Can You Sell Your Business Without Selling Out?

Strategies for independent, privately-held companies:
Monetizing value, diversifying wealth and positioning for robust growth.

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As a business owner, you may be contemplating new sources of capital to pump into your business and/or the opportunity to monetize the significant value you and your employees have created. And, while valuation multiples in today's market remain at unprecedented, elevated levels, you also may worry about the ensuing tradeoff if you sell.

"Selling Out" Fears

Business owners do have options when considering a liquidity event, but some hesitate to explore them for fear of "selling out." This can take on different forms: Some owners are wary of bringing in a financial partner because they risk diluting the control they have over the business. Another common concern is the preservation of company identity, culture, and employees. While these are legitimate concerns, they should not be paralyzing. Given the significant oversupply of private equity capital in need of deployment relative to the number of available investment opportunities, today's market affords business owners the opportunity to achieve partial liquidity and simultaneously align with a partner for growth without compromising the integrity and culture of the business.

Despite the seemingly push-pull decisions with which owners may be faced, the good news is we believe you can sell without selling out.

It is possible to secure a genuine, value-added financial partner for your company and "take chips off the table" while continuing to operate the organization you, and perhaps multiple generations of your family, worked so hard to build.

The Backdrop

To explore how this idea can become a reality, let's look at the economic window that has opened in the industrial distribution (ID) industry. The marketplace is a vast one, representing approximately five percent of the U.S. gross domestic product, or roughly $750 billion. ID companies are geographically dispersed, employ more than 1.4 million workers and range in size from single-location firms that sell less than $1 million of products per year to multi-billion-dollar global enterprises. Many operate within specialized verticals such as MRO, safety and environmental, PVF, fluid power, flow control, hose and accessories, bearings and power transmission, fasteners, electrical, plumbing and HVAC, automotive aftermarket, fuel and lubricants, oil and gas consumables, and jan/san, among others.

The industry remains highly fragmented. Some estimates suggest the top 50 industrial distributors in North America comprise less than 10% of the total industry revenues, creating an open marketplace for investment, acquisition or organic expansion, as distributors are confronted by a combination of increasing customer demands, pricing expectations, product expansions, and an incessant competition in gaining new clients.

Evaluating Pros and Cons

Given the importance of driving growth in your business to remain competitive, it is critical to weigh the pros and cons of aligning with a financial partner.

On one hand, you can continue to build your business independently and keep most of your wealth tied up in one investment. On the other hand, the partnering approach allows you to diversify wealth and unlock even more growth potential without compromising the company's legacy brand, culture, and so on – sometimes referred to as "taking chips off the table."

This second option (Path #3, described at right), may have fewer disadvantages than you think, because of the sometimes-misunderstood perspective of financial partners. At the end of the day, these partners are primarily looking to invest in "buyers" of businesses rather than "sellers." As such, they typically ascribe more value to those companies with strong management teams and a strategic vision to grow both organically and through acquisition. Given that there are pros and cons to all approaches, it is important to look carefully at each option, and determine which path makes the most sense for your company and its stakeholders.

A Variety of Options Exist

Today's middle-market ID business owner has multiple paths to consider, several of which are highlighted at right. For business owners looking to monetize a portion of the value created, diversify their wealth and inject additional resources and/or capital into an ID business without proverbially "selling out," please refer to paths #2 and #3.

Path #1: Continue to operate under current ownership.
This is very much a status quo alternative. A majority of your personal wealth remains tied up in the business, leaving fewer resources to invest in strategic growth initiatives (should that be of interest). Chances are you also spend more time running the daily aspects of your company rather than exploring external opportunities to augment your business platform.

Path #2: Raise minority equity from a financial investor.
Here, you commit to finding a qualified financial sponsor willing to invest in a less-than-50-percent ownership stake in your business. You retain majority ownership, but the minority equity investment is subject to a lower valuation due to the new investor's lack of control, ultimately resulting in you giving up more ownership on a dollar-for-dollar basis than you otherwise would if you were selling 50.01%. In this scenario, the investor has less of an incentive to provide you with anything more than capital, so you may miss out on other resources that could be beneficial, such as those outlined in path #3.

Path #3: Recapitalize the business through partnership with a financial sponsor.
This structure is quite possibly the truest form of "selling without selling" and represents one of the most direct routes to both growth and wealth diversification (i.e., lower risk/greater reward). In this scenario, the owner sells 51 to 90 percent of the business to enable investment in key growth initiatives while monetizing some of the value they have created in what is currently one of the most attractive M&A markets in terms of valuation multiples and purchase agreement terms. You retain a significant level of

equity in a more powerful organization with a lower risk profile. In addition, the financial partner will likely provide resources beyond its capital, including sector expertise, management advisory services, and additional business contacts. To make this happen, the founding shareholders must agree to relinquish a significant portion of their stake in the company by partnering with a firm that shares a similar strategic vision and cultural alignment. Furthermore, your residual ownership stake provides you with the ability to "take a second bite of the apple" by selling at a later date when earnings are substantially higher.

