

THE
**ONE PERCENT
SOLUTION**

An Introduction to Wealth Managers and Business Owners
to the Concept of Managing Pre-Liquid Wealth

Z. CHRISTOPHER MERCER, ASA, CFA



THE ONE PERCENT SOLUTION

An Introduction for Wealth Managers and
Business Owners to the Concept of Managing
Pre-Liquid Wealth

Z. Christopher Mercer, ASA, CFA

Published by Peabody Publishing, LP
© 2007 Z. Christopher Mercer

THE ONE PERCENT SOLUTION

Copyright © 2007 Z. Christopher Mercer

All rights reserved. No part of this publication may be reproduced, stored in or introduced into a retrieval system, or transmitted, in any form or by any means (electronic, mechanical, photocopying, recording or otherwise) without the prior written permission of both the copyright owners and the publisher of this book.

This publication is designed to provide accurate and authoritative information in regard to the subject matter covered. It is sold with the understanding that neither the author nor the publisher is engaged in rendering legal, accounting, or other professional service. If legal advice or other expert assistance is required, the services of a competent professional person should be sought.

The scanning, uploading, and distribution of this book via the internet or via any other means without the permission of the publisher is illegal and punishable by law. Please purchase only authorized electronic editions and do not participate in or encourage electronic piracy of copyrightable materials. Your support of the author's rights is appreciated.

Peabody Publishing LP
5860 Ridgeway Center Parkway, Suite 400
Memphis, Tennessee 38120
Tel: 800.769.0967 » Fax: 901.685.2199

THE ONE PERCENT SOLUTION

INTRODUCTION	1
THE ONE PERCENT SOLUTION	6
Wealth Management Principles.....	10
Liquid vs. Pre-Liquid Assets.....	11
One Percent Solution Activities.....	18
What is the Yield, or Return of a Business?.....	25
There's (Almost) No Such Thing as a Free Lunch.....	31
One-Percent Solution: Top Ten Questions.....	31
Liquidity (and Diversification) without Selling.....	35
<i>Implement a Dividend Policy</i>	38
<i>Declare a Special Dividend</i>	39
<i>Dividend Recapitalizations</i>	40
<i>Repurchase Stock</i>	41
<i>Execute a Leveraged Stock Redemption</i>	42
<i>Execute a Combination Redemption/Special Dividend</i>	43
<i>Partial Management Buy-In/Installment Sale</i>	44
<i>Management Buy-In with Outside Equity</i>	45
<i>Seek Private Equity Investment</i>	46
<i>Conduct a Private Equity Recapitalization</i>	47
<i>Install an Employee Stock Ownership Plan (ESOP)</i>	48
<i>Execute a Private Merger with Partial Redemption</i>	49
ABOUT MERCER CAPITAL	50
ABOUT THE AUTHOR	51
BOOK CHRIS MERCER TO SPEAK	52
FINAL THOUGHTS	54

INTRODUCTION

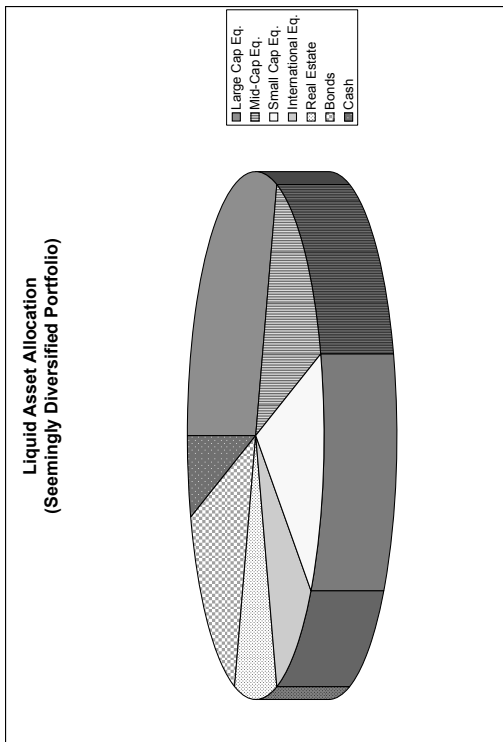
The title of this booklet is “The One Percent Solution.” Possible subtitles could include the following:

- Bringing Investment Management and Corporate Finance Principles to Private Companies
- Managing the Investment You Have in Your Business Like All Your Other Assets
- Managing All of Your Assets, Even the Big One

It is almost axiomatic in the field of wealth management that money managers are compensated based on percentages of the assets they have “under management.” The percentages might range from 20-30 basis points for bonds and other fixed income securities to 50 basis points for basic equity portfolios, to 150 basis points (1.5%) or more for private equity portfolios or venture capital funds.

