CHAPTER 1

Buyout Examples

Opportunity is missed by most people because it is dressed in overalls and looks like work.

—Thomas Edison

COPYRIGHTED MATERIAL
http://www.pbookshop.com

Throughout this book I reference many case studies of real companies that have gone through the buyout process. Additionally, there are many illustrations of buyout principles without naming specific companies for confidentiality reasons. Years of speaking and consulting have me concluding that the reference to appropriate case studies is a time honored and preferred means to communicate key concepts. Case studies with real life applications are so much more viable than dry technical narrative.

This first chapter is intended to introduce you to a select number of thought leaders, visionary thinkers, and hands-on business entrepreneurs that illustrate how to roll up your sleeves and work toward accomplishing extraordinary results. In order of presentation we will explore SRC Holdings Corporation in Missouri; SSG Financial Services a public accounting and consulting firm in Ohio; and Quality Assembly and Logistics, LLC in Wisconsin. The last case study is Jumbo Heater and Manufacturing Company, Inc. in Cleveland with some personal lessons learned.

CASE STUDY—SRC HOLDINGS, CORPORATION

Perhaps one of the most celebrated management buyouts of a business is the case of the International Harvester's ReNew Center Repair Division which was started in 1974. The Division became known as Springfield ReManufacturing. Mr. Jack Stack joined the company in 1979 and played an integral

JWBT754-c01 JWBT754-Miller Printer: Courier Westford June 16, 2012 10:55 Trim: 6in × 9in

part in the buyout from Harvester. As part of International Harvester's Construction Group in Woodfield, Illinois, the unit focused on remanufacturing engines and components used as replacement parts in Harvester equipment. In 1981 International Harvester itself was realizing financial difficulties and that stress was making its way throughout the entire organization. A recession was gripping the country and Springfield ReManufacturing was already experiencing a wage freeze.

Jack Stack, General Manager for Springfield ReManufacturing, was thinking of ways to save jobs at the plant. The Springfield ReManufacturing Division was still profitable even as the fortunes of the parent Harvester were deteriorating. The thought of buying the operation from Harvester was broached, but Harvester was having so many of its own problems at the corporate level the proposed buyout was delayed. After a succession of new Harvester managers in a short period of time, the management proposal was lost in the increasing mountain of Harvester problems. Compounding the stress, Harvester placed the Construction Group on the sale block and one large international company was bidding on the bundle of operations. At the darkest hour, Jack was convinced that the plant would be sold to a third party.

The proposed sale kept getting delayed. Jack was aware that negotiations were very complex. Suddenly in the middle of negotiations, Jack received a call from a lead Harvester negotiator stating that talks were at an impasse, and some of the issues involved Springfield ReManufacturing. In reference to an earlier purchase inquiry from the management, the Harvester negotiator said they could have the plant for an additional million over the preliminary offer of $6 million. Jack was "tapped out" for financial resources at $6 million. Virtually all that amount was debt, and finding another $1 million seemed impossible. With his creativity hat on, Jack proposed the extra million be in the form of an unsecured one year note from Harvester to Springfield ReManufacturing. On paper it is an extra million with "terms." Nothing like some delayed payments to overcome lack of cash today. Harvester was Springfield ReManufacturing's largest customer and they could see that repayment on the note was likely. The deal was accepted.

Management succeeded against impossible odds to acquire the business unit and in 1982 SRC Holdings Corporation (SRC) was formed. The structure of the transaction still is haunting today. Management, numbering 13 individuals, in 1983 was able to raise $100,000 in equity between them toward the eventual purchase price of approximately $9 million. When we look at the math SRC was leveraged approximately 89:1 debt to equity. In an era when financial institutions like to see debt to equity ratios of 2:1

http://www.pbookshop.com

or 3:1 it is easy to understand the miracle of SRC. Under the category of "more good news," SRC was in a delicate position of not being able to make any operational missteps due to the heavy debt load. The first year SRC posted an operating loss of approximately $60,000. Employment was maintained among the staff, operations were strengthened and most of the "equity investment" was now on the balance sheet as a debit balance (loss). The SRC stock was valued at just 10 cents a share that first year. A consortium of 13 management investors along with a recently created Employee Stock Ownership Plan and Trust (ESOP) were the new SRC owners.

