Special Focus:
Mergers and Acquisitions

Getting Out of Dodge

Merging or being purchased might be the perfect exit strategy.

By Kate Peterson

Anyone could learn a lot about how to build a business by watching Tom Gegax, cofounder of Tires Plus, over the past 25 years. That's because Gegax turned a three-store service-station dealership into a nine-state, 140-store chain with 1,600 employees and a legendary reputation for sales, service, and employee retention.

Still, despite his marketing, management, and customer relations prowess, Gegax's most enlightening lessons about business could very well be about developing and executing a great strategy for exit. Last August, Gegax and his partner, Donald Gullett, sold Tires Plus to a Florida company called Morgan Tire and Auto. The resulting business—which adopted the Tires Plus name—now has 540 shops in 25 states.

For Gegax, the close of the sale was the culmination of a long, carefully considered process aimed at allowing employees, customers, and shareholders to "win" through the transition. (In addition to Gegax and Gullett, there were about 35 others who had earned stock in the company.)

Though Gegax didn't feel it was necessary to sell Tires Plus immediately, Gullett wanted to retire and sell his portion of the business. In addition, none of Gegax's or Gullett's children was interested in taking over the company. That left the partners to ponder exactly what they were going to do with the firm. "We built this thing up from nothing, from scratch to $200 million in sales, 1,600 teammates, and we had to think about, 'How are we going to pass this on?'" recalls Gegax.

With the help of Minneapolis investment bank Goldsmith Agio Helms, Gegax analyzed a number of options for Tires Plus: going public, merging with another regional tire retailer, or taking on a major private investor. Gegax's research led him to the conclusion that selling outright would result in something of a triple crown. There would be generous financial rewards, an opportunity for Tires Plus employees to continue working at a quality company with a bright future, and a clean-cut solution to the problem that nagged him about his other options—namely, that he would still have a

ILLUSTRATIONS BY HARRY PULVER JR.

good amount of his own money invested in the business, but would have a lot less autonomy.

"One of the options was private equity—having a company come in and buy a portion of us," recalls Gegax. "We determined that would be difficult, at least for me, because I could see potential power struggles going on."

Gegax isn't alone in discovering the benefits of selling outright when it comes time to hand over the reins. For most private business owners, going public is increasingly difficult and provides little liquidity in the short-term. A properly executed sale, on the other hand, typically yields generous and immediate financial rewards. And a full sale can offer a clean break for business owners who are uneasy about the idea of having only some, but not complete, control of their companies.

OPPORTUNITY KNOCKS

The initial public offering (IPO) market has its ups and downs, but when it's up, the business world is abuzz with tales of companies whose stock rises to 30 or 40 times their initial offering price. Though such stories seem commonplace in boom times, they actually are fairly rare. And often the steep climb is followed by an equally precipitous drop.

Even companies with the most successful IPOs are seeing pretty down-to-earth stock prices these days. Remember Red Hat? It traded between $100 and $150 per share for about a month and a half after going public in late 1999, then began a steady descent. In February, it was trading at about $9 a share.

Another problem with IPOs is that when the market is in a slump, new stock issues come to a virtual standstill. Thomson Financial Securities Data reports that in the fourth quarter of 2000, for example, only 58 companies went public. In all of 2000, 430 companies held IPOs. And even in the best of times, companies in certain industries are essentially shut out of the market because they are too small, too Old Economy, or simply not in the right sector.

Mergers and acquisitions, on the other hand, aren't nearly as vulnerable to the volatility of the marketplace. Thomson reports that 10,879 mergers and acquisitions were closed in 2000; almost 2,400 of those were completed in the fourth quarter. And while the price of some deals can be affected by a drop in the stock market or tighter commercial lending practices, those events don't kill the acquisitions market. And just about any quality company—regardless of industry or size—is fair game for acquirers.

Even so, investment bankers say M&A prices started to drop off a bit last fall, though acquirers were still hungry for quality companies. Jeff Turner, a managing director who works on middle-market mergers and acquisitions for US Bancorp Piper Jaffray in Minneapolis, says softness in the stock market and the tightening of financial markets can contribute to a general reduction in "multiples," a term that indicates how many times its annual operating cash flow a company is sold for.

> "There are still tremendous numbers of potential buyers who are very actively and aggressively looking for acquisitions," says Jack Helms of Goldsmith Agio Helms. "The opportunity for a seller of a business right now is as great as it's ever been."

Nonetheless, Turner says, "We have still been able to get great multiples for high-quality companies that we're representing. Niche market leaders with good growth dynamics can still get very attractive multiples."

Goldsmith Agio Helms Managing Partner Jack Helms says that pricing aside, "There are still tremendous numbers of potential buyers who are very actively and aggressively looking for acquisition opportunities. The opportunity for a seller of a business right now is as great as it's ever been."