Investors make portfolio choices, and wealth managers assist them in making those choices and then, in implementing specific investment strategies designed to achieve their objectives. Consider an individual with \$5 million of liquid assets. His advisor has implemented a diversified portfolio:

THE ONE PERCENT SOLUTION

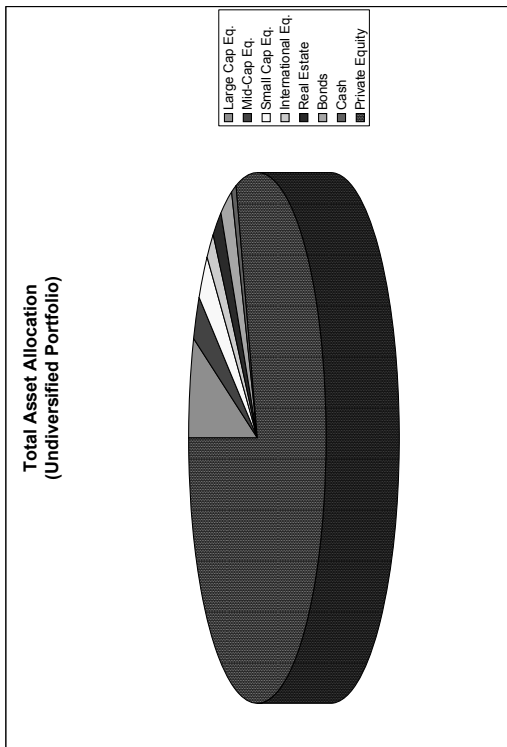


THE ONE PERCENT SOLUTION

The only problem is that this allocation is highly misleading and does not take into account the individual's ownership of a private company, whose current value has just been determined by appraisal to be \$20 million.

The actual asset allocation chart looks like following, and does not reflect much diversification at all.

THE ONE PERCENT SOLUTION



THE ONE PERCENT SOLUTION

Assume that the management fee on the liquid portfolio averages to be 75 basis points, or \$37.5 thousand per year. Almost certainly, no management fee at all is being paid on the \$20 million of private wealth. In fact, the owner(s) of that business might consider expenses related to wealth management of even \$37.5 thousand per year to be either unnecessary, exorbitant, or both.

We hope this booklet will help change the thinking of not only business owners, but wealth managers as well, by introducing the concept of the *One Percent Solution* – a new and powerful way to manage all the wealth, both liquid and pre-liquid, for the benefit of the business owner (as well as the wealth manager and possibly other professional advisors).

THE ONE PERCENT SOLUTION

What is the solution to financing the expenditures necessary to manage the wealth tied up in closely held businesses? The solution is so obvious that we overlook it, thinking that such activities either are too expensive, too time-consuming, or worse, not a high priority. For owners of closely held businesses, the solution lies in the decision to treat their ownership interests as an investment. Again, we term this the *One Percent Solution*.

Let us ask a few important questions about current American investing habits:

- *What do the very wealthy in America do to manage their wealth?* The very wealthy quite often establish what are called “family offices” through which investments are handled and a variety of personal or family planning activities are administered. By and large, these family offices hire staffs responsible to the family for allocating their assets among a variety of investment funds and strategies, seeking diversification, satisfactory (or superior) returns, and reduction in volatility, or risk.

THE ONE PERCENT SOLUTION

The very wealthy place their assets across a variety of investment classes, ranging from Treasuries, to fixed income securities, to market portfolios bearing numerous names representing their “strategies,” to private equity funds, and even to hedge funds. Then, there are investments in land, timber and developed real estate, either through REITs or more directly, through proprietary funds, and even direct investments.

In addition, the very wealthy are continually investigating tax-efficient ways in which to preserve their wealth and to pass it to subsequent generations, or, increasingly, to give it away (like Bill and Melinda Gates, Warren Buffet, and many others).

- *What do the merely wealthy in America do with their money?* In many respects, the merely wealthy do the same thing as the very wealthy, except they may outsource the investment decisions to a trust department of a bank or to a variety of investment managers.

Quite often, the merely wealthy will spend considerable time and money seeking tax

THE ONE PERCENT SOLUTION

and legal advice to accomplish their objectives of intergenerational wealth transfers as well as their charitable objectives.

- *What do the affluent in America do with their money?*
Most affluent Americans place all, or at least large portions of their liquid assets, into a variety of mutual funds, or place their assets with other investment intermediaries who, in turn, place collective assets into some of the same funds used by the very wealthy.
- *What do the rest of Americans do with their money?*
Many Americans who may have virtually no liquid assets nevertheless have assets invested on their behalf through their retirement plans at work.

The fiduciaries of these plans, who deal with growing pools of assets over time, are charged with the duty to invest retirement funds, and they do so through the same vehicles as do the very wealthy or merely wealthy.

What do all of these investments, by the very wealthy, the merely wealthy, the affluent, and the rest of us in America, have in common? The first common denominator of the

THE ONE PERCENT SOLUTION

investing habits of most Americans is that our assets are treated like investments, and they are placed in the custody of capable investment managers who handle the direct investment activities and periodic changes to our portfolios. In other words, there are structures in place to facilitate decisions regarding asset allocation, diversification, risk profiles, return monitoring, and also, wealth preservation and transfer activities.

The payment of management fees to asset or wealth managers is the second common denominator. These fees are frequently based on a percentage of assets under management and are paid monthly or quarterly, often in advance. Returns are provided net of these asset management fees, so most people never even think about them.