From those dark moments one may ask what has SRC done in the intervening 30 years since 1982? What began as an engine and components remanufacturing facility has grown into a diversified company with over 12 operating units, annual sales exceeding $350 million, and with over 1,200 employees. SRC has been recognized as one of the top 100 places to work and is acknowledged as a leader in management systems.

http://www.pbookshop.com

Starting at Ground Zero

Jack was fortunate to have a management team that was trusting in its leader, and committed to making SRC a financial success. The team instituted open book management long before it became a popular buzzword on the speaking circuit. Financial information was routinely and openly shared with all the employees. The feeling was that the employee stakeholders were not going to feel like owners unless they were in fact treated like owners. Daily and weekly meetings were held to analyze the financial performance at the plant. Together as a team, obstacles were addressed and solutions found. Methodically, the operational issues on the plant floor and in the administrative offices were vetted and resolved. When you are leveraged 89:1 from a pragmatic standpoint there is only one way to go. At that point decreasing the leverage to 60:1 is a victory. The story is substantially better than that and by 1986 only three years after the buyout, revenue was increasing by 30% annually and sales exceeded $42 million. SRC was flirting with genuine financial respectability.

The Great Game of Business

The success of SRC was becoming legendary. Through the 1980s the company was growing and diversifying. As an employee-owned company they succeeded in building a culture of ownership. All the employees had a direct financial interest in the success of SRC. In 1992 Jack along with Bo Burlingham co-authored the book *The Great Game of Business*

JWBT754-c01 JWBT754-Miller Printer: Courier Westford June 16, 2012 10:55 Trim: 6in × 9in

(Currency/Doubleday), which detailed the shop-proven management strategies and philosophy so instrumental in the financial success of SRC. *The Great Game of Business* was so successful that SRC started an affiliate The Great Game of Business, Inc. to teach the lessons SRC learned on the production floor. One central theme that is emphasized, is why they teach employees how to make money. By insisting on financial literacy, SRC has succeeded in promulgating a spirit of cooperation and ownership. The employees know how important their contributions are to the financial health of SRC and their own financial well being.

Following the first book, Jack and Bo co-authored *A Stake in the Outcome: Building a Culture of Ownership for the Long-Term Success of your Business (Crown Business)* in 2003. This second book details the trials and tribulations SRC experienced since the first book in 1992. The Company was having growing pains and second thoughts about its future as an employee owned business. An employee-owned company is great on paper until the stock of investors has to be redeemed. The stock redemption obligation seemed as a crushing burden to the original investors. They wanted to remain employee owned, but they also wanted to convert their now substantial equity stake in SRC into cash for retirement.

The solution that SRC embraces is to sell more of the stock of departing individual investors to the ESOP. With time the percentage of stock owned by the ESOP has increased. There are substantial tax benefits to both the individual shareholders and the ESOP to encourage more employee ownership. ESOPs are discussed at length shortly.

http://www.pbookshop.com

Looking into the Future

During 2008 SRC was on the cusp of a crucial decision. SRC had grown into a complex company with many business units and management wanted to have a structure that enabled the employee teams within the various units to have some significant control over their future. If it made sense, SRC would sell a business unit to its employees, in much the same spirit as Harvester sold SRC to its employees. SRC elected to have the ESOP acquire the last of the outstanding shares of individual investors and is today a 100% ESOP Company.

Having the ESOP as the sole shareholder enables the Company to access the vast financial benefits of being an S corporation. SRC is able to redeem the stock of departing employees and recycle it to the remaining stakeholders. The Company has succeeded in building and maintaining an ownership culture. Hundreds of companies representing thousands of employees have journeyed to Springfield, Missouri to learn the Great Game of Business.

JWBT754-c01 JWBT754-Miller Printer: Courier Westford June 16, 2012 10:55 Trim: 6in × 9in

Only those that are interested in building long-term value and a culture of ownership will likely find the investment in time and money worthwhile. Jack Stack and his team have demonstrated a serious flaw in short-term thinking and chasing financial results of the moment.

CASE STUDY—SSG FINANCIAL SERVICES

The public accounting firm of Saltz, Shamis, and Goldfarb (now SSG Financial Services) was founded in 1987. The principals of the firm were concerned that in that era the traditional and conservative career path for many certified public accountants (CPAs) was to be promoted into the partnership as an equity holder or leave the firm. This "up or out" protocol was challenging to the SSG partners, and they wanted to think about options to this potentially hostile employee environment. Many accounting professionals don't want to become "partners" because of the professional commitments, demands, and liabilities that come with the territory. In the world of changing family values and with a high percentage of women CPAs, the up or out philosophy was hurting the profession in the opinion of Gary Shamis, President of SSG.

SSG believed that providing a career path for CPA professionals with a competitive compensation program without becoming a traditional equity partner was a worthwhile goal. Embracing this non-traditional approach to the team was attractive to the partners because it provided SSG with a distinctive brand literally not seen in the profession.

