7 Ways to Monetize Your Equity

By Wayne Wilson

Most owner/CEOs look forward to the day when they can cash in some or all of their business "chips." Many have not, however, thought much beyond the dollar signs to the process or mechanics by which the pay out can be achieved. When asked, their answer is often "I guess I will just sell the business." And while selling the business may be the right choice (more on that later), some other options are worthy of consideration as well.

But first, let's consider a few preliminary questions. Your responses to these and similar questions may help to clarify the liquidity options most appropriate for your particular situation.[1] For example:

- Is your business mature or still growing rapidly?
- Is your industry stable, consolidating or declining?
- Does the business generate excess cash or require continual investments?

- Do you wish to continue working?
- Is successor management in place or available?
- Are there logical buyers or investors?

- Do you want cash now or over time?
- Do you wish to retain an equity upside?
- Do you have other business opportunities with greater potential?
- Are there other personal, family or health issues?

- Will you accept only **Cash**[2] or will you consider an **Earnout,**[3] **Seller Notes,**[4] **Stock**[5] **(theirs or yours)** or some other form of currency?

If you are considering a transaction which involves a currency other than cash, the transaction really becomes an investment decision requiring that you think carefully about the pros and cons of accepting that particular currency before you proceed.

Depending on your answers to the preliminary questions and your appetite for the available currencies, here are 7 ways to monetize your founder's equity.

1. Pay a Dividend

If your business generates excess cash on a regular basis or has accumulated excess capital over time, consider distributing it in the form of bonuses or dividends. There are numerous tax issues here relating to the legal form of your business, reasonable compensation guidelines and the effects of state taxes which should be carefully analyzed before proceeding.

On the other hand, the current 15% federal income tax rate on qualifying dividends is probably the lowest rate you will ever see. If a dividend distribution makes economic sense, don't let the tax tail wag the business dog.

2. Recapitalize

Sometimes a business has excess capital but not much cash. In these circumstances, a recapitalization or "recap" may be the best way to free up capital in the form of cash. A **recap** can be as simple as borrowing money to finance a dividend or stock buyback or involve a formal recap through the sale of a majority or large minority equity interest to private equity or other external investors.

An **informal recap** requires a strong balance sheet because commercial banks, the typical lenders to small and medium-sized companies, are seldom keen on lending you money to put in your pocket. On the other hand, if the business holds a valuable asset such as appreciated real estate which is not essential to the business, taking out a real estate mortgage to finance the distribution may make sense.

A **formal recap** involving outside investors may allow for a larger cash distribution because the new investor will bring new equity capital to the business as well as its own lenders who are typically more accustomed to lending into high-leverage situations.

This can be an excellent path in two particular situations:

- You want to take some money off the table now but continue to work for a larger payout down the road, or

- Today's outright sale value is insufficient to meet your needs or desires, and the infusion of external cash and other resources will help you generate the larger value later.

But now you have a partner in the business to whom you will owe performance accountability. Most private equity investors will expect a final sale transaction within 5 to 7 years, although some private equity investors are long term holders. Either way, you should be sure you are comfortable with the notion of having a partner, as well as the particular partner, before committing to a formal recap.

3. Go Public

For some companies, an initial public offering or "IPO" may be the preferred route to founder equity monetization. An IPO can generate some founder liquidity immediately and create a market for future stock sales, while leaving the founder in control of the business. Being the CEO of a newly public company can produce significant psychic income while also putting money in your pocket. But there are many downsides.

The public markets are not available to everyone. There are many limitations to access based on the type and size of business, expected future revenue and earnings growth rates, and "market conditions." Market conditions include investor appetite for IPOs as well as the general stability and optimism of the public equity markets. In addition, the Sarbanes-Oxley era has placed many new corporate governance, reporting, and regulatory burdens on public companies. These requirements can be especially onerous for young or smaller public companies.

4. Sponsor a Management Buyout

A management buyout or "**MBO"** is a common method for monetizing founder equity in small and mid-sized closely-held companies. Essential ingredients include capable and established non-owner senior managers who can take over management of the business; business capacity to take on and service significant new debt; and senior managers willing to borrow money against personal assets to contribute equity to the business and/or personally guarantee the new business debt required to buy out the current owner(s). The selling owner may also need to take back some seller paper to make the MBO numbers work.

MBOs can provide an excellent vehicle to put ownership in the hands of loyal and trusted managers and employees while protecting their jobs and livelihoods. Depending on the number of employees to be included in the new ownership group, an employee stock ownership plan or "ESOP" may be an efficient vehicle for transferring ownership to employees. ESOPs, however, are very complex and require significant legal, tax and financial advice to ensure that they are created and operated properly.