THE ONE PERCENT SOLUTION

Wealth Management Principles

Wealth management involves at least five discrete steps, or phases:

Phase	Investment Principles
1	Set Objectives
2	Establish Strategies
3	Regular Monitoring
4	Constantly Enhancing
5	Review re: Reallocating

Wealth managers who work with liquid assets are intimately familiar with these principles and work with their clients through an ongoing process of setting objectives and establishing strategies. Once these are set, there is regular monitoring of liquid asset portfolios, and consistent efforts to enhance performance through manager selection and other techniques. Then, given varying performance in the various segments of the portfolio, reallocations of assets are made as appropriate to remain consistent with the initial objectives.

THE ONE PERCENT SOLUTION

Finally, the objectives are periodically reviewed over time and adjusted as necessary to meet the changing needs of clients.

All the while, clients are paying their wealth and asset managers fees based on assets under management.

Liquid vs. Pre-Liquid Assets

The wealth management principles are well-established for liquid assets. The picture is quite different when the typical wealth manager encounters *pre-liquid* assets.

What are pre-liquid assets? For our purposes, pre-liquid assets are the values of private companies in America. They are called “pre-liquid” because, as we will see, every company will eventually be sold, or liquefied, in some manner.

Pre-liquid assets either become liquid or facilitate the creation of liquid assets when they are sold (entire businesses or partial sales) and when they distribute cash to their owners.

Are we talking about real money when we mention pre-liquid assets? Professors Moskowitz and Vissing

THE ONE PERCENT SOLUTION

Jorgensen, writing in the prestigious *American Economic Review*, suggest that the magnitude of private equity and public equity markets were similar in magnitude, at least through the 1990s.¹

Was our example of an entrepreneur's portfolio in the previous pie chart above realistic? Listen to the professors:

“We find investment in private equity to be extremely concentrated. About 75% of all private equity is owned by households for whom it constitutes at least half of their total net worth. Furthermore, households with entrepreneurial equity invest on average more than 70% of their private holdings in a single private company in which they have an active management interest. Despite this dramatic lack of diversification, the average annual return to all equity in privately held companies is rather unimpressive. Private equity returns are on average no higher than the market return on all publicly traded equity.”

1 Moskowitz, Tobias J. and Vissing Jorgensen, Annette, “The Returns to Entrepreneurial Investment: A Private Equity Premium Puzzle?,” *American Economic Review*, Volume 92, No. 4 (2002), pp. 745-777.

THE ONE PERCENT SOLUTION

Let's look at the typical wealth manager's considerations of liquid and pre-liquid assets for the same clients.

Phase	Investment Principles	Wealth Managers Current Role	
		Liquid	Pre-Liquid
1	Set Objectives	Yes	Maybe
2	Establish Strategies	Yes	Maybe
3	Regular Monitoring	Yes	No
4	Constantly Enhancing	Yes	No
5	Review re: Reallocating	Yes	No

Very few wealth managers are involved in setting investment objectives *for the substantial pre-liquid assets held by some of their clients*. If they do not help set objectives, it is difficult to be involved in establishing strategies.

Worse, in many cases, the wealth manager is attempting to help his or her client without specific knowledge of what is likely the largest single asset in the client's portfolio.

Worse still, when clients obtain liquidity from their privately held business, they may seek larger, more

THE ONE PERCENT SOLUTION

sophisticated wealth managers for this newly-obtained liquidity – especially if the existing wealth manager was not involved in the owner’s decision-making process.

Do owners of privately owned companies typically think about their pre-liquid assets as investments? Not if our experience is representative, as can be seen in the following comparative chart.

THE ONE PERCENT SOLUTION

Phase	Investment Principles	Wealth Managers Current Role		Business Owner's Role
		Liquid	Pre-Liquid	
1	Set Objectives	Yes	Maybe	Sometimes
2	Establish Strategies	Yes	Maybe	Sometimes
3	Regular Monitoring	Yes	No	Seldom
4	Constantly Enhancing	Yes	No	Occasionally
5	Review re: Reallocating	Yes	No	Seldom

THE ONE PERCENT SOLUTION

The bottom line is that liquid wealth tends to be managed, while pre-liquid wealth tends not to be managed.

Now, a business owner (or a wealth manager) may be thinking, “Why of course my pre-liquid wealth is managed. I run the business every day.”

That’s not the point. Every *company*, public or private, is managed (to greater or lesser degree). What we are talking about is managing the pre-liquid *wealth* in private companies and creating strategies for converting that wealth from pre-liquid to liquid form over time through enhanced performance, distributions, partial sales, or ultimately, the sale of a business.

The good professors quoted previously explain the need to manage pre liquid assets:

“What we hope to convince the reader is that a complete theory of household portfolio choice should emphasize both public and private equity.”

The fact is that pre-liquid wealth is often not managed at all, and is seldom managed to the degree typically found with liquid wealth.

THE ONE PERCENT SOLUTION

So, what are some of the implications of the disparity of management of pre-liquid wealth and liquid wealth?

