.71	1% of sales per year
Gross Profit	$2.00	$2.73	$3.72	$5.05	$6.85	
SGA	$1.00	$1.17	$1.35	$1.54	$1.71	1% of sales decrease per year
EBITDA	$1.00	$1.56	$2.37	$3.52	$5.14	
Multiple	4	5	5	5	7	
Value	$4.00	$7.80	$11.83	$17.58	$35.99	55% appreciation in value
Equity	$1.00	$5.40	$10.03	$16.38	$35.39	104% ← return
Value	$3.00	$2.40	$1.80	$1.20	$0.60	

Figure 6: Three sample scenarios for increasing the value of a business.

chase. In this scenario, the returns increase substantially.

So, in year one, just like in the first two examples, revenues are $10 million and costs of goods sold are $8 million, which results in a gross margin of $2 million. SGA costs are $1 million, so the EBITDA (cash flow) is roughly $1 million. In this example, the scenario assumes a value multiple of 4X, so the value of the business in year one is $4 million.

Of this $4 million, it is assumed the business is purchased with only $1 million in equity and $3 million in debt. (It is rare in today's environment to purchase a business with so little equity. Typically, deals require 40 percent plus equity in the transaction.)

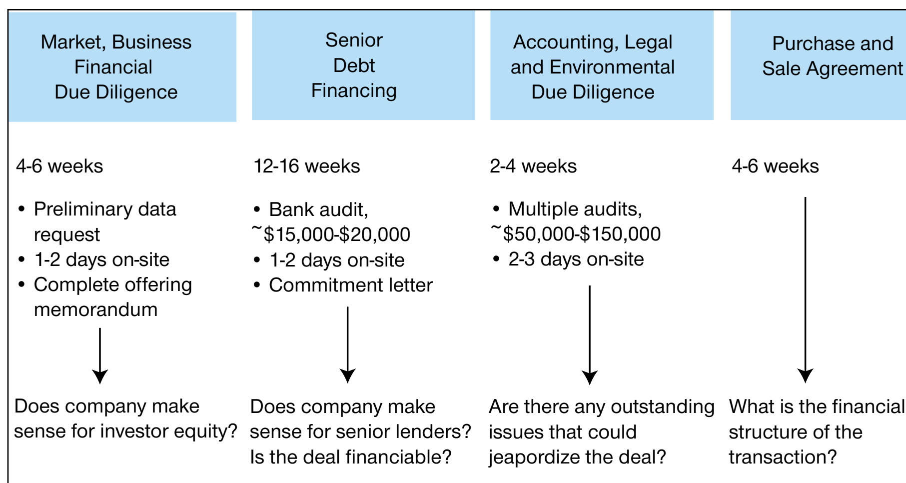


Figure 7: PEG due diligence process map.

Again, like both earlier scenarios, each year, the business is assumed to grow at 30 percent, so revenues in year two are $13 million, $16.9 million in year three and $28.56 million in year five. As mentioned, costs and SGA expenses are assumed to decrease by 1 percent of revenues per year, so by year five the EBITDA is $5.14 million.

In this third scenario, the business is assumed to be sold at a 7X multiple, so the total sales value is $35.99 million. The debt is assumed to be amortized over five years, so $600,000 is paid down per year. In year five (depending at what point in year five the business is sold), the debt level could be as high as $600,000. So, the debt is subtracted from the total sale price and the remaining $35.39 is equity. In this scenario, the equity has grown from $1 million to $35.39 million over five years which is a 104 percent return.

This scenario has a host of optimistic assumptions. It is very rare to have such high returns on an investment, but the scenario is intended to highlight some of the methods PEGs use to create a return on their investments.

