



What if You Could Cash Out of Your Business and
Maintain Ownership and Control?

Finding Business Liquidity Using an Entrepreneur Recapitalization



CORNERSTONE
WEALTH MANAGEMENT GROUP

Is your business your largest asset? A 2014 CNBC study revealed that most business owners have 70% of their wealth invested in their firm, with 20% of owners having over 80% of their wealth in their business. This presents several challenges, including increased financial risk and lack of liquidity.

An Entrepreneur Recapitalization (E-Recap) transaction may allow business owners to take significant resources away from their company without giving up management control. The process includes a third party investor providing cash and debt to help facilitate an ownership restructuring. There are costs and risks associated with the transaction, which should be considered along with the benefits to the firm and its owners. In this paper, we'll review the use of E-Recap transactions to fund ownership transfers and liquidity events while preserving a majority ownership.



WITHDRAWING CASH FROM YOUR BUSINESS

Entrepreneurs and business owners often have most of their wealth concentrated in their businesses. This presents an undesirable risk to their financial health and their ability to pursue financial freedom. Many business owners have achieved financial certainty, by earning enough to meet their needs or even financial independence. But a large majority are unable to achieve true financial freedom without taking assets from their businesses. Financial freedom allows entrepreneurs to find balance in their lives, with their families, and to contribute to the causes they care about most.

By withdrawing cash from their business, owners strive to lower their overall financial risk and diversify their wealth. By removing assets from a business, the owners potentially lower their exposure to events such as economic downturns, industry changes, lawsuits, and tax changes. The proceeds can potentially compound free of business risk, however, investing does involve risk including loss of principal. The benefits of withdrawing cash include both increased resources and lower risk.

INCREASED RESOURCES POTENTIALLY PROVIDE:

- Improved balance in life
- Diversification of wealth
- Community and charitable contributions
- Living on your own terms before your family and health suffer

LOWER RISK PROVIDES REDUCED EXPOSURE TO:

- Economic downturns
- Industry changes
- Lawsuits
- Tax changes

Many business owners who choose to cash out of their businesses do so because they are nearing retirement age and their appetite for risk has decreased. Often, they aim to spend less time running their firm and more time enjoying their families and passions. While many do not wish to fully retire, they may seek to transfer management to younger partners and step aside from day-to-day operations.

With an E-Recap, the owner of the business may be able to take out **over 70%** of the value of their business and still maintain up to **75% control**.¹

1: Upton Financial Group, 2016.

WHAT IS AN E-RECAP?

The E-Recap is a recapitalization transaction designed to offer business owners an alternative to:

- A traditional sale
- A minority recapitalization
- An ESOP

Traditional methods to cash out of a business often mean losing majority ownership and saddling your business with excess debt. An E-Recap allows business owners to remove cash from the firm, without necessarily giving up ownership control. This process used to be reserved for companies worth \$50 million or more but is now available for companies worth \$10 million or greater. An E-Recap uses a third-party institutional investor to leverage the company with debt and sell a portion for cash to accomplish the business owner's goals.



The E-Recap process begins with a valuation of the business. Most businesses are measured by EBITDA (Earnings before Interest Taxes Depreciation and Amortization). Then, a multiple is selected for the business to compute the market value. If a business has two million dollars in EBITDA and a multiple of five, the business value would be \$10 million.

Then, the business owners and their advisors choose the appropriate mix of debt and equity to restructure the business. Approximately 25% of the equity is sold to an institutional investor to raise cash. The cash raised from the sale typically goes to the owners to provide them with liquidity, no longer subject to the risk of the business. The same third-party investor often will also provide the debt portion of the financing.

The remaining 75% equity still belongs to the owner, but they have taken significant cash out of the business. This can provide both asset diversification as well as a desirable liquidity for the owner.

Finally, the third-party investor works together with the business owner to grow the value of the business over time. Eventually, both partners exit and receive their portion of equity from the firm. The goal of an E-Recap is to maximize the lifetime benefit of the owner, yet allow them to receive a portion of their equity long before their final exit from the firm.

WHAT ARE THE BENEFITS OF AN E-RECAP?

With the E-Recap transaction, business owners of companies valued at \$10 million or more may seek to:

- Remove cash from their business to obtain complete financial freedom
- Keep operational control and majority ownership
- Position the business to grow faster
- Obtain higher final sale multiple due to partnership with an Institutional Investor
- Receive a higher payout during final sale

FINDING LIQUIDITY FOR THE EXIT OF ONE PARTNER

The E-Recap transaction can be an effective solution for a firm with one partner who wants to exit with cash and another who wants to continue running the firm. By introducing a new source of capital, the exiting owner can sell his share of the business while allowing the remaining owner to continue running the firm without disruption.

HOW DOES AN E-RECAP DIFFER FROM A PRIVATE EQUITY SALE OR AN ESOP?

In traditional private equity transactions, the private equity group seeks majority control. This means that the business owners typically lose both control of the future of the company and the ability to benefit from the company's long-term growth. With an E-Recap, the business owner is able to maintain control to participate in the management of the firm and a greater percentage of future earnings.