- Substantial fees paid to wealth managers for managing liquid assets
- Little use of investment or corporate finance principles by wealth managers as applied to pre-liquid assets
- Virtually no fees paid to wealth managers for managing pre-liquid assets
- Little attention paid by business owners to the management aspects of their pre-liquid wealth
- Inadequate attention paid by business owners to corporate finance techniques designed to enhance value
- Almost no attention paid by business owners to the critical monitoring and enhancing investment principles, and to the reallocation of pre-liquid wealth into liquid form

THE ONE PERCENT SOLUTION

Just to be clear, let's ask this question: *What do many, if not most business owners do to manage the wealth tied up in their closely held business?* For many, the answer to the question is “not much.”

A Top Ten list of questions for business owners is presented at page 32 to determine if you, the owner, are treating your business as an important investment.

The eleventh question is a bonus added here: How can anyone answer the first ten questions or get others to help answer them? The answer lies in making one simple decision – *to treat your investments in closely held businesses as the important investments they are.* Business owners pay significant fees to the people who manage their wealth because that wealth is treated as an investment.

The *One Percent Solution* is based on the premise that owners of closely held businesses should treat their ownership interests just the same way – as important investments.

One Percent Solution Activities

The *One Percent Solution* suggests allocating a *percentage of value* for the illiquid assets *under management* to provide

THE ONE PERCENT SOLUTION

the budget necessary to manage wealth. If the wealth were liquid, that budget would be one percent of assets under management, plus or minus, depending on the asset category of investment. For pre-liquid wealth, we suggest a budget for investment management of one to two percent of value for businesses with values of \$20 million or less, as indicated in the following table. The management fee can scale down in percentage terms as business value increases.

THE ONE PERCENT SOLUTION

The One Percent Solution for Managing Wealth in Closely Held Businesses						
Assumed Pre-Tax Income (\$m)	Assumed Valuation Multiple	Value of Business (\$m)	Management Fee as % of Value	Budget for Investment Management (\$m)	Management Fee as % of Earnings	
\$1,250	4.0	\$5,000	2.00%	\$100	8.0%	
\$2,222	4.5	\$9,999	1.50%	\$150	6.8%	
\$4,000	5.0	\$20,000	1.00%	\$200	5.0%	
\$8,333	6.0	\$49,998	0.75%	\$375	4.5%	
\$14,286	7.0	\$100,002	0.50%	\$500	3.5%	
\$62,500	8.0	\$500,000	0.25%	\$1,250	2.0%	

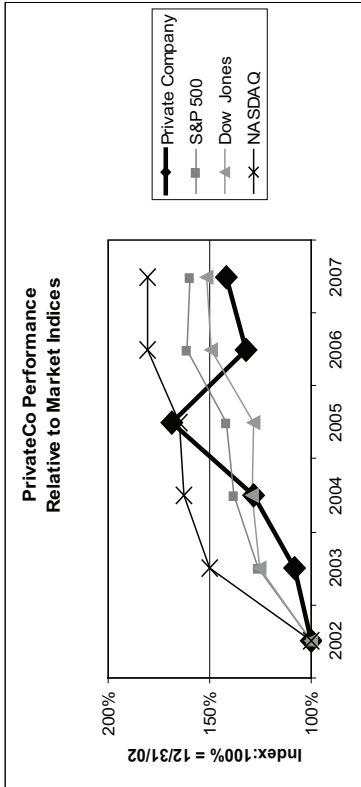
THE ONE PERCENT SOLUTION

Assume a private business is worth \$20 million, as highlighted previously. This business earns \$4.0 million pre tax per year and is valued at a multiple of 5 times earnings. The *One Percent Solution* would suggest a budget of *one percent of value*, or \$200 thousand *per year* to be dedicated to managing that block of illiquid wealth. This \$200 thousand investment management budget amounts to 5% of pre-tax earnings in the example. What would that budget be spent on? There are a number of possibilities:

- *Wealth Manager Compensation.* The wealth manager who introduces *One Percent Solution* concepts to business owners may seek compensation based on a percentage of the value of the business, or based on specific fees in some circumstances.
- *Annual valuations and monitoring of value growth.* Liquid assets are valued every day, and portfolio performance reports are made at least quarterly for most portfolios. Annual valuation is the best way of tracking investment performance over time, and for reporting to shareholders about a company's return performance relative to itself and to other asset categories. (See the chart of the performance of our example private company relative to the S&P, Dow

THE ONE PERCENT SOLUTION

Jones and NASDAQ indices in recent years. If you were the wealth manager, what questions would you be asking of the business owner(s)?



THE ONE PERCENT SOLUTION

- *Buy-sell agreement pricing.* Annual valuations can establish the value for buy-sell agreements. They are so important that we wrote an entire book on these critical and often ignored business agreements.²
- *Annual review of buy-sell agreements.* The investment management budget would also include an annual review of the buy-sell agreement by legal counsel and business advisors.
- *Life insurance funding.* The budget could certainly include the cost of life insurance purchased on the lives of key shareholders to fund buy-sell agreements. The annual valuation can establish the amount of life insurance needed, and be a prompt for necessary adjustments to the amounts purchased as value changes over time.
- *Estate planning.* Tax counsel could be retained to provide ongoing advice regarding estate planning issues for shareholders.

² Mercer, Z. Christopher, ASA, CFA, *Buy Sell Agreements: Ticking Time Bombs or Reasonable Resolutions?* (Memphis, TN, Peabody Publishing, L.P., 2006) Available at mercercapital.com.