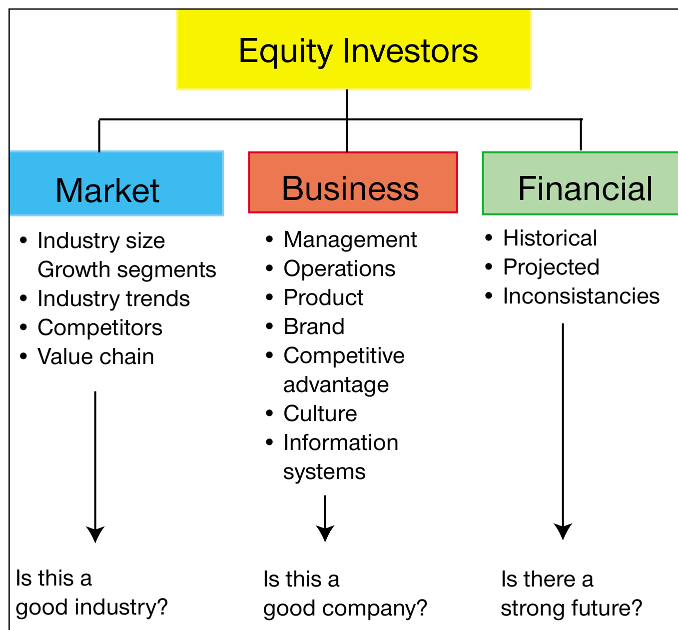


Figure 8: Market, business and financial due diligence.

Due Diligence Process

As Figure 7 illustrates, the PEG due diligence process typically has several steps involved. Each of these aspects are critical to the deal proceeding, and negative conclusions will often end a PEG negotiation. In terms of timeframe, the process generally takes between six and eight months to complete.

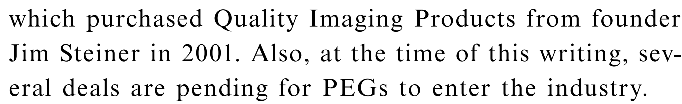
The threshold due diligence (Figure 8) analyzes the industry, the business and the financial aspects of the deal. The completion of this first step will determine whether the deal makes sense and will conclude in an offering memorandum.

The PEG due diligence process culminates in a purchase and sales agreement that details the financial and legal structure of the transaction. Several professionals are involved in the process including attorneys and accountants. Typically, the process costs about $200,000.

PEGs Interest in Aftermarket Industry

Every industry has pros and cons, and the aftermarket is no different. "The aftermarket industry has a lot of pros going for it," explained a PEG member. "It is growing rapidly, and it will continue to grow rapidly. Also, the profit margins on the laser side specifically are quite favorable. When you combine these two attributes, guys like me are going to take notice of the industry."

Indeed, several PEGs have entered the aftermarket during the past few years, including Champlain Capital Partners LP, which raised a reported $4.7 million for Clarity Imaging in 2003, and Blackford Capital LLC,



which purchased Quality Imaging Products from founder Jim Steiner in 2001. Also, at the time of this writing, several deals are pending for PEGs to enter the industry.

Martin Stein, president of QIP and former managing director of Blackford Capital, said, "We found the aftermarket industry attractive in 2000 and 2001 because it was large, growing, profitable, highly fragmented and operational excellence was a competitive differentiator. We believed that in the industry, the correct business model combined with successful execution would yield strong returns."

PEG Concerns in the Aftermarket Industry

Interestingly, there have been at least two PEGs that have reportedly backed out of an aftermarket investment close to the transaction closing date. Sources say that investors got cold feet and couldn't get comfortable with the deal.

One area of the aftermarket that provokes investor discomfort is the intellectual property (IP) issues. According to an unnamed member of a PEG, the risk of being sued by an OEM weighs heavily on their minds. "As an investor managing money, you do not want to put money somewhere when you know there's a risk out there that you can't control," he said. "We could make an investment today, and then get sued by an OEM tomorrow, forcing us to pay over a million dollars to defend the company in court."

According to antitrust/intellectual property litigation attorney Ron Katz of Manatt, Phelps and Phillips, this is a reasonable fear. "The nuisance of IP lawsuits is high, at least mid-six figures," he said. However, Katz suggests that PEGs should ultimately be able to get comfortable with this issue. "With appropriate due diligence, the risks are no larger in the remanufacturing industry than elsewhere," Katz said.

