

IPO VS. M&A TO GO PUBLIC OR MERGE?



Which owner or manager has never dreamt of taking his company public? IPOs (for initial public offering) have become synonymous with success and fortune. The business pages, especially with the recent .com mania, are filled with stories of spectacularly successful IPOs of high tech companies where insiders and venture capitalists become rich long before the company establishes its ability to even survive.

However, as many owners and managers of family businesses have discovered, going public may not be the best option to cash out their investment or develop their company. In fact, for most businesses, a sale or merger may be a more appropriate solution to meet the needs of the company and to provide liquidity to its owners.

BURSTING THE MYTH OF IPOs

Is an IPO right for you? To ask the question is to assume that an opportunity exists for a company to go public. This means that the company has a history of successful operations in a growing market or is somehow perceived to have significant growth potential due, for instance, to the personality of the entrepreneur or the products that the company proposes to develop.

If such an opportunity exists, going public

does offer many advantages. An IPO makes future financing quicker, easier, and less expensive. It enhances the image of the company and provides it with greater visibility among vendors, customers, and the investment community. It enables the company to establish stock-option plans and provide better incentives to its employees. Finally, an IPO gives the company a possibility to finance its future acquisitions with stock.

Going public, however, can also be a source of considerable trouble and expense. First of all, the IPO process is long and painful. The incurred out-of-pocket expenses will be considerable, and the process will disrupt the operations of the company for several months since a number of key personnel will be diverted from ordinary duties. Secondly, once the company is public, it will become subject to the reporting requirements of the federal securities laws. Previously secret information, such as the remuneration of management, will have to be disclosed. In addition, the managers of a public company typically become

from 3 months to a number of years) following an offering so that insiders do not appear as wanting to unload large portions of their stock. Finally, a public company's valuation is at the whim of the markets. The valuation could rise, but it could also fall abruptly for any number of reasons, some of which are independent from the performance of the company, such as a change in macroeconomic conditions or degradation of a specific sector.

While a few highfliers make the papers, the majority of companies that launched IPOs are performing poorly in the stock market. The myth that IPOs deliver money to the pockets of investors, owners, and employees just isn't true. According to Broadview Associates, of the 826 information technology companies that went public with amounts greater than \$10 million between 1992 and 1998, only 49 percent are trading above their IPO price, and they are yielding a median annualized stock return of -5.4 percent. The best stock performance turned out to be with-

INITIAL PUBLIC OFFERING (IPO)	
ADVANTAGES	DISADVANTAGES
• Easier future financing	• Available only if requirements are met
• Company image enhancement	• Out-of-pocket expenses
• Stock-option plans	• Disruption of operations
• Future stock acquisitions	• Disclosure of sensitive information
	• Short-term orientation
	• Insiders' stock "lock-up"
	• Stock subject to market whims

short-term oriented, that is, focused on the company's performance for each quarterly report rather than focused on a five-year plan. Thirdly, the liquidity of the insider's investment will not immediately be enhanced. Underwriters generally require a "lock-up" of existing shareholders' stock for a specified period (lasting anywhere

in the first year of going public where the median annualized stock return was 13 percent. After five years, however, the stock has a compounded annual return of 0.5 percent for its public shareholders that invested at the IPO price.

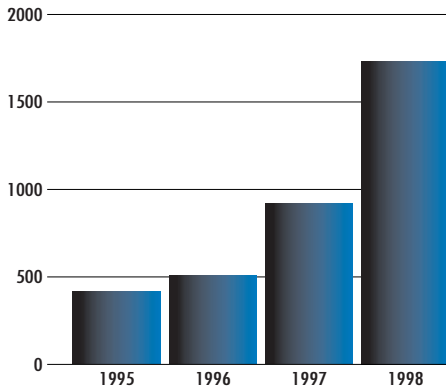
(See **IPO VS. M&A** on page 2.)

RISE TREND TOWARD MERGERS AND ACQUISITIONS

In contrast to the IPO market, 1998 was a record year for mergers and acquisitions (M&A). U.S. deals racked up a staggering \$1.73 trillion, an 89% gain over 1997's record of \$917.7 billion. (*Mergers & Acquisitions Report*, January 1999).