THE ONE PERCENT SOLUTION

- *Financial planning.* Key owners and shareholders could retain personal financial advisors to assist with their personal financial planning. The annual valuation will assist financial planners in advising with respect to asset allocation decisions for non-business assets.
- *Audited financial statements.* While an audit might be considered a normal business expense, many private companies do not obtain an annual audit. It is a fact that having audited financial statements enhances the marketability of companies, so part of investment management expenses could include the annual audit – or at least make it easier to make the decision to obtain an audit.
- *Annual legal review.* It is often helpful to have legal counsel review a company's board of directors' minutes and other legal documents and contracts on a periodic basis. This practice helps to identify and eliminate issues that, left alone, can create potential problems in the future.
- *Other "make-ready" projects.* Most businesses can be sold – at some price. Businesses that are "ready

THE ONE PERCENT SOLUTION

for sale,” however, tend to sell more readily and for better prices.³ They are more attractive to larger pools of potential buyers, and their sales processes are less frequently caught in snags from surprises with inventories, accounts receivable, fixed assets, information shortfalls, and the like. If there are known issues at a company, it can be helpful to consider funding their correction with the investment management budget.

Most business owners work *in* their businesses. Those who consider their ownership positions as investments will also regularly work *on* their businesses.

What is the Yield, or Return, of a Business?

The reason to work *on* a business is to increase its return, or yield. In the context of an owner's overall portfolio, the reason to work on the business is to increase the total yield, or return, of the entire portfolio.

3 *Is Your Business Ready for Sale?*TM Teleseminar Series, available at www.mercercapital.com or 1 800 769 0967.

THE ONE PERCENT SOLUTION

How important is this concept? Recall the pie charts showing liquid assets and total asset allocations for one owner. Assume that his wealth manager has invested well, and that the total return on the \$5 million liquid portfolio is 11.8%, based on stellar equity returns and single digit returns for bonds, real estate and cash. Assume for perspective that the broad market increased 11.0% that year. The wealth manager produced stellar returns from a diversified portfolio and “beat the market.” Our investor should be excited.

Now assume that his business is worth \$20 million, raising the total portfolio value to \$25 million. The return from the business last year (dividends plus increase in value) was only 7.0%. The heavy weighting of this single asset (80% of the portfolio) and its relatively low return lowered this investor’s total return to an overall 8.0%.

If the wealth manager had produced a return of 8.0% in an 11% market, the investor might be looking for another manager!

Unfortunately, many business owners never have the valuation information necessary to make the calculation of their business investment returns, and few wealth managers

THE ONE PERCENT SOLUTION

have the information necessary to incorporate return estimates into their overall planning for their clients.

Interested wealth managers will encourage their clients with private business wealth to obtain regular valuations, to make such calculations, and to work on the business if returns are inadequate.

The following table illustrates that the yield, or return on capital employed for a business, is a function of four broad valuation-related categories.

THE ONE PERCENT SOLUTION

Critical Valuation Issues	Business Issues	Outsourcing Opportunities
Growth	Client acquisition, retention	Growth specialists
Margin	Business productivity, reputation	Expense consultants, marketing
Activity	Operating efficiencies	Operational specialists, corporate finance
Financing	Capital structure	Valuation/corporate finance
Yield	Yield	Yield
Returns on Capital	Improvements Over Time	Enhanced Returns on Capital and Value

THE ONE PERCENT SOLUTION

The activities of a business that influence its return on capital (and value) can be grouped into four activities related to growth, margin, activity, and financing.

The valuation process can help business owners pinpoint the areas presenting the earliest opportunities for earnings, and hence, value improvement. Growth, for example, relates to client acquisition and retention. Conceptually, there are only three ways to grow revenues:

- Increase the number of new customers
- Increase the revenue per customer
- Decrease the attrition of existing customers

Business owners can, of course, work to increase growth in revenues without outside help. However, knowledgeable wealth managers will consider introducing specialists to their clients who can help accelerate the growth process. Remember this basic present value principle: A dollar today is better than a dollar tomorrow.

The chart at page 28 outlines possible actions and outsourcing possibilities related to enhancing margin, increasing activity (efficiencies), and financing (leverage, or capital structure).

THE ONE PERCENT SOLUTION

So wealth managers and business owners, if they are working together to enhance overall portfolio yields, will pursue activities related to:

- *Increasing sales*
- *Decreasing expenses*
- *Enhancing earnings*
- *Recapitalizing or paying dividends to maintain optimal capital structure*
- *Improving operations*
- *And, anything else that makes sense to increase the yield of the business, and/or to reduce its riskiness.*

Just as we work on our businesses, it is important to work on how wealth is allocated in individual or family portfolios. Believers in the *One Percent Solution* will engage in regular estate planning, so that if or when a business is sold, value will be realized by the right people in the right (i.e., planned) amounts with minimum tax consequences.

THE ONE PERCENT SOLUTION

There's (Almost) No Such Thing as a Free Lunch

While there's no such thing as a free lunch, the investment management budget for closely held firms may be at least partially free. Any dollar spent is certainly not available for distribution or reinvestment, so investment management expenses are definitely not free. However, *One Percent Solution* expenses become almost free when returns are enhanced to more than offset the expenses, and when dollars spent on annual valuations, life insurance policies, estate planning, financial planning, etc. are added back to earnings by buyers in their normalizing processes.