While Employee Stock Ownership Plans (ESOPs) may provide liquidity for business owners, an ESOP is highly regulated by ERISA and includes obligations to the company's employee shareholders. Compliance and ongoing requirements of ESOP transactions may add additional costs and complexity. The advantages, risks, and costs of each transaction should be weighed carefully with an experienced professional.



DO YOU WANT TO LEAVE YOUR BUSINESS TO A FAMILY MEMBER?

Many entrepreneurs would like to leave their business to a family member. A study by a leading finance magazine, *Chief Executive*, states that 80 percent of business owners want to pass the family business on to the next generation. However, only 33 percent of these businesses will succeed as a going concern after the transfer.

Additional research shows that only about 12 percent of businesses left to a family member will succeed to the third generation. Only 3 percent will survive into the fourth generation. As time goes by, the odds of success go down dramatically.



One strategy that aims to improve the probability of success for a family business is an E-Recap. An E-Recap transaction can provide liquidity for the business owner, without saddling the family business with unnecessary debt. If just a portion of the business is sold, those family members active in the business can continue to run the operations, have the potential to receive large salaries, and enjoy equity in the business.

The new partner who buys a partial interest in the business will be well-capitalized and financially committed to seeing the business grow. Their expertise, combined with capital, can increase the chances of successfully transitioning a business to the next generation. The business will have access to the funding needed to grow as well as expert advice and a fresh perspective on growth strategies. Often, this can provide the company with a competitive advantage.

Additionally, an experienced professional with legal, business, and regulatory expertise can help handle complex issues such as liability protection, regulatory risk, and supply chain issues. The goal is a healthier family business for the next generation to enjoy into the future.

WHO SHOULD CONSIDER AN E-RECAP TRANSACTION?

Business owners who are considering selling their firm within five years should understand the unique benefits of an E-Recap, including the ability to:

- Take significant cash out of a business
- Maintain operational and ownership control
- Step away from day-to-day operations
- Accelerate revenue growth

An E-Recap may be appropriate for the following business scenarios:

- A company has multiple shareholders and one or more would like to be bought out.
- A business owner wants to sell to management, but lacks cash and requires liquidity for financial freedom.
- An owner seeks to share the economic benefits of a family-owned business with working and non-working siblings, without taking on debt or business risks.
- The business owner is not yet ready to retire, but seeks reduced exposure to the business and increased diversification.
- A business owner believes in growth potential but seeks to take chips off the table.
- The owner wants cash for an acquisition, investment, or expansion, yet is not willing to increase their financial risk.



DO YOU HAVE TRUE WEALTH?

Many business owners are thankful for their careers but long for true financial freedom in order to pursue their greatest passions. We understand that as a business owner, you may seek true wealth by both withdrawing cash from your business as well as leaving a thriving firm to your heirs.

If your business is your largest asset, you may benefit from diversifying your wealth to reduce overall risk. By withdrawing cash from your firm, you may obtain more balance in both your wealth and your life. To learn more about whether an E-Recap may be appropriate for your unique situation, contact us today.

ABOUT SCOTT FORD

Scott Ford is Founder and CEO of Cornerstone Wealth Management Group, an independent Registered Investment Advisory firm serving entrepreneurs, business owners, executives, and their families. The firm specializes in business liquidity strategies and SBA financing. It is Scott's mission to help his clients pursue financial freedom and live a balanced and fulfilled life.

Scott is a registered principal at LPL Financial and a Registered Financial Consultant (RFC). He is ranked in the top one percent of all LPL Registered financial advisors based on annual production. He was recognized as one of the 20 Rising Stars of Wealth Management by Private Asset Management Magazine in 2008 based upon assets managed of \$1 million or more per client.

Since 2005, Scott has been an active financial technical analyst and is currently a Chartered Market Technician (CMT) candidate.

Clients often choose to work with Scott because of his experience with the challenges business owners and executives face as well as his firm's disciplined process. His personal and proactive approach is designed to bring clarity and simplicity to the complex issues of financial management. For over 20 years, he has been helping his clients define and pursue their own unique version of "True Wealth."

Scott is the author of three books: *Financial Jiu-Jitsu: A Fighter's Guide to Conquering Your Finances*, *The Widow's Wealth Map: Six Steps to Beginning Again*, and the New York Times Bestseller, *The Sustainable Edge: Fifteen Minutes a Week to a Richer Entrepreneurial Life*.

He and his wife, Angie, reside in Hagerstown and have two wonderful children as well as a dog and a cat. In addition to spending time with his family, Scott is a voracious reader and enjoys woodworking, Brazilian Jiu-Jitsu, golf, hunting, permaculture and beekeeping.



19833 Leitersburg Pike, Suite 1
Hagerstown, MD 21742
Local: (301) 739-8505
Toll-Free: (866) 485-8505
Fax: (301) 739-8513



Content in this material is for general information only and is not intended to be a substitute for specific individualized tax or legal advice. We suggest that you discuss your specific situation with a qualified tax or legal advisor regarding your specific business needs before taking any action based upon this information. LPL Financial and its registered representatives do not offer business valuation, lending, or loan services.

Securities offered through LPL Financial, Member FINRA/SIPC. Investment advisory services offered through CWM, LLC, a Registered Investment Advisor. LPL Financial is under separate ownership from any other named entity.