CASE STUDY

What Happens When the Music Stops?

The following case study is based on a true story. For owners of closely held businesses, this case study highlights the importance of engaging an experienced and professional exit planning team. Even when an exit appears to be years in the future, circumstances might force a change to the exiting owners' timing. Therefore, we recommend that all business owners seek help from professional exit planners, like our NAVIX Consultants.

Key Lessons:

One of the four possible exit strategies is to sell the company to an outside buyer. These buyers can fall into one of two main categories: strategic buyers or financial buyers. At NAVIX, we call selling to an outside buyer an "Outie" exit strategy. Key risks for this type of transaction are timing, readiness for the actual execution of the transaction, and securing a satisfactory price and acceptable terms.

- **Timing Changes –** An owner's age, shift in priorities, evolving co-owner relationships, and health declines are all reasons why owner exit timing can change.
- **Industries Evolve –** As technology progresses and industries change, a business may not generate significant interest from buyers if it is not positioned for industry changes.
- **Golden Handcuffs –** If key employees are not properly rewarded and retained, they may leave at inopportune times.
- **Ownership Documents –** Legal agreements between co-owners must be systematically reviewed and updated. They should address the rights of majority and minority owners.
- **Professional Help –** Most business owners do not have the expertise and experience to know all the potential risks and opportunities associated with exiting their business. They should seek help from a professional exit planning team.

What Happens When the Music Stops?

Bob and his wife Anne Martin built their IT services company, BJM Consulting, into a profitable operation. The company's cash flow was providing a nice lifestyle, but constant HR issues and other factors were sapping their passion for the business. As a result, they began to think about their eventual exit from the company. The Martins decided that their preferred exit strategy would be to sell the company to the management team that had helped them grow the company to its current size.

The BJM management team had five principals in addition to the Martins. Peter was the head of project management, and Bob believed Peter was the most logical person to become CEO after the sale. The rest of the team was comprised of the following people: Brian was in charge of recurring services, Jerry was the chief technical officer, Dan was the top salesperson, and Sara was in charge of marketing.

During a weekly management team meeting, Bob brought up the idea of selling the company to the team. Reaction was enthusiastic. Within a couple weeks, Peter, the head of project management, sent Bob a 50-page slide deck outlining how he would run the company. Unfortunately, Bob received a similar proposal from Jerry, who thought that, having been with the company the longest, he should be the post-sale CEO. Bob also received a three-page letter, written by Peter and signed by the whole team, outlining new information sharing requirements and financial controls that Bob would need to agree to in order for the team to feel comfortable going through with a sale. Meanwhile, Sara began asking how long she would have to hold onto her shares after the transaction, because she was looking forward to cashing out and staying home with her new baby.

Clearly, the process was spinning out of Bob's control. He reached out to NAVIX for help. Bob let us know that he was still interested in selling to his management team, but only on his own terms. However, he worried about the team's reaction if he had to withdraw his offer.

Our message to Bob was that he needed a structured approach to address the three key pillars of an inside sale: management team interest, management team capability, and financial feasibility for everyone involved. We also stressed to Bob that a properly structured process would let the outcome unfold naturally. In the event that a deal couldn't be reached, the reasons would be clear to everyone involved and nobody would feel that they missed on an offer.

Management team interest was the first step in the process. When asked, most managers will say that they would love to be an owner of the company, but the real issue is at what price and under what terms. Interest can fade quickly as the details become clearer. At BJM Consulting, Sara's interest in ownership was purely financial. She thought that if she could work for a couple more years and earn some shares in the company, she would cash out and be a stay-at-home mom. Bob quickly concluded that Sara would not be part of the long term solution. When Sara was told that there would be no path to quickly cash out her shares, her interest in ownership waned and she opted out of the purchase.

Management team capability was next in the process. We asked Bob to complete an assessment of his management team. Bob had conducted many reviews and assessments of his team's performance, but this was the first time he used an assessment that was designed to gauge their ability to fill roles after his departure. It quickly became clear to Bob that while Brian, who was in charge of the recurring services, was able to run his side of the business satisfactorily, he relied on Bob to step in and clean up occasional problems. Brian's shortcomings were not enough to kick him out of the proposed ownership group, but Bob realized that the other team members would have to pick up the slack.

Another aspect of the management team capability assessment involved mapping the company's business processes, identifying which ones were done by Bob and Anne, and coming up with a plan to transition those processes to other team members. At the annual management retreat, Jerry unveiled his detailed plan to take over as CEO of the Company. Naturally, this did not go over well with the others, and Bob made a mental note that any sale to management would probably have to happen without Jerry's involvement.

Financial feasibility was the last piece of the puzzle. The inside sale had to work for everyone involved. After sending the initial letter with the demands for increased financial visibility and constraints, Peter followed up with a second letter outlining the team's financial offer. Bob and his wife Anne thought the offer was low. More importantly, it would not get them to their level of financial freedom. After realizing that they would not come to terms, Peter became frustrated and lost interest in being "just an employee." Within a month he left to join a company he had been talking to for several months.

Then, something unexpected happened. With Peter gone, Jerry became much happier and more productive. More importantly, the HR headaches that had Bob and Anne ready to exit the company diminished significantly. They came to realize that Peter had been a big source of the headaches both directly and through his interactions with other employees.

Meanwhile, Sara left the company to spend time at home. She was replaced by Bob and Anne's daughter, who had been doing much of the marketing legwork anyway. Several months later, Brian was replaced with a stronger manager for the recurring services division.

Fast forward to today and we find Bob and Anne are recommitted to the company. They are on pace to significantly increase its value of over the next several years, and then sell to an outside buyer. In order to lock in the value they are building, they gave Dan, the top salesperson, a phantom stock award that will pay him 10% of the selling price over a two year period after the sale.

By going through a structured process, Bob and Anne avoided selling their company to a management team that was likely to implode well before Bob and Anne were fully paid. The "management interest" hurdle tripped up Sara. The "management capability" hurdle uncovered Jerry and Brian's shortcomings and the "financial feasibility" issue led to Peter's departure. In each case, the problems became self-evident, and people opted themselves out of the process. Nobody had to be told "No."

Bob and Anne enjoy running their company again and are on pace for a better financial outcome. Sometimes the best deals are the ones that you don't do.

NAVIX® is a proprietary process that helps business owners plan for and achieve successful exits.

NAVIX® helps owners of closely held businesses plan for and execute successful exits: achieving financial freedom, creating a sustainable legacy, and exiting on their own terms.

NAVIX® was designed out of experience seeing business owners struggle to achieve financial freedom, create a sustainable business legacy, and exit on their own terms. NAVIX® is a dual track process, that prepares both the business and its owner(s) for exit. NAVIX® is not just about planning; we also help clients execute the strategies and tactics needed to achieve a successful exit.