In other words, while dollars spent on investment management activities do reflect real expenses, the returns on their investments may exceed the actual investments and may be capitalizable at the time of the ultimate sale of a business.

One-Percent Solution: Top Ten Questions

The *One Percent Solution* reflects a conscious way of thinking about the wealth held in closely held businesses as an *investment*. It then provides a conceptual way to create a budget for investment management activities and expenses related to the *investment nature* of ownership in a business.

THE ONE PERCENT SOLUTION

These “top ten” questions are designed to help business owners apply the concept of the *One Percent Solution*.

Do You Treat Your Business As An Investment? Top Ten Questions

1. How much is your company worth? Has it been valued in the last three years?
2. What has been your shareholders' rate of return on their investment over the last one, two, three, four, or five years or more? How does this rate of return performance compare with other alternative investments?
3. What portion of your net worth is tied up in your business ownership interest?
4. Is your wealth adequately diversified to avoid the risk of major loss from adverse events with any of your assets, including your business?

Do You Treat Your Business As An Investment?

Top Ten Questions

6. Are you reinvesting distributions in liquid assets in a plan to diversify your wealth? If not, why not?
7. What is the plan to obtain liquidity from your ownership of your business? And for your other shareholders, if any, to obtain liquidity from their investments? Is this plan realistic? Is it documented? And is it workable in the event something adverse happens to you or to another key owner/manager?
8. Is your business “ready for sale?” In other words, not that you want to sell it today, but should you make that decision, is the business positioned to be attractive to a range of prospective purchasers?
9. Are there things you know that need to be done and that take time to begin to get the business in a position to be “ready for sale?”

THE ONE PERCENT SOLUTION

Do You Treat Your Business As An Investment?

Top Ten Questions

10. What is the plan to transfer ownership and/or management to other members of your family? Is this plan realistic? Is it documented?

Bonus Question: How can anyone answer the first ten questions or get others to help answer them?

Bonus Answer. *The One Percent Solution*

THE ONE PERCENT SOLUTION

Liquidity (and Diversification) Without Selling

Business owners often think of ownership in binary fashion: “Either I own the business, or I don’t. I’ll just keep it until I sell it, and that’s that.” It is a fact that every business owner will sell his or her business, either partially or totally.

Consider the options in the Business Transfer Matrix:

	Partial Sale/Transfer	Total Sale/Transfer
Voluntary Transfer	Outside Investor(s) "Inside" Sales to Management "Inside" Sale to ESOP Combination Merger/Cash Out Going Public Gifting Programs Buy-Sell Agreements	Sale of Business Stock-for-Stock Exchange w/ Public Company Stock/Cash Sale to Public Co. Installment Sale to Relatives/Insiders ESOP/MBO Buy-Sell Agreements Liquidation
Involuntary Transfer	Divorce Forced Restructuring Shareholder Disputes Buy-Sell Agreements	Divorce Forced Restructuring Bankruptcy Shareholder Disputes Buy-Sell Agreements Liquidation Death

THE ONE PERCENT SOLUTION

The Business Transfer Matrix identifies many of the things that can or will happen to cause owners of closely held businesses to sell some or all of their investments.

There are actually a number of financial tools available to the typical, successful private business to assist in the investment management objectives of creating liquidity, diversifying wealth, reducing risk and enhancing returns.

Unfortunately many of these tools are overlooked not only by business owners, but by their advisors, as well.

Valuation firms with investment banking experience may be well-suited as sources for expertise to implement many of these basic corporate finance tools.

The following list provides more than ten legitimate, effective, and available techniques to create shareholder liquidity and cash flow, enhance business performance and returns, and provide opportunities for overall portfolio diversification.

Key benefits of the various strategies include:

- Acceleration of cash returns
- Enhancement of returns on equity

THE ONE PERCENT SOLUTION

- Enhancement in earnings per share
- Liquidity for shareholders independent of their companies
- Optimization of capital structures of companies
- Enhanced performance and reduced business risk
- Ability for shareholders to diversify their portfolios

One Percent Solution strategies are tantamount to applying modern investment theory concepts and basic corporate finance principles to private corporate America.

THE ONE PERCENT SOLUTION

Implement a Dividend Policy

Strategy 1: Implement a regular dividend or distribution policy

Most mature public companies pay shareholder dividends.

Consider obtaining valuation or investment banking assistance in establishing your dividend policy.

Many business owners remember the time when dividends were taxed at ordinary income tax rates. Many have been counseled that dividends are “tax inefficient.” However, until there is a change in dividend tax rates, dividends are just as tax efficient as capital gains.

THE ONE PERCENT SOLUTION

Declare a Special Dividend

Strategy 2: Declare a one-time special dividend

Remember Microsoft's famous special dividend.

Consider obtaining valuation or investment banking assistance to establish the magnitude of the special dividend (and to set a dividend policy for the future).