Another downside to going public: If you're looking for liquidity, it's going to be a long time coming. In 1986, Brian Sullivan founded Brooklyn Park–based Recovery Engineering, which developed the PŪR line of water filters. The company was financed through private placements as well as public offerings in the early and mid-1990s. "We went public because we needed to raise capital to fulfill our business plan. And that was the only reason. We weren't thinking of liquidity," says Sullivan, who describes going public as something of a "liquidity trap."

Helms notes that at the time of an IPO, and for a considerable time thereafter, the market simply doesn't tolerate insiders selling stock in their public company. "It could be years and years and years before an owner is able to generate meaningful liquidity by taking his company public," says Helms. "And that's not even touching on the legal issues. We're just talking now about the market's unwillingness to buy shares of a company where the owner is selling his or her shares."

But those legal issues are no small matter, says Dave Grorud, who specializes in M&A and securities law as a partner with Minneapolis law firm Fredrikson and Byron. Those who were the primary owners of a company before it went public and continue to own a significant number of shares—insiders by definition—will have a difficult time reselling stock in the open market.

For example, insiders can't sell more than 1 percent of their outstanding stock every three months. "So if you are a very large shareholder, it would take you many, many months to actually be able to sell all your holdings," Grorud says. In addition, once you are an insider in a public company, you really cannot sell stock any time you have material, nonpublic information. One exception is if you have stock-sale arrangements already in place that don't allow you to control or change the amount, pricing, or timing of your sales, says Grorud. "As an insider, at almost any moment in time you probably will find that you have material, nonpublic information about your company," he explains.

FINANCIAL REWARDS

On the other hand, when business owners sell outright to another company or an investor group, they usually receive all or most of the sale price in cash—or in some cases, the buyer's stock—immediately.

Local investment bankers say sale prices are typically from five to 20 times the amount of the company's operating cash flow. Specific sectors often occupy either end of that pricing spectrum. Industries in the upper range are technology, telecommunications, and medical, while industries in the lower range are automotive, paper, and certain manufacturing businesses, because they are perceived to be cyclical, according to Helms.

When bank financing is tight, sellers are likely to see slightly lower multiples, perhaps down by a full point or half a point, Helms says. Another likely outcome of tighter financial markets is variation in the structure of deals. A buyer might be more inclined to pay the seller with company stock, for example. Or, less frequently, if a buyer has difficulty obtaining bank financing, the seller may be asked to finance a small portion of the sale price, which would be paid back with interest.

"We don't often see seller financing in our transactions," says Turner of US Bank. "Part of that is that our clients want cash at close, and we do a good job of negotiating so that they get cash at close. Occasionally, we'll have a client who says, 'I'm okay holding a note' and they'll offer it, but you don't see that very frequently."

Even though prices may decline a bit when financing is tight, it ends up being something of a wash for sellers who put the proceeds back into the stock market. "Most sellers see the relativity of pricing and the marketplace," Helms explains. "If you sold your business at the peak of M&A pricing—let's say in the fall of 1999—and you put all your proceeds in the stock market, your after-tax proceeds would now be worth less than they were when you sold because the equity markets are off."

But if a seller sold a year later and received a slightly lower price, he or she could have invested the proceeds in the stock market, and because of lower stock prices could have purchased more shares, Helms explains. "That analysis works except for the person who says, 'Well I wouldn't have bought any stocks; I would have bought all bonds or gold or something.' But there aren't many people like that."

LOOKING FOR A BRIGHT FUTURE

Though it's hard to argue with Helms' logic, many business owners might be tempted to hang onto their companies until pricing rebounds to the levels sellers saw in the past year or two. Investment bankers and other experts urge them not to. In fact, they say, waiting too long to sell is the most common and damaging mistake business owners can make.

"The best time to sell is when the future is the brightest," says Brian Holcomb, a partner with Greene Holcomb and Fisher, a Minneapolis investment banking firm.

"So many owners make the mistake of delaying the decision process, and then some issue comes up and they say, 'I don't want to deal with this now,' and so they decide to sell," Holcomb adds. "Unfortunately, the issue that has forced their decision will most likely have a big negative impact on the value of their company."

Experts say two factors have the greatest influence on whether the future looks bright to prospective buyers: the company's potential for growth, and the outlook for its industry. "People don't realize that the multiple is determined by this growth prospect: Standing wherever you are today, looking out as far forward as you can, and seeing what the landscape looks like," says Helms.

Business owners need to ask themselves what the company will look like in the future. "If the rate of growth falls, your multiple will fall, and you can actually go backwards, even though the earnings of your company have grown," Helms explains.

Turner adds: "You want to sell just before you get to the top—almost right at the top, but at a point where there's still some upside that the next guy can see. You obviously want to get paid for that upside."

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Outlook for the industry is also critical. Buyers need to be confident that your company's industry looks promising over the next couple of years. And sellers need to recognize when industry dynamics could damage pricing. "If I decide I want to sell and the top three strategic buyers in the industry are all having financial difficulties and aren't very logical buyers, maybe I don't want to go out to the market right then," Turner says.

