

SMALL BUSINESS



MERGING AS A MEANS OF EXITING A CLOSELY HELD BUSINESS

Imagine a small family-run business that has achieved success. The entire family fortune may be tied up in the firm, as might be the case if a successful entrepreneur — say, Grandpa — started a business, brought his sons and daughters in as they reached adulthood, and continued to run the enterprise as it grew.

In such a situation, particularly if the firm is valued in the millions, the family's entire financial well-being may depend on the success of this business. As long as Grandpa is healthy and continues to run things, everything is fine. Grandpa may, in fact, be reluctant to sell the business; it gives him something to pass on to his family, and it provides a place for his children and grandchildren to work.

Closely held family businesses are fairly common in the United States, yet for several reasons, maintaining the business in its closely held form may not be in the family's best interests. First, there is the problem of succession. Because at some point Grandpa will retire or die, the issue of who will succeed him is important. Sometimes there is a clear choice for the successor, and everyone agrees with the choice. More often, however, even in families that are very close, the problem of succession can split the family apart. This problem is especially acute if Grandpa dies unexpectedly. At a highly emotional time, a key business decision — the choice of a new president — needs to be made, and the choice is not a simple one. It is, therefore, essential that Grandpa and the other principals set up a plan of succession. If the issue is not resolvable, plans should be made for the outright sale of the business in the event of Grandpa's death.

A second problem is that the business represents the family's primary asset, but family members have no easy way to realize that value when they need cash because the business is not liquid. Sometimes a plan will be made for someone to buy a family member's stock at a predetermined price, such as at its book value per share. This enables the family member to obtain cash, but the price paid probably bears little relation to the market value of the shares. Thus, a family member gives up a valuable asset for the sake of liquidity, taking a potential loss in the process. An alternative is to register the shares and take the company public so that family members can use their equity as they choose. A disadvantage to this approach is the potential loss of control as the number of shares held by the public increases.

A third problem is that as the firm grows, the family may be unable to provide the financial resources necessary to support that growth. If external funds are needed, they will generally be more difficult to obtain in a private, closely held business.

Perhaps an even more serious problem is that, since the family's entire wealth is tied up in a single business, the family holds an *undiversified portfolio*. As was explained in Chapter 5, diversification reduces a portfolio's risk. Thus, the goals of maintaining control and reducing risk through diversification are in conflict. Again, a public offering would allow family members to sell some of their stock and to diversify their own personal portfolios.

Both the diversification motive and family members' liquidity needs often indicate that a business's ownership structure should be changed. There is, however, another alternative besides going public — that of selling the business outright to another company or of merging it into a larger firm. This alternative is often overlooked by owners of closely held businesses, because it frequently means an immediate and complete loss of control. Selling out deserves special consideration, however, because it can often produce far greater value than can be achieved in a public offering.

With the sale of the business, the family gives up control, yet that control is what makes the firm more valuable in a merger than in a public offering. Merger premiums for public companies often range from 50 to 70 percent over the market price. Therefore, a company worth \$10 million in the public market might be acquired for a price of \$15 to \$17 million in a merger. In contrast, initial public offerings (IPOs) are normally made at below-market prices. Furthermore, if the owners sell a significant amount of their stock in the IPO, the market will take that as a signal that the company's future is dim, and the price will be depressed even more.

What are the disadvantages to a merger? An obvious disadvantage is the loss of control. Also, family members risk losing employment in the firm. In such a case, however, they will have additional wealth to sustain them while they seek other opportunities.

The owners of a closely held family business must consider the costs and benefits of continuing to be closely held versus either going public or being acquired in a merger. Of the three alternatives, the merger alternative is likely to provide the greatest benefits to the family members.