Path #4: Sell 100 percent of business to a strategic or financial party.
On this path, owners choose to sell completely—but many remain involved in the business. By selecting the right partner, an owner ensures that the business can achieve full or nearly full liquidity, supporting its growth trajectory and operational improvements. The owner also realizes their personal return on investment in the business at its full potential. Negotiated management agreements may or may not provide

the owner a role in the company for an agreed-upon period of time, should they so desire.

In our recent experience, recapitalizing the business through a partial sale (Path #3) is an option frequently chosen by owners of middle-market ID companies in today's "seller friendly" market.

Seeking a Tailored Approach

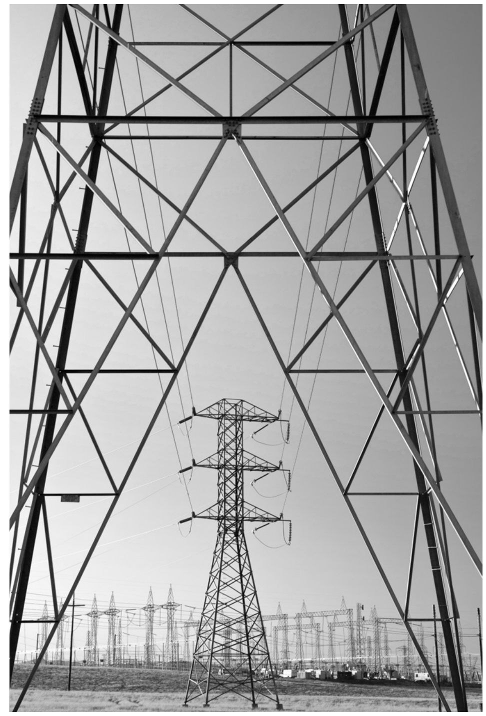
KeyBanc Capital Markets has a long history of working with middle-market companies to help them chart a path towards higher growth and/or wealth diversification without increasing the risk profile of the company. If there is one thing we have learned, it is that there is no silver bullet. Each company and each business owner is different. Every business owner deserves a customized strategy tailored to achieve the growth and financial objectives of their specific business.

For middle-market, privately-held ID companies that decide to align with a financial partner, the market awaits.

Current trends suggest the climate for middle-market M&A activity in the ID sector favors independent, privately-held firms.

Financial sponsors are attracted to ID companies as a result of five key characteristics, augmented by the underlying fragmentation in an industry that is ripe for consolidation (see Figure 1 for more information):

- Highly scalable business model
- Attractive free cash flow (positive working capital dynamics with low CapEx)
- Strong information technology (IT) systems
- Minimal risk of import competition
- Experienced management team



Key Dynamics That Attract Financial Sponsors to the ID Sector	
Highly Scalable Business Model	The fragmented distribution industry provides a wealth of acquisition opportunities that enhance scale, footprint, product offering, supplier relationships and customer base. The ability to increase the scale of your business is critical to staying competitive with the added benefit of increasing the value of your equity.
Attractive Free Cash Flow	In recessionary environments, distributors have the ability to reduce working capital (inventory and A/R) ahead of a decline in demand, resulting in strong cash flow during market downturns. Free cash flow remains strong through the upcycle as EBITDA returns to normalized levels.
Strong Information Technology (IT) Systems	Implementation of a superior IT platform delivers efficiencies across distribution operations and enhances the "stickiness" of customer relationships, establishing confidence, increasing reliability, and improving EBITDA margins.
Minimal Risk of Import Competition	The majority of distribution competition is limited to domestic local and regional companies. High shipping costs and lack of brand name awareness eliminate the risk of competition distributors based overseas.
Experienced Management Team	One of the primary keys to success for any private equity group is aligning with strong management teams that share a consistent, well-thought-out strategic vision.

Figure 1.

While these attributes are applicable to virtually all companies in the ID sector, financial partners are paying increasingly more attention to (and higher valuation multiples for) companies exhibiting many of the characteristics in Figure 2 below:

Characteristics of ID Companies Attractive to Financial Sponsors
Leadership position in specific product categories
Proven reliability (demonstrable, tangible value proposition for customers and suppliers)
Operating performance metrics at the higher end of best-in-class publicly-traded ID companies (same day/next day delivery, fill rates, customer wallet share, supplier product share, purchasing power, etc.)
Meaningful MRO / aftermarket content with supporting services offering
Robust SKUs consisting of leading brands relevant to the product's application
Proprietary channel ownership and diverse geographic presence
Balanced organic and acquisition growth story
Strong free cash flow performance through down cycles
Minimal exposure to commodity price volatility (i.e. lack of inventory de-valuation risk)
Profit margins, ROIC/RONA and inventory turns at the higher end of the sector
Management team with strategic vision
Strong and/or proprietary systems such as CRM, MIS, customer interface, established e-commerce platform, etc.

Figure 2.

Taking steps to ensure your company reflects as many of these attributes as possible can position it for the highest valuation, and attract the "right" partner for your business.

By carefully considering which path is best for your company, and then preparing for whichever path you choose, our experience has shown that it is indeed possible to sell—without selling out.

To learn more, contact:

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Visit key.com/industrial

Sources: KeyBanc Capital Markets, Industrial Distribution Media, Industrial Supply Association, U.S. Department of Labor Bureau of Labor Statistics.