ANNOUNCED U. S. M&A DEALS

(Value in Billions)



While some of these transactions were combinations of large public companies, the private M&A market also developed considerably over the last few years. This is due to the fact that M&A transactions constitute both a good exit strategy for the owners and a significant growth opportunity for the company.

As an exit strategy, selling the company, rather than taking it public, offers many advantages. First, it is faster than exiting through an IPO, since the process of selling the company is generally less time-consuming than the process of going public; in addition, the owner will not be subject to a

“lock-up” agreement which will force him to hold on to his stock for months. Second, selling the company offers a higher degree of certainty: while the price of a newly-public company’s stock can decline before the owner of the company has a chance to sell it, the cash purchase price offered for a company, absent any earn-out provision, is known on the day of signing of the purchase agreement. If the purchase consideration consists of equity in a seasoned public company, the price risk often can be mitigated by transaction structuring and/ or hedging techniques. Third, unlike the disclosure requirements that come along with an IPO, companies involved in most merger or acquisition transactions are not required to file disclosure statements. Finally, selling a business is an option that is available to a wider range of owners than going public. If your company has erratic earnings, you may still be able to find a buyer, whereas you will never be able to convince an investment bank to underwrite your IPO.

For the company, a merger or an acquisition can represent a significant growth opportunity. Facing changing trends and customer preferences, many owners of smaller companies find it increasingly difficult to compete in the market; therefore, many sell to larger national companies that have the capabilities and access to capital to negotiate the changing market demands. The owner or man-

agement of the company may also choose to sell in order to benefit from the synergies created with a larger, more financially viable corporation. Possible sources of synergy include revenue enhancement and cost reduction. Revenue enhancement may come in the form of marketing gains from improvements in previously ineffective advertising efforts, a weak existing distribution network, and an unbalanced product mix. An acquisition may also offer strategic benefits to the seller in the form of a new product line or value-added services. In addition, by combining with a larger company, the seller may benefit from economies of scale, as well as new markets, technology transfers, and management expertise. For many family businesses, combining resources with other firms may provide the missing ingredient for continuous, long-term success.

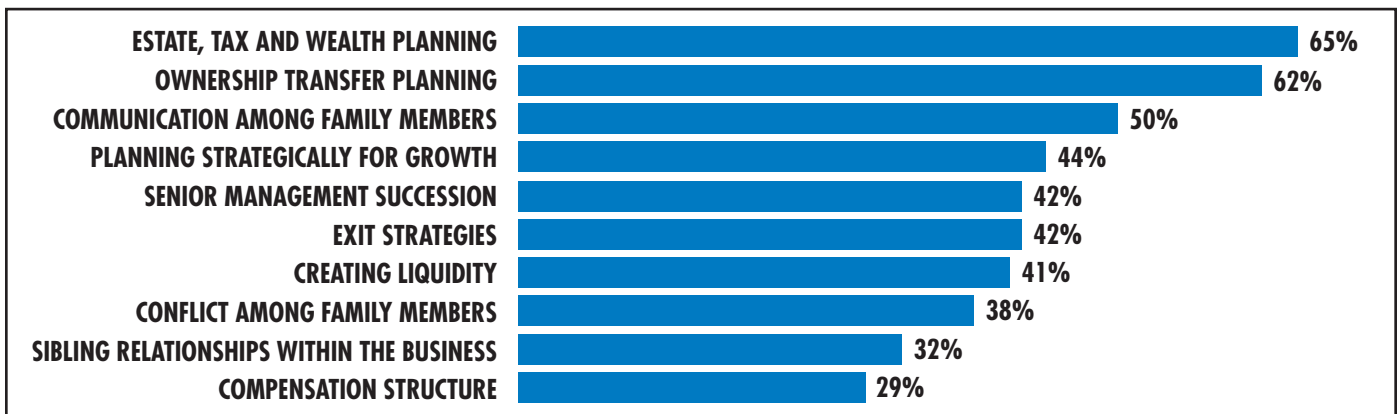


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ADVANTAGES OF A MERGER OR ACQUISITION
• Fast exit strategy
• Certainty of sale price
• Reduced disclosure requirements
• Benefits from merging with a larger company
• Synergies

KEY ISSUES AS VIEWED BY FAMILY BUSINESS OWNERS

In December, 1998, a survey of family business owners was conducted by ReGENERATION Partners. Our purpose? To identify and address the most timely and significant issues family businesses are facing today. Of the twenty issues considered, respondents were asked to identify the five issues they considered most significant. The results? Dramatic! The ten issues topping the list and the percentage of people who chose these issues are shown below.