QIP's Stein also stated, "In addition to the IP concerns, some of the other drawbacks to the aftermarket industry are: a) limited accounting infrastructure and financial controls, b) inordinately complex cost structures and inventory valuations on cores, c) highly variable raw material inputs, and d) inconsistent price structures across the industry. Each of these factors, individually, is not a deal breaker, but, collectively, they present significant odds to closing a deal. For example, an aftermarket entrepreneur can alter the bill of materials and revalue inventory levels based on aggressive and optimistic replacement assumptions for components. These changes can have a large impact on margins and, ultimately, affect the value of the company by substantial amounts. A PEG unfamiliar with the industry can be blindsided when they learn about these tactics, and it can shut down a deal."

Clarity Imaging

After a 2003 investment by PEG Champlain Capital Partners, Clarity Imaging Technologies was on track for growth. The company stood out as one of the largest regional players and continues to sell through both direct and distribution channels. Clarity made a name for itself with its PageMax program and was one of the early entrants into the cost-per-page model.

Warren Feldberg is CEO of Champlain Capital and was formerly the CEO and president of U.S. Office Products, which was sold to Corporate Express in 2001. In its first fund, Champlain raised a reported $4.7 million for Clarity, and Feldberg became chairman of both companies. Not coincidentally, Clarity soon became a vendor for Corporate Express (the largest distributor of remanufactured toner cartridges in the world) as well as other large end-user accounts such as Citigroup (the largest company in the world according to Fortune's Global 100). Most likely, Clarity's business doubled in size shortly after Champlain's investment. This is the benefit of a PEG strategy.

PEG Pros and Cons

"Private equity groups have a number of advantages," explained Grant Thornton's Schenkenberg. "First, they provide access to professional management. Second, they are good at long-term strategic thinking. Third, they have ready access to capital. Most importantly, they have high expectations for organizations, which can sometimes be a negative for a management team that does not perform." Most PEGs expect to see a past history and future plans for aggressive growth.

In terms of downsides, a PEG transaction can become expensive. Attorney, accounting and consultant professional fees often total six figures, up to $200,000.

Also, you must be prepared for organizational change. PEGs will often insert new directors and management into the company. In some cases, existing staff may be replaced. "There will be members of your existing team that can't keep up," cautioned one PEG. "They might be the person who's been with you since the beginning. You will have to replace them, and if you don't, we will replace you."

Finally, be aware that most PEGs seek to deploy and recoup their capital within a three- to seven-year window, meaning that a secondary exit strategy must be planned. Options include going public or selling to another buyer

for a profit. For example, an equity firm may buy a remanufacturer for three or four times earnings, improve its market share and performance, and resell the company for five or six times earnings.

"It's important to know who you're getting in bed with," stated a PEG member. "Just as the PEG is going to do an extensive due diligence process on the entrepreneur and his business, that entrepreneur should be just as diligent in checking out the firm he's considering partnering with. Unfortunately, there's a lot of sharp-toothed guys in the private equity world who give people like me a bad name. There's also a lot of good guys who are focused on growing and building businesses. You have to learn the difference."

Strategic Buyers, Mergers and Acquisitions

Many relatively large-scale remanufacturers have chosen the option to sell to a strategic buyer. A strategic buyer is a company that has a presence in the industry, whereby the selling company adds some value to the buyer's existing business.

The added value can take many forms, including increased market share, product line expansion, geographic expansion or vertical integration. The additional synergy or added value is expected to allow the buyer to pay more for the business because they can appreciate more of the value.

"People buy businesses for strategic reasons. There is a market out there," said Robert Goldstein who founded, sold and later repurchased Future Graphics from Nu-Kote Holding.

Examples of large-scale strategic buyer transactions include Golden Imaging/Turbon Group (2000), Graphic Technologies/Summit Laser (2004), and Nu-Kote acquisitions ICMI (1992), Future Graphics (1993) and Pelikan (1995).