Ralph Weinberger, a partner in the technology-industry group in the Minneapolis office of accounting/consulting firm PricewaterhouseCoopers, says that when it comes to selling their businesses, owners need to remain flexible and willing. "The right time for a lot of companies is when somebody else is interested," he says. "That could be anytime."

For business owners trying to evaluate the market for their companies, now can be a difficult time. Their business may be at the perfect point in its growth trajectory and their industry hot, but pricing may be off because financing is somewhat tighter than in recent years. That's why it's important to avoid trying to time the market, experts say.

"Trying to time your sale is like being a day trader," says Robin Engelson, senior vice president of GE Capital Commercial Finance in Minneapolis. "You need to pick a strategy that makes sense for what you're trying to accomplish, with market conditions being a consideration, but not the catalyst to action."

NEGOTIATING BEYOND PRICE

For most business owners, price is probably the most important factor in the sale process. Still, other issues can weigh heavily on a seller's mind as he or she proceeds with a sale. Those issues can be addressed to the owner's satisfaction if the negotiations are handled thoughtfully.

Mostly, there is the critical issue of whether the owner will remain involved in the company after the sale. For those who want to continue to play a role, it's certainly a possibility. But it's rare to find situations where an operating company buys another business and actually leaves management control with the seller, says Helms of Goldsmith Agio Helms.

"The buyer almost always will ask the management team of the seller to stay," he says. "Most buyers talk about post-closing autonomy and staying the course. Some actually perform on that basis, but more say it than actually do it."

Helms says some buyers leave the company they've purchased reasonably well alone. "That continues so long as things are going well," he adds. "But if there are problems, you're going to find the management team of the buyer coming in and saying, 'We're going to make some changes.'"

For that reason, most sellers don't want to stay in control after the sale. When Sullivan of Recovery Engineering sold his company to Procter and Gamble, there was no management contract and no future involvement. "After spending 14 years building the company and being the guy in charge, I really wasn't interested in becoming a divisional president for a company the size of P&G," explains Sullivan. "It's a fine company, but I didn't really have an interest in running it as the person who's not in charge."

That's why many sellers like the opportunity for a clean break that M&A transactions offer. But even if they intend to walk out the door and never look back, many business owners are concerned about how the buyer may run their company.

Experts say it's common for owners to express concern about issues such as preserving the company name, keeping a plant in the same location for a specified period of time, or providing a specific severance package for employees who may be laid off in the transition or within a certain number of years after the sale. These are items that are often successfully negotiated in a sale contract.

TEXTBOOK CASE

Business owners looking for guidance on handling the nonprice matters of a sale can look to Gegax and Tires Plus. First, he essentially hand-picked the buyer of his company: the owner of another privately owned regional tire retailer who Gegax believed had a similar business style. Gegax and the buyer, Larry Morgan, had actually spent time together socially over the years. Because he knew Morgan so well, Gegax felt comfortable with the company's future.

Though most sellers would be hard-pressed to find such a familiar buyer, investment bankers are able to provide solid research and analysis of buyers. They also can give business owners an indication of how a potential buyer has managed previous acquisitions.

Gegax continues to play a role in the company that he sold to. He is chairman of the board, though he's quick to point out that he has no decision-making authority. "Clearly Larry Morgan, the CEO, is the leader; I don't have ownership in the company," says Gegax. "Therefore, I consider myself a mentor, a coach, a consultant to the coaching and leadership team."

Perhaps most important, though, Gegax and his partner, Don Gullett, made a major personal and financial commitment to the employees of Tires Plus before and after the sale, which Gegax says gives him great peace of mind.

"We paid out the stock options that we had given—and even some that weren't earned," Gegax says. "We paid loyalty bonuses to anybody who had five years or more; for each year we gave X amount. We paid transition bonuses to our teammates. Some people call it severance—I don't like that word. Between those three things, we paid out $10 million."

The benefits to the former employees are clear. "You know how hard it is for certain people to be able to get ahead in the game, to be able to have a lump sum of $40,000 or $100,000 or $500,000? If it doesn't work out with the ongoing company, at least these people aren't left in the lurch," says Gegax. "These dollars mean they still have flexibility in the future."

That step, more than any other in the negotiation of the sale contract, has given Gegax confidence in the sale and the process. "I feel really good about it," he says. "Had I walked away and said, 'Don and I started it, we had mostly all of it, they didn't get much,' that wouldn't have felt very good."

It's clear that Gegax also feels good about the future of Tires Plus, even without his leadership. And that, says Weinberger of PricewaterhouseCoopers, is at the core of why a business owner sells rather than doing an IPO.

"Going public is about obtaining resources to continue on with what you've started," says Weinberger. "Mergers and acquisitions are, in many cases, much more strategic, in that it's taking something you've developed and saying, 'There's somebody else that can take it the rest of the way.'" ■

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