In 1996 SSG introduced what is technically a non-qualified stock purchase program (Plan). The concept is to allow the professionals to purchase "stock" in SSG. Partners Gary Shamis and Mark Goldfarb worked on the Plan along with a compensation consultant to refine the details. The non-qualified stock purchase program is in essence a phantom equity plan. Participants have to acquire the "equity" in SSG with their own after-tax dollars. From the beginning days:

- Eligible participants had to be CPAs (based on existing Ohio law barring non-CPA ownership).
- Participants had to meet a minimum employment period.
- Full time and part-time employees are eligible.
- 90 percent of the investment is unsecured debt with a fixed interest rate.
- The balance of the investment is in non-voting stock.
- There is a minimum investment required.

http://www.pbookshop.com

JWBT754-c01 JWBT754-Miller Printer: Courier Westford June 16, 2012 10:55 Trim: 6in × 9in

The Plan provides for participants leaving the employment of SSG, voluntary withdrawals for personal circumstances, and there is a non-competition agreement.

Impact of the Plan

When the Plan was introduced SSG had approximately 80 employees centric to the Akron-Cleveland area. Today the firm has grown to over 400 professionals in multiple offices throughout Ohio and Kentucky. Gary Shamis contributes the dynamic growth and financial success of SSG in large measure to the approach of treating their associates as partners.

The risks of introducing the Plan at first were numerous. Remembering the Plan was introduced in 1996, this "outside-the-box" thinking was not part of the CPA profession's career protocols. Most partners are loath to share any information regarding the financial performance of their firm, let alone with just staff members. It was believed that staff members would not responsibly handle the confidential financial information being shared. Since the Plan was voluntary, non-participation could be embarrassing to individuals and damaging to the moral of the firm. A catastrophic legal judgment against the firm would put the investments at risk.

The SSG partners considered these issues at length but decided that the benefits would outweigh the disadvantages. There are many positive aspects that tipped the decision in favor of installing the Plan. The professional staff members understand SSG has two distinct career paths. One career path is the traditional one that culminates in an equity ownership in the firm. The second path offers a career to those professionals that want to be affiliated with SSG and still have a lifestyle compatible to their needs. According to Gary Shamis the SSG professionals are distinctive from those of competitors because they are also owners, imbued with an ownership outlook. The commitment to the firm-client relationship is reinforced because of the employee investment that has been made. Due to the Plan, everyone may share in the success of the firm. Ohio law has subsequently been changed permitting non-CPAs to be shareholders in the firm. The invitation to become an owner is now extended to all eligible employees.

http://www.pbookshop.com

Intangible Benefits

The SSG partners had a "gut" feeling that installing the Plan would have a disproportionately favorable impact on the firm. Treating all associates as partners including part time professionals; has been exceedingly beneficial. Many outstanding professionals have stayed with SSG for that very reason. Gary Shamis notes that the structure of SSG is advantageous in recruiting

JWBT754-c01 JWBT754-Miller Printer: Courier Westford June 16, 2012 10:55 Trim: 6in × 9in

because SSG offers an immediate opportunity for new associates to participate in the success of the firm. The value of the stock in the Plan is a function of the dividend that is paid, and also the growth in cash receipts. SSG has been growing at a double-digit rate since the Plan was introduced. This has led to an attractive increase in the value as everyone is focused on providing the best client service and developing new business opportunities.

Several important lessons have been learned according to Gary Shamis. You cannot assume that the financial benefits will be self-evident. The advantages of the Plan have to be carefully and repeatedly communicated to the employees. The existence of the Plan is intended to be a winning circumstance to SSG and the employees. This commitment to communication is a lynchpin with other firms that have embraced employee participation with similarly positive results. The Plan needs to be communicated as an attractive investment vehicle for the future of the employees. Address what the firm will do with the influx of investment cash; in the case of SSG the capital is committed to growing and expanding the firm. The Plan is a “buy-in” program for those employees that want a part of the ownership of SSG.

Looking into the Future

SSG maintains equity participation for select individuals, which follows a more traditional public accounting firm template. Professionals will be invited to participate at this level. When the principals retire or leave SSG, their equity is redeemed according to a shareholder agreement. Professionals that aspire to this level of responsibility are most often those that have also elected to make an investment in SSG through the Plan. The connection with ownership, commitment, and professionalism combines to make SSG one of the leading employers in the region.