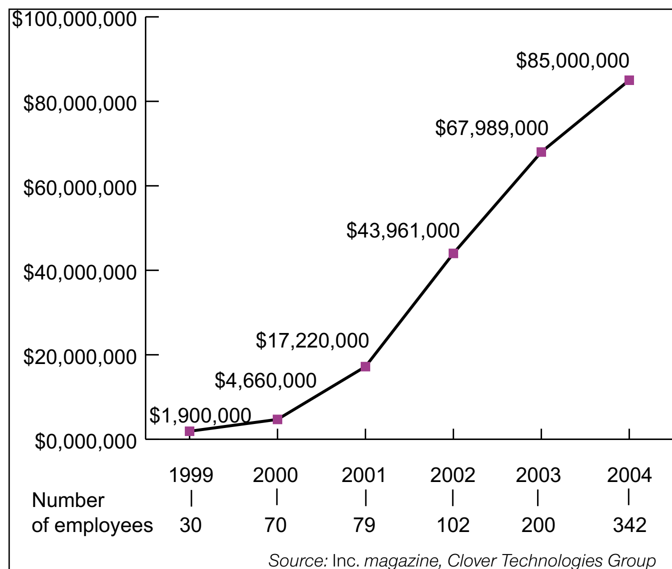


Figure 9: Clover Technologies Group total revenue and employees by year, 1999-2004.

Strategic Acquirers

Strategic acquirers usually have several key characteristics, including: 1) being large enough to acquire a business, 2) having a solid infrastructure that can support the business integration and 3) the need to acquire something that cannot be developed in-house.

For example, when ribbon manufacturer Nu-Kote purchased ICMI and Future Graphics in the early 1990s, it did so to meet the product needs of its distribution customer Office Depot. At the time, Office Depot wanted to carry remanufactured/compatible toner cartridges and Nu-Kote did not have the ability or knowledge to develop toner cartridges in-house.

Aftermarket Example: Clover Technologies

Illinois-based remanufacturer Clover Technologies Group is currently in the process of negotiating two strategic acquisitions. Clover President Jim Cerkleski adds that Clover's target is to "acquire four or five companies over time."

Cerkleski, who has a background in strategic acquisitions and was formerly division president of U.S. Office Products, has no plans to slow down Clover's growth or to exit the business anytime soon. As Figure 9 shows, Clover has experienced very impressive organic growth since 1999 when Cerkleski purchased the company.

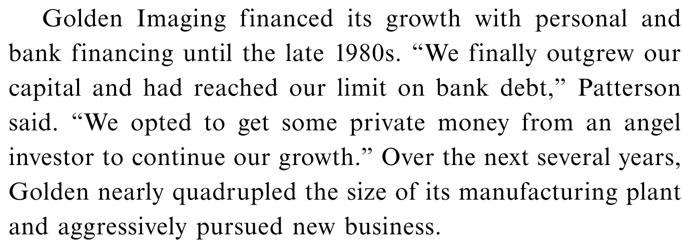
"Bigger is only better if you can manage the business and remain profitable," explained Cerkleski, who seems to have a keen sense of what it takes to be successful in today's market. "I think the only way to remain successful in this business is to reinvest to stay in line with the OEMs."

Attributes that Clover seeks in a potential acquisition candidate include geographic location, existing customer base and profitability. If the company is not profitable, Clover can quickly determine whether the business can be turned around during the due diligence period.

Cerkleski envisions 2005 being Clover's best year ever. Given Clover's strong track record of growth and ambitious nature, Clover is on track to become one of the industry's bigger players.

Strategic Seller Profile: Golden Imaging

Golden Imaging started as Golden Ribbon Corp. in 1981. "We were guys right out of college," explained co-founder Bill Patterson. "We did quite well in the ribbon manufacturing business. We grew and grew." Golden Ribbon Corp. was named one of Inc. magazine's fastest growing privately held companies in 1987.



Golden Imaging financed its growth with personal and bank financing until the late 1980s. "We finally outgrew our capital and had reached our limit on bank debt," Patterson said. "We opted to get some private money from an angel investor to continue our growth." Over the next several years, Golden nearly quadrupled the size of its manufacturing plant and aggressively pursued new business.