YOU JUST CAN'T KEEP IT ALL!

Because the only two things that are certain in life are "death and taxes," most people think, consequently, there is nothing that can be done about estate taxes. So, they grudgingly accept what they consider to be the only option for disposing of their Social Capital – paying it to the IRS. Family Wealth Counseling Concepts, Inc. / SMITH & FRANK

The Federal Government has very effectively designed the tax laws so that, no matter how creative or how ingenious your planning, you will not be able to keep everything you accumulate for yourself and your heirs without leaving something to support the general welfare of our country and/or mankind. It simply cannot be done. You cannot enjoy all the benefits this country has to offer, including the opportunity to become wealthy, without putting back some of what you have taken. For example, consider estate taxes. You have amassed a sizeable estate, and when you die the government says that anything over your \$650,000 credit will be taxed up to a maximum 55% rate. That means that 55 cents of every dollar you have accumulated, you will not be able to keep for your heirs. This money is what we call Social Capital. This is the part of your estate that you accumulate but cannot keep beyond your own lifetime.

Because the only two things that are certain in life are "death and taxes," most people think, consequently, there nothing that can be done about estate taxes. So, they grudgingly accept what they consider to be the only option for disposing of their Social Capital – paying it all to the IRS.

However, to many people's surprise, this is not the only option for their Social Capital. In fact, paying the IRS is what we call exercising the "default option." You do nothing and the IRS will collect all your Social Capital without even so much as sending you a thank you note.

The other option for your Social Capital (that which you cannot keep) is elect to bypass the IRS and, instead, give the money directly to organizations that provide a social good to our country, avoiding a tremendous loss of these funds to government administration and waste.

So, you can actually have two options, (1) the default option which is to give it all to the IRS, or (2) the self-directed option allowing you to give your Social Capital to the organizations that you believe best support the general welfare of the country. I am yet to meet anyone who, when presented with these two options for their Social Capital, chooses to still exercise the default option.

The amazing fact is that by choosing the self-directed option for your Social Capital the government has designed the income and estate tax laws in such a way as to reward you for making the effort to exercise this alternative option. Consequently, you end up with more personal capital during the rest of your life, and your children are able to actually "recover" the lost Social Capital through the use of an Asset Replacement Trust.

One recent Family Wealth Plan we just delivered to a client illustrates the tremendous leverage that is possible with choosing the self-directed Social Capital option:

You can see what we mean. First, our country wound up with over two million dollars being contributed to the general welfare. Secondly, they avoided (a) the loss of a huge percentage of their Social Capital to government administration, and (b) their Social Capital will not be put into pro-

	DEFAULT SOCIAL CAPITAL PLANNING	SELF-DIRECTED SOCIAL CAPITAL PLANNING
Income to Owners	2.5 Million	3.6 Million
Benefit to Heirs	1.9 Million	6.2 Million
Social Capital	1.9 Million	4.1 Million

grams that in many cases only further weaken the infrastructure of our culture and our society.

The amazing fact is that by choosing the self-directed option for your Social Capital the government has designed the income and estate tax laws in such a way as to reward you for making the effort to exercise this alternative option.

It has been said that only about 25 cents of every tax dollar ever really hits the streets to do some good for the people. If, however, that money would go directly to charity, bypassing the government, the amount that hits the streets to do good might be as much as 75 cents on the dollar. Using the above client as an example, instead of only \$500,000 actually doing social good, they have created over \$3million that will make a meaningful difference. That is a whopping six-fold increase! These spectacular figures just cannot be ignored, especially by

people who really do care about the future of this great country in which we live.

But, not only have these estate owners chosen a superior option for the use of their Social Capital, the leverage created by exercising this option ballooned the inheritance to their children to actually exceed the original value of the estate. And our clients will add over \$1 million more net, spendable income over the rest of their lives.