Sometimes, companies that have been reluctant to pay dividends but, nevertheless, generate more cash from operations than needed to support those operations, allow assets to accumulate on their balance sheets. Think of such assets as “excess assets” not needed for normal business operations. This is a good idea, because they provide a nest egg for a rainy day, right? Wrong.

Excess assets dampen shareholder returns, give management a false sense of security (i.e. misplaced “comfort”), and prevent or delay shareholder diversification.

THE ONE PERCENT SOLUTION

Dividend Recapitalizations

Strategy 3: Implement a dividend recapitalization and normalize the balance sheet.

Recall the recent transaction involving Palm, Inc., the maker of the popular Treo PDA. Palm declared a special dividend, borrowed funds, and even brought in some additional private equity.

This should require qualified legal, accounting, and valuation or investment banking assistance.

Private equity funds have engaged in hundreds of leveraged special dividends (i.e. “dividend recapitalizations”) in recent years. For companies with little or no leverage (or lots of additional leverage capability) and significant cash flow, dividend recapitalizations can be particularly advantageous.

All shareholders receive their pro rata share of the special dividend in a dividend recapitalization and they maintain their pro rata ownership of the enterprise.

Many successful private companies are candidates for this type of transaction with the help of appropriate valuation and financing expertise.

THE ONE PERCENT SOLUTION

Repurchase Stock

Strategy 4: Begin a process of regularly repurchasing stock from shareholders who need or desire liquidity.

Many public companies regularly repurchase stock at current market prices. Also, founders of public companies often sell stock into the market to diversify. Private business owners can accomplish this goal with repurchase programs.

This should require qualified legal, accounting, and valuation or investment banking assistance.

Think for the moment again of companies that generate more cash from operations than necessary to sustain operations. If the owners don't want to declare a regular dividend, the excess cash flow can be used to repurchase stock from shareholders and to "make a market" in the company's stock.

THE ONE PERCENT SOLUTION

Execute a Leveraged Stock Redemption

Strategy 5: Design a leveraged stock redemption to buy out (partially or wholly) a significant shareholder

Many public companies have engaged in leveraged redemption programs.

Should require qualified legal, accounting, and valuation or investment banking assistance.

Does one shareholder desire to sell his interest in a business? Do the rest of the shareholders desire to buy out a particular shareholder? More specifically, does Dad want substantial liquidity but is not ready to sell out and doesn't want to sell the company? Leveraged stock redemptions can accomplish either goal by borrowing sufficient funds to accomplish large repurchases. And like all stock repurchase programs which reduce the shares outstanding, the returns and ownership interests of the remaining shareholders are enhanced.

THE ONE PERCENT SOLUTION

Execute a Combination Redemption/Special Dividend

Strategy 6: Implement a leveraged special dividend and stock redemption transaction.

Should require qualified legal, accounting, and valuation or investment banking assistance.

Transactions can be designed to provide special dividends for all shareholders simultaneously with the total or partial redemption of a significant shareholder.

This transaction has lots of bells and whistles, but is conceptually sound and provides many potential benefits to all the shareholders.

The magnitude of the dividend relative to the repurchase in combination with the purchase price for the redemption determines the ending relative ownership.

THE ONE PERCENT SOLUTION

Partial Management Buy-In/Installment Sale

Strategy 7: Sell stock to management on an installment sale basis.

Should require qualified legal, accounting, and valuation or investment banking assistance.

Is management capable but lacks financial resources to purchase the entire company. Owners may want to support a leveraged buy-in by one or more key managers.

This type of transaction will work if the owner(s) trust management and are willing to extend credit.

This type of transaction can be part of a longer-term plan to sell the business, but at a time when management has a more significant ownership stake.

THE ONE PERCENT SOLUTION

Management Buy-In with Outside Equity

Strategy 8: Sell some stock to management via installment sale and sell additional equity to outsiders.

Should require qualified legal, accounting, and valuation or investment banking assistance.

Don't want to sell the entire company and want management to have a stake? Sell shares to key management on an installment sale basis while simultaneously selling a portion of the company to outside equity holders.

This type of transaction is facilitated by a high degree of trust between all parties.

THE ONE PERCENT SOLUTION

Seek Private Equity Investment

Strategy 9: Locate a private equity partner who wants you to run the business and to have a significant stake in its success.

Should require qualified legal, accounting, and valuation or investment banking assistance.

Some business owners are ready for some liquidity while still running the business. There are a number of private equity funds that specialize in minority investments in private businesses. Others desire control, but do not mind having a key management/shareholder have a significant piece of the post-transaction pie and the potential for a second pay-day in a few years.

THE ONE PERCENT SOLUTION

Conduct a Private Equity Recapitalization

Strategy 10: Sell a portion of stock and recapitalize with a private equity group.

Should require qualified legal, accounting, and valuation or investment banking assistance.

Want to have a current pay-day and the opportunity for future returns on steroids? Sell a significant (minority or control) interest in a business to a private equity group who uses your remaining equity and their cash as the basis to leverage (recapitalize) your business. In these transactions, you get to stay around to run the business for a few years. If successful, the second “pop” can be bigger than the first.

THE ONE PERCENT SOLUTION

Install an Employee Stock Ownership Plan (ESOP)

Strategy 11: Sell a portion of stock to an ESOP.