5. Hire & Retire or just Retire

Some businesses are sufficiently established and well managed that a founder/owner can simply retire from active management while continuing to draw a salary, receive dividends or establish some other form of compensatory consulting arrangement. If the business has strong middle managers but lacks a clear CEO candidate, the solution may be to hire a new CEO and then provide for an orderly management transition.

Under these scenarios, the founder/owner may retain final decision-making authority for certain strategic decisions, while effectively delegating all operating decisions to one or more trusted senior managers. Although the retirement option does not solve the long-term ownership or estate planning issues, it may provide an appropriate next step for some founder/owners who wish to pursue other activities and do not need to liquidate all of their equity at once.

6. Liquidate

For many small or medium-sized businesses, their most valuable asset may be the real estate on which the business operates. And if the business itself is marginally profitable, profits may barely cover the owner's salary. In such a case, closing the business and selling the real estate may be the best option for monetizing the owner's equity value.

For other historically profitable businesses which have now fallen on hard times, liquidation may also be preferable to having the owner's remaining equity value consumed by the operating losses of a declining business. Despite the negative effects of liquidating a business on the employees and other stakeholders, an orderly liquidation now will likely preserve more value than a fire sale under duress later.

7. Sell Out

And finally, there is the out right sale. For many owner/CEOs, selling the business will be the most direct path to equity monetization. Common types of acquirers include strategic buyers, financial buyers, or new operators.

Strategic buyers include competitors in consolidating or contracting industries or owners of businesses in adjacent spaces who see an opportunity to expand their business by moving into your space. Strategic buyers are often willing to pay more for the business if they believe that cost savings or other synergies can be obtained through the combination.

Financial buyers include private equity firms and other external investors. Financial buyers are typically more interested in solid businesses with strong cash flows and little or no debt currently. They will expect to acquire control, if not 100% ownership, and use large amounts of debt to fund their purchase. Financial buyer timeframes are often short and they may subject the business to intensive restructuring, including employee layoffs, in order to achieve their target financial returns.

For many smaller businesses without successor management internally, selling to **a new operator/owner** may be an effective vehicle. These types of transactions frequently require the owner to accept a large amount of the sales price in seller paper even if the new operator has significant cash available to contribute to the deal. And selling to someone who has management experience in your industry is preferable to selling to a new operator without such experience, especially if you must accept seller notes.

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While there are numerous variations on these 7 ways for monetizing your equity, some thoughtful consideration of these techniques undertaken today could well improve the probability of successfully monetizing your founder's equity at some time in the future.

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Notes

[1] **Disclaimer** – The material presented in this article is intended solely for informational purposes and does not constitute accounting, tax, investment banking or other professional advice. Please seek appropriate professional advice before acting upon any information presented in this article.

[2] **Cash** is always my first choice recommendation: certainty of value with little or no future performance risk. If your goal is to leave the business behind completely, and the valuation is acceptable, cash is usually the best currency.

[3] An **earnout** may provide the opportunity for greater total cash over the near term (typically, 6 months to 5 years) based on the future performance of the business, but it usually requires the owner to stay and make it happen. If you wish to continue working, the all-cash valuation does not meet your target, or you are selling for other reasons (such as the need for additional capital in the business), an earnout can be a very profitable way to monetize your equity.

[4] "**Seller notes,**" or "**seller paper**," refers to purchase money debt issued by the new owner or the acquired business as part of the purchase price. Seller notes may take the form of term notes payable in annual, quarterly or monthly installments of principal and interest or balloon notes payable in a lump sum several years out (typically, 5 years). The notes may be secured or unsecured and are typically subordinated to any new or existing bank loans. While seller notes often carry above market interest rates, repayment will be heavily dependent on the continued health of the business as well as the management competence of the new owner(s).

[5] A selling owner may also receive **stock** for the sale of the business. If the buyer is a public company, taking stock may allow diversification of your investment, deferral of some or all of the capital gains taxes which might otherwise result from a sale, and a public market for the gradual or eventual sale of the shares. Holding the buyer's stock provides a continuing upside opportunity but also subjects your proceeds to the risk of a performance decline by the buyer. If the buyer is a financial buyer, the stock you receive or retain may be stock in your own company or a "newco" formed to acquire the business. While the value of such stock may be more under your control if you are the continuing manager, there will generally be no market liquidity until a future sale or public offering of the business.