The recent recession has momentarily slowed the historically strong growth rate. Gary Shamis believes that the attributes of SSG are so strong that they will continue their trajectory of continued growth. Currently one of the largest public accounting firms in the region, SSG continues to think “outside the box” and is affiliated with the Leading Edge Alliance of like minded public accounting firms.

The creative thinking by the leadership at SSG and their approach to the professionalism of their entire team sets the groundwork for expected continued success. SSG has expanded into many other service areas not necessarily associated with being a CPA. The open culture and having the Plan is an invitation to a wide range of career minded individuals that SSG offers an attractive future of significance. With over 400 motivated associates the likelihood of continued success is assured. When asked if he

http://www.pbookshop.com

and his partners had any regrets regarding the Plan, Gary Shamis had one: "Not starting the Plan sooner." Gary Shamis, meet Jack Stack.

CASE STUDY—QUALITY ASSEMBLY AND LOGISTICS, LLC

In a garage in 1979, founder Mr. Dave Brandt started Engineering Research and Design Associates (ERDA) with five employees making specialized lightweight seating for the airline industry. This is a classic entrepreneurial initiative started with little more than some good ideas and enthusiasm. With time ERDA grew and branched into specialized manufacturing and assembly with particular expertise in the medical industry in addition to the airline seating focus. In 2000 the Company was acquired by DeCrane Aerospace, Inc. (DeCrane) largely for its airline seat manufacturing expertise.

DeCrane manufactures interior products and completion kits for aircrafts as well as systems integration for aircrafts. DeCrane works within a broad spectrum of the various facets of the aviation industry including commercial airlines, military applications, individual aircraft owners, and original equipment manufacturers (OEMs). In 2009 Mr. Guy Meyerhofer, Vice President of the DeCrane Seating Division, approached DeCrane about the possibility of acquiring the ERDA Division. Mr. Meyerhofer was interested in the opportunity to acquire the Division and determined a price he was willing to pay. The Division was profitable, but it ceased to be a strategic fit for DeCrane.

There are several attractive attributes of the Company including ISO 9001 Certification, which is indispensable when negotiating with large quality-conscious accounts. The Company also employs Kanban point-of-use inventory. Kanban is a visual signaling system to trigger action on the production floor. The system reduces waste, provides quick responses to changes, and provides the tools for ongoing review of production processes. They are Food and Drug Administration Registered, Electrical Testing Laboratories Certified, and Underwriters Laboratory Certified. They occupy a modern facility with 56,000 ft of floor space in Marinette, Wisconsin. The location provides for virtually unlimited expansion opportunities.

Mr. Meyerhofer was tasked with putting in place an offer acceptable to DeCrane. He partnered with Generation Growth Capital, Inc. (Generation) in Milwaukee, Wisconsin who provided some of the financing for the buyout. The Company was renamed Quality Assembly & Logistics (QAL), LLC. in 2009, in concert with the buyout. Mr. John Reinke, Managing Director with Generation, indicated they took a flexible approach to financing the

http://www.pbookshop.com

JWBT754-c01 JWBT754-Miller Printer: Courier Westford June 16, 2012 10:55 Trim: 6in × 9in

QAL management with the buyout. The assets were acquired from DeCrane using a combination of equity provided by management for a controlling block of common stock; an investment in preferred stock by Generation that carried a dividend and warranted for a percentage of the QAL stock; proceeds from a local bank and assistance from Marinette County and Marinette City.

Generation's flexibility was particularly helpful in putting all the financial pieces in place. Their investment in Preferred Stock was the equity needed to permit the debt leveraging provided by the bank loan package. QAL has an option to redeem the Generation Preferred Stock and common stock warrants once certain financial goals have been met. According to Mr. Reinke, "Generation provided financial assistance to the QAL management so that with time they will own the Company. The business plan will take several years to complete, but QAL is growing and remains under local management control." QAL is an integral part of the Marinette business community thanks to the team approach and long-term vision provided by the financial partners.

http://www.pbookshop.com

Success Factors

For those following the timeline, QAL was acquired at the height of the recession in 2009. The Company was negatively impacted by the recession as most other businesses. During this time there were very few management buyouts, particularly in the risk-averse heartland. If the transaction was going to be completed with the retention of many skilled employees, the buyout needed to be accompanied with a significant amount of equity financing provided in a manner allowing the management to retain control during the buyout period.

Generation understands the core capabilities of QAL and knew the management was capable of strong cost and quality controls. The prospects for growth would provide QAL with an exit from the acquisition leverage with time. If QAL was capable of increasing sales and profitability, and needed additional capital to grow, Generation