Why should you work so hard to keep the government out of your pocket during your working years only to quit the game right at the final whistle and voluntarily give up over half of what you have worked so diligently to accumulate? Why not let us help you finish the game with the same creativity and finesse with which you played it during your life? It could be everyone's benefit if you did.

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BOOK ReVIEW

A MULTITUDE OF MILLIONAIRES

Masters of Enterprise: Giants of American Business From John Jacob Astor and J.P. Morgan to Bill Gates and Oprah Winfrey
By H.W. Brands

There is more than one way to create a lasting business. If you take nothing else away from this well-written and thoroughly researched set of biographies of famous American entrepreneurs, take that. From Cornelius Vanderbilt's use of physical intimidation to cow shipping rivals, to Mary Kay Ash's offer of pink Cadillacs to inspire cosmetics salespeople, we see a virtual rainbow of business practices that have but one thing in common: They worked.

H.W. Brands, a history professor at Texas A&M University, does an admirable job of highlighting the

similarities as well as the differences in the style and approaches of 25 well-known business founders. The contrasts between the likes of Walt Disney and 19th-Century robber baron Jay Gould are pretty obvious. Disney labored to provide children with wholesome entertainment – Gould to amass gold by any means whatsoever.

Brands also illumines the common tendencies toward compulsive work habits shown by Bill Gates (repeated all-nighters) and Oprah Winfrey (taping 200 shows a year) and the obsessive attention to detail of Sam Walton (crawling under Wal-Mart rivals' counters) and Ray Kroc (policing McDonald's parking lots.) So if you're ever tempted to think there's just one route to the top, whether it's being born there or just being lucky, think again. Masters of Enterprise maps out a multitude of paths, each with its own challenges and rewards.

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EDITORIAL



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When *ReLATIVELY Speaking* was conceived in 1995, our mission was to become the information and thought leader for individuals involved in family businesses. Although we are very proud of our accomplishments as a publication, we have to admit we occasionally scratch our heads and wonder who is actually doing the thought provoking.

Last month I had the good fortune to speak to a group of graduate business students from Southern Methodist University about the impact of family businesses. In the question and answer period, one student posed a timely question, "Do I think family businesses will have less impact on the economy in the next century?"

There is no doubt that the most powerful trend in business or, indeed, in society today is the switch from an industrial economy to one based on knowledge and information. In the Information Age, the key to economic success is not ownership of capital resources, such as factories and mines and land. Replacing these, as the most valuable resources in the Information Age are, of course knowledge, intelligence and the management of those intellectual assets. But also crucial, when customers of every variety are constantly bombarded by commercial offers in the bewildering array of media, is simple attention.

The ability to command the attention of customers is the reason for the amazing stock market valuation placed on Information Age companies such as Yahoo! Inc. and Amazon.com Inc. Despite modest, if any, profits to date, these companies are valued in the billions of dollars by investors who appreciate the worth of their early stake in the Internet arena and their resulting power of commanding people's attention.

What does this have to do with family business? Plenty. In an era where companies rise to prominence

seemingly overnight, and once-indomitable brand names disappear almost as quickly, trust is the commodity almost beyond price. And when consumers are dealing with a family business, with the identity of the founder, owners and the current management over the door, trust is a given. Trust in a family name is what makes a commodity such as tomato ketchup worth billions of dollars when plastered with the name of H. J. Heinz. Trust in a person, not its anonymous stockholders, is the reason even a public company such as Wendy's builds its advertising around the image and personality of founder Dave Thomas. In an age when business as well as people seem limited to only 15 minutes of fame, family businesses possess potent possibilities for turning that brief moment of acclaim into lasting success.

Family businesses have always been here. They have survived vast change as a group and, in some cases, individually for centuries. They have outlasted many innovations in business organizations and continue to dominate many fields. They have made major, lasting contributions to the economy and to society. And they are well-positioned to continue in just this fashion in the third millennium and, it seems likely, beyond.

Creating liquidity is one of the ever-present issues in a family owned business. When searching for someone to assist us with this far-reaching subject, we sought out the prestigious wall street private bank firm Brown Brothers Harriman & Co. Although the stock markets may be "correcting," the IPO market is still hot. But IPOs may not be for everyone as you will learn in *IPO or M&A*, written by Rick Witmer, Jr. and Lianne Lim of Brown Brothers. Chris Faye, a longtime adviser to family businesses, joins us for the first time with *You Just Can't Keep It All*.