Will require qualified legal, accounting, other professional and valuation or investment banking assistance.

It is difficult for most companies to engage in a 100% sale to an ESOP. But if the owners are patient and want to work for a few years, it is possible to sell partial interests over time. ESOPs can provide excellent ownership transition vehicles for profitable service companies. And S Corporation ESOPs can be particularly attractive for employee owners.

ESOP transactions are somewhat complex and require the assistance of numerous advisors, including legal, ERISA, administration, valuation, independent trustees, and others.

THE ONE PERCENT SOLUTION

Execute a Private Merger with Partial Redemption

Strategy 12: Merge with another private company, and take out a significant shareholder in the process

Will almost certainly require qualified legal, accounting, and valuation or investment banking assistance.

Many private companies have thought about merging with other private companies, but the difficulties seem just too difficult to overcome. If the shareholders of two companies know each other well, it may be advantageous to design a transaction in which they merge and purchase the shares of one or more shareholders in one or both companies. Private company mergers require excellent valuation advice, probably independently for both companies, or a firm that can work with both companies with integrity. Transactions of this nature are “positioning” strategies designed to enhance future growth.

ABOUT MERCER CAPITAL

Mercer Capital is an employee-owned, independent financial advisory firm. We offer a broad range of business valuation and investment banking services, including financial reporting and tax valuation, M&A advisory, fairness and solvency opinions, ESOP and ERISA valuation services, and litigation support.

For twenty-five years, Mercer Capital has been bringing uncommon professionalism, intellectual rigor, technical expertise, and superior client service to a broad range of public and private companies located throughout the world.

Learn more at mercercapital.com, or give us a call at 800.769.0967.

ABOUT THE AUTHOR

Z. Christopher Mercer (“Chris”) is one of the leading business appraisal experts in the nation. His latest book, *Buy-Sell Agreements: Ticking Time Bombs or Reasonable Resolutions?* is a true *One Percent Solution* tool needed by every business owner and wealth manager. His formal resume can be found at mercercapital.com.

Chris has been talking about the *One Percent Solution* to business owners for many years, and is now bringing the message to wealth managers, as well.

BOOK CHRIS MERCER TO SPEAK

Chris can address your group on the following topics:

- *The One Percent Solution.* This presentation outlines steps for wealth managers and business owners to work together to manage the pre-liquid assets (i.e., wealth in private companies) that will eventually become liquid assets. This session lasts for up to one hour, depending on your needs.
- *Is Your Business Ready for Sale?* A business that is “ready for sale” is more valuable and a lot more fun to run than one that is not. This session, which is informative and compelling, can run from 45 minutes to several hours, depending on your needs and format.
- *Buy-Sell Agreements: Ticking Time Bombs or Reasonable Resolutions?* Buy-sell agreements are some of the most important, yet least examined of corporate contracts. Many dangers are lurking in existing agreements. In this session, which can

THE ONE PERCENT SOLUTION

run from 45 minutes to 3 hours, Chris addresses buy-sell agreements from business and valuation perspectives and outlines how to review your existing or prospective agreements.

- *How to Get Liquidity from Your Business Without Selling It.* Most business owners tend to think of their business ownership in binary terms, either owning them – or not. Chris can talk about many ways to get liquid without selling out so that you can have your business and growing outside liquidity, as well, for qualifying companies.

For availability and booking information, call Barbara Walters-Price or Matt Washburn at 1-800-769-0967.

To book him to speak at your next event, call Barbara Price at 901.685.2120 or e-mail at priceb@mercercapital.com.

FINAL THOUGHTS

- *Share the One Percent Solution with your friends, family members and colleagues.* Receive a 50% discount for orders of 10 or more. Call 1-800-769-0967 to order additional copies of the book, or use the order form in this book.
- *Go to www.mercercapital.com.* Mercer Capital's website is well-known for its content. You will find articles and information that is helpful for wealth managers, business owners, and other advisors to businesses.
- *Send us your comments.* We'd like to hear from you with any comments about the *One Percent Solution*, and about your experiences in discussing the subject with clients or with implementing its ideas. If you have ideas you have for our future reference or for additional books, send me an email: mercerc@mercercapital.com



Z. Christopher Mercer, ASA, CFA
mercerc@mercercapital.com

THE ONE PERCENT SOLUTION

ORDER ADDITIONAL COPIES OF THE *ONE PERCENT SOLUTION*

Name _____

Firm _____

Address _____

City _____

State _____

Zip _____

Phone _____

Email _____

Qty	Price	Total*
	\$14.00	

*TN Residents: add 9.25% sales tax to total.

50% discount for orders of 10 or more

Check enclosed (make payable to Peabody Publishing LP)

Visa

Mastercard

Amex

Card Number _____

Name on Card _____

Signature _____ Exp Date _____

Send to: Peabody Publishing, LP

5860 Ridgeway Center Parkway, Suite 400

Memphis, TN 38120 » 901.685.2120 (P) » 901.685.2199 (F)

\$14.00 U.S.



5860 Ridgeway Center Parkway, Suite 400
Memphis, Tennessee 38120
901.685.2120 (P) » 901.685.2199 (F)

www.mercercapital.com