By the early 1990s, Golden entered the toner cartridge business by acquiring remanufacturer LaserTek in Las Vegas. In 1997, Golden acquired a second laser cartridge business from PM Company and became one of the bigger remanufacturers in the aftermarket at that time. Total annual revenue was reportedly about $10 million.

Although Golden had a good quality product and an impressive operation, it was never able to fill the additional capacity.

"It was unbelievable how many times we came in second place to Nu-Kote, Turbon or Dataproducts on large (superstore/contract stationer/co-manufacturing) deals," recalled Patterson. "We just didn't quite have the capability to get the big customers on those deals. They liked us. They liked the plant. They just ultimately picked a bigger player."

In the end, Golden wound up with excess capacity and a high overhead structure. "We ended up with a huge overhead," confessed Patterson. "In retrospect, we should have stayed in the smaller space and just put on another shift."

The partners decided that it was the right time to sell the company. "We'd talked with Turbon on and off for a couple of years about selling," Patterson said. "We talked about the synergies of coming together, and there was mutual interest."

The Turbon Group, owner of such companies as Curtis Young and Jetfill, was a logical candidate. There was a long-term relationship between the companies, and Turbon was actively acquiring at the time. Once the decision was made, it took only about four to five months to complete the transaction.

In the end, Golden's customer base was secured and its operations were discontinued and merged into Turbon over a short period of time in a professional manner. According to Patterson, the company downsized from around 90 employees in 1999 to about 12 employees in 2001.

"Letting go of the bricks and mortar isn't as hard as the people," Patterson said. "Some of the employees had been with us since the early 1990s, and we'd grown fond of each other. We had a good crew."

On the Decision to Sell

From time to time, Patterson and his three business partners sat down and discussed exit strategies. "By 1999, we'd been in business 18 years. A couple of the partners were ready to go or needed to go do something different.

"It was time, and the deal made sense," said Patterson, who did express some regret for selling, but added that not all the partners wanted to continue running the business. As part of the deal, Patterson signed a three-year management contract with Turbon to oversee the transition.

By contrast, in 1993 Robert Goldstein sold Future Graphics on a Friday and never stepped foot back in his office again.

According to Goldstein, he originally sold the business to Nu-Kote for personal objectives. "I had worked five years, 24/7 building Future Graphics into the largest cartridge remanufacturer in the industry. We went from three employees to more than 250 employees in a very short period of time."

"Selling the business to Nu-Kote offered me an opportunity to recharge my batteries and go spend time with my family."

Option to Merge

Graphic Technologies founder Ira Seaver is doing things his own way. Seaver opted not to exit the company that he started in 1985, choosing instead to merge the business and simultaneously take a step back from his presidential responsibilities.

"I don't want to work a 60-hour week at this point in my life," explained Seaver, who is in his late 50s and has three children ranging in age from 12 to 16. "My children are not old enough to take over the business, and I was not looking for an abrupt exit. Merging with Summit Laser was the perfect fit," said Seaver, who seems genuinely at peace with his decision.

In his new role, Seaver will focus his efforts into areas of the company that he enjoys most. "I prefer to spend my time working in the product development side of the business," he explained, adding that he finds R&D "captivating." Seaver, who has a degree in journalism, is known as a highly proficient technical expert who enjoys overcoming difficult challenges.

Steven Hecht has taken over the reigns as president of the new organization, renamed Summit Technologies (a merging of the two company names), which is headquartered in New York. Seaver remains a minority shareholder and employee of the organization.

According to Seaver, the most difficult part of the transaction was negotiating the contract, which went through more than a dozen versions before being finalized. "Bringing together these two large companies was very complex," he said.

Pros and Cons

Often, the deal terms are controlled by the seller in a strategic acquisition or merger. This is a main benefit, but also puts

the responsibility on the seller to articulate exactly what they want and what they are willing to give up. Deals usually take three to six months to complete.