Our country has experienced unprecedented growth during the last ten years. That's the good news. The bad news is that the estate tax is undermining the long term liability for many family-owned businesses. Kerri Houston joins us with an op-ed opinion on this subject.

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A MORALLY, ECONOMICALLY BANKRUPT TAX

It's derisively called the death tax, the vulture tax, the survivor's tax, the exit tax, or the departure tax. But the federal estate tax is no laughing matter. For many farmers and business owners, it is the most destructive tax in the IRS arsenal.

The estate tax is a redistributive device that cuts deeply into the investments, savings and wealth of family members who've passed away.

The tax generates little more than droplets of net revenue. What it does do well is undermine the dearest ideals of this country: enterprise, thrift and continuity of family.

According to a new study by economists Gary and Aldona Robbins for the Institute for Policy Innovation (IPI), "The Case for Burying the Estate Tax", this statute has no reason to live. Estate and gift taxes make no sense on three distinct fronts.

First, they make no economic sense. It's fiscally destructive anti-growth consequences include both "trickle down" and "trickle up" effects.

Trickling upward are unemployment and possibly even welfare rolls as businesses are routinely closed for asset value in order to pay the debt.

Parceling off farm and forestry lands leads to an increase in surreptitious environmental abuse. A potential decedent's expenses expand upward and away from savings and capital reinvestment as avoidance dollars are spent on attorneys, financial planners, and yes, even estate tax insurance.

The harmful downward trickle includes decreases in personal savings and cash needed for capital formation, job creation and technological innovation.

Incredibly, upwards of 70% of family and closely-held businesses do not survive to the next generation, often because of the death tax, according to the Center for the Study of Taxation.

Secondly, they make no sense to the Treasury. Excluding compliance costs, their effect on federal revenues is minimal (just over 1%). Compliance costs due to administration, collection and litigation can range from 65 cents on each dollar collected to zero. But IPI's new study is the first to use dynamic analysis to include the rippling effects of the death tax. IPI found that repealing the estate tax would begin adding revenue by 2010.

Third, economics aside, perhaps the best argument against the death tax is the moral one. It is no longer a problem for the polo set. Growth of small to midsized businesses, higher real estate values, personal retirement plans and whole life insurance policies have made the death tax a penalty felt by almost every American.

IPI found that the largest estates do not even bear the highest burden. Midsized estates do. This is clearly not what the liberal politicians and socialist economists intended when the death tax was first put forward as a wealth redistribution device.

The Estate Tax is intentional, personal harm done to Americans.

It takes the best of America and taxes it. The IRS has no ethical business walking up to what's left of a doorstep in Oklahoma and telling the heirs of a farmer killed in last month's tornado that although Dad only eked out income of \$40,000 last year, he had the misfortune of purchasing the land twenty-odd years ago. It is now worth \$800,000 and Uncle Sam wants \$56,500 of it. Now. So what if Dad never even heard of the estate tax.

At a recent IPI briefing on Capitol Hill, John Meagher of the House Ways and Means Committee stated the case for repeal clearly and eloquently: "The estate tax is immoral and dishonors the hard work of people who have passed on. Something is sacred about the fruits of your parents' labor, and you have a deep sense to protect it. This is their legacy, and it is representative of what their life is all about. This tax violates the sanctity of those efforts and the government should not take part of it."

Death used to have a terrible finality. But a twisted tax code has made a taxpayer's demise yet another opportunity for the IRS reaper to strike. It's time to lay this statute to rest once and for all.

Kerri Houston is director of external affairs for the Institute for Policy Innovation, a Dallas-based non-partisan free market public policy institute.

Business Is Business. EXCEPT WHEN IT COMES TO FAMILY BUSINESS.

Family businesses are unique. While corporations have CEOs and VPs, family businesses have relatives. The challenges and obstacles facing traditional business are compounded by the dynamics and stresses unique to family business. Issues like:

- Declining performance • Conflict among family members
- Intergenerational leadership issues • Recapitalization for growth
- Communication among family members • Sibling relationships
- Senior management succession • Exit strategies

ReGENERATION Partners understands and helps you address family-specific issues that can hurt your business' performance.

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