

# Stradling

## Attorneys at Law

### Innovative Ways to Achieve an Exit

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A successful exit is a goal that many innovative companies have in common. There are occasions, however, when a traditional mergers and acquisitions, or M&A, transaction is unavailable no matter how innovative the company may be. In these circumstances, if a company is willing to consider less traditional alternatives, a successful exit can still be achievable.

#### 1 + 1 = 3

If management is aware of another company in its industry with which it could combine, the synergies may increase the value of the combined company beyond the sum of its parts and make it a more attractive candidate for being acquired in a traditional M&A transaction. Private equity firms do this quite often, buying two or more similar companies, combining those portfolio companies and selling off the combined company for an even higher valuation. Innovative companies don't necessarily have to wait for a private equity firm to come knocking on their door; they could follow the same structure themselves. Often times, larger companies (and sometimes private equity firms) are divesting business units or assets, or spinning off companies, and this could be another source of opportunity for executing on this strategy. In many cases, this structure can be achieved in an all-stock deal in which the owners of each company receive stock in the new combined company. In instances, however, where one of the parties wants cash from the transaction, then achieving this structure will require finding a financing source. Companies that have had trouble raising capital in the past may be surprised to learn that financing may be more readily available for a combined business.

#### Option Deals

Sometimes an innovative company has what it takes to attract the attention of potential buyers, but isn't yet acquisition ready in the eyes of those suitors. In this case, the potential buyer may be willing to pay an option fee in return for an exclusive right to acquire the innovative company in the future for a fixed price during an option period on pre-negotiated terms and conditions. The upfront option fee can be a welcome infusion of cash without dilution that the innovative company may need to build its business to the point where it will be an attractive acquisition for the buyer. The structure also may include the parties entering into a joint development agreement to help the innovative company further develop its products, technologies or services which in turn may further enhance the innovative company's value proposition to the buyer. The strategic insight and assistance that a potential buyer can provide throughout the option period can be priceless.

#### ESOPs and MBOs

For a founder of a company that has positive cash flow but is, for whatever reason, an unattractive M&A candidate, an employee stock ownership plan, or ESOP, and/or a management buyout, or MBO, transaction may provide the founder with his or her desired liquidity while preserving a future for the company. In an ESOP transaction, the company creates an ESOP to which the founder sells his or her shares of the company at fair market value in exchange for cash (if outside financing is available from an ESOP sponsor) or for an interest-bearing seller promissory note. The ESOP provides ownership opportunities to the company's employees and, depending on the structure, the ESOP transaction can provide certain tax benefits to the selling owner. In an MBO transaction, certain key members of management

buy the company from the founder either with their own cash or by borrowing the purchase price from an outside source or from the founder through an interest-bearing seller promissory note. While ESOPs and MBOs are not appropriate for every company, they sometimes may be the only available exit strategy if the company cannot attract a third party buyer.

#### Bridging Valuation Gaps

Sometimes parties reach the stage of negotiating a letter of intent for a traditional M&A transaction, but can't quite agree on terms because the buyer isn't willing or is unable to pay the purchase price that the seller wants. In these situations, creative negotiations can help bridge this valuation gap between the parties to move the deal across the finish line. Properly negotiated earnout structures that are realistically achievable can provide the seller with the total consideration it is seeking while providing the buyer with an incentive tool to keep the seller's team motivated to grow the business post-acquisition. Similarly, a properly negotiated equity rollover structure, where the seller continues to have a stake in the future value of the sold business through retaining some modest amount of equity ownership post-acquisition, can have the same impact and may ultimately represent an even higher value for the seller in a future sale of the business than in the first.

#### Licensing Arrangements

While not considered a true exit, entering into certain kinds of licensing arrangements could provide cash to an innovative company while being structured in such a way that the innovative company would not have to play an active role in bringing the products to market or in other aspects of the venture. In a way, these arrangements sit somewhere between an M&A transaction and actively operating a business. In certain license arrangements, the cash consideration could take the form of a royalty stream equal to a percentage of net sales of the products that the other party develops using the innovative company's intellectual property. These royalty streams in turn could be valuable enough that the innovative company may be able to sell the future royalty stream itself to a royalty monetization firm.

#### Seek Advice

If a traditional M&A transaction is not an option, there are still a number of different ways to achieve a successful exit if one is willing to take a creative approach. Not every deal structure is right for every company, and less traditional deal structures often can be quite complex. It is imperative that any company embarking on such a path seeks out experienced counsel and other advisors to guide them appropriately.

Parker Schweich is a shareholder in Stradling's Corporate and Securities practice group and is a member of the firm's Mergers & Acquisitions, Public Company and Emerging Growth practice groups. Parker helps clients raise capital, invest in or acquire businesses, achieve successful exits and navigate the complexities of corporate and securities laws.