Selling all or part of your shares to a strategic acquirer for cash is probably the best way to gain liquidity and maximize value. The owner may completely exit, or not, after a transition period typically between 12-24 months.

Because many aftermarket business owners are young — many are less than 40 years old when they sell — they use the experience as a springboard to pursue other opportunities. Bill Patterson completed his management contract and started a new business called B2B Direct. Robert Goldstein repurchased Future Graphics in an asset sale four years after the original sale to Nu-Kote and rebuilt the company to where it is today.

Additional pros for the business are growth opportunities and access to resources not otherwise available. Sometimes, being a part of a larger company can offer strategic advantages.

One major con is losing control of the organization. Often, strategic acquirers have a different vision for the company and pursue it. One industry observer says it comes down to a simple question: "Do you want to be rich, or do you want to be the king?" Most often, you are no longer king when you sell the majority of your shares to a strategic acquirer.

ESOP Facts (U.S.)	
Number of…	
Total ESOP companies	12,000
ESOP companies that are majority-owned by the ESOP	3,000
ESOP companies that are 100 percent owned by the ESOP	1,200
Employees participating in an ESOP	8 million
Percentage of ESOP companies in manufacturing sector	25 percent
Source: ESOP Association (www.esopassociation.org)	

Figure 10: ESOP fact table.

"If you stay on, be prepared for lots of change," Patterson cautioned.

"You've got to get beyond your personal control issues or you are destined for failure," Seaver added.

Another downside is that company cultures may clash between organizations. Seaver offers his advice: "It simply comes down to how things are done. Sometimes you have to let go of the way you always did it before."

Finally, a disadvantage of strategic acquirers is that the fate of the existing employees is unknown. Although key management will often sign a management contract, the employees may be released depending on the buyer's objectives.

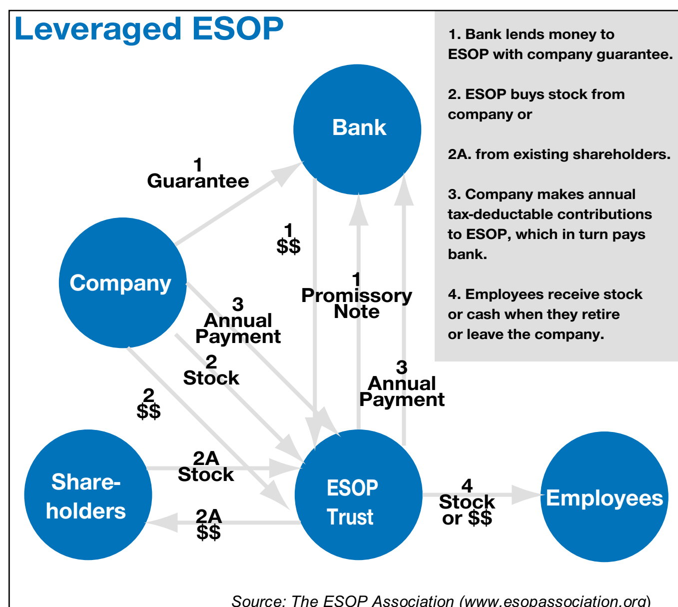


Figure 11: Typical transaction for a leveraged ESOP.

Words of Wisdom

"My biggest piece of advice for sellers is to hire a professional adviser to assist with the transaction," Schenkenberg said. "The adviser does not need to be a high-priced Wall Street investment banker, but should be someone who has experience with transactions. Advisers play an important role for a seller, who might not have sold a company before."

Employee Stock Ownership Plan (ESOP)

An ESOP is an employee stock ownership plan that makes the employees of a company the stockowners in that company over time. The ideal candidate for an ESOP is a profitable midsize company that pays corporate taxes and expects to continue doing so. The business must be a C or S corporation (partnerships or sole proprietorships cannot have ESOPs).

As Figure 10 shows, there are approximately 12,000 total ESOP companies in the United States, and 25 percent of them are in the manufacturing sector. Generally speaking, the number of ESOPs in the United States has remained flat since 1990.

How Does it Work?

A company sets up an ESOP by first creating a trust to which the company makes an annual contribution. Figure 11 shows a typical transaction for a leveraged ESOP where the trust obtains bank financing to pay for the company stock that the owner sells into it. Then, the company (not its employees) pays off the bank loan, making both the principal and interest tax deductible.

Stock is typically allocated to each employee based on compensation, years of service or some combination thereof. The

stock must vest for a period of time before employees are eligible to receive the asset. Employees receive the vested portion of their asset in the event of termination, disability, death or retirement.

"An ESOP is not a workplace democracy," said Michael Keeling, president of The ESOP Association, who added that an ESOP does not give employees any implied or express decision-making authority. However, Keeling warns that there is a psychological effect that occurs post-ESOP. "If you cannot get comfortable psychologically with selling to the employees, you shouldn't proceed because it does have an impact on the company both short and long term."

Common ESOP Valuation Approaches and Methods			
	Asset-Based Approach	Market Approach	Income Approach
Definition	A valuation process for the business whose primary source of income is its assets.	Valuation of a business by comparing a similar business that has been sold.	A valuation based on the income generated by the business.
Methods	Adjusted Book Value Method	Evaluating publicly traded companies	Capitalization of Earnings Method
	Liquidation Value Method	Sales of similar companies	Discounted Cash Flow Method

Figure 12: Common ESOP valuation approaches

ESOP Example

Aftermarket leader Bob Daggs chose this option when he sold a majority of his GRC stock to the company's more than 450 employees through an ESOP in 1995. Although Daggs prefers to keep the details of the transaction quiet, he did disclose that he willingly stepped down as president and became chairman of the board after the sale. His sons Jim and Bill continue to work for the company today, and Daggs remains active in both the company and the aftermarket industry.

Valuation

The valuation of an ESOP must meet requirements that are set forth by the Internal Revenue Service and the U.S. Department of Labor. Under IRS Code Section 401(a)(28)(C), a company must conduct an independent appraisal of its shares each time the plan acquires stock and at the end of each plan year.

As Figure 12 shows, there are three common valuation approaches in an ESOP, including the asset-based approach, the market approach and the income approach.

Common ESOP Valuation Approaches

According to IRS Revenue Ruling 59-60, all aspects of the business must be considered in the evaluation, including the nature of the business, its economic outlook, the outlook of the industry as a whole, the financial condition of the business, the book value of the stock, the company's earnings potential, the company's dividend paying capacity, and perhaps most importantly, the market price of interests or stocks issued by companies in a similar line of business.

Pros and Cons

According to Schenkenberg, a main advantage of an ESOP is the tax advantages for shareholders. "Companies owned by ESOPs tend to have a lower effective tax rate than companies with other ownership structures," he said.

Two other advantages of an ESOP are retaining organizational control and the terms of sale. In essence, the owner is negotiating with himself. Post transaction, the company may choose to continue to run the organization in the same manner as before the ESOP.

In theory, an ESOP should align employee goals and serve to motivate and empower employees. However, this is not always the case. Employees receive a yearly statement that tells them the value of the stock. Inevitably, the stock value will stagnate or go down and employees may blame management for conditions outside of their control.

Another disadvantage is transaction complexity and ongoing maintenance cost. Each year, an ESOP company must complete an independent valuation of the shares. ESOP Association's Keeler explains that "ESOPs are an animal of federal statute. They have tons of tax law and ERISA law, which combines both tax and labor laws." The result is ongoing professional fees.

Finally, a company with an ESOP becomes more difficult to sell. According to a PEG member, "ESOPs limit the strategic opportunities available to a company from a mergers and acquisitions standpoint."

The growth and success of the aftermarket has opened up new opportunities for exiting owners. Private equity investments and strategic mergers and acquisitions seem to be on the rise. As the industry continues to consolidate, large-scale remanufacturers are positioning themselves for the future. It appears the big are getting bigger. This may serve as a cue for smaller companies to consider their top level and exit strategies.

In the next installment, we will consider options for smaller sellers, including strategic mergers and individual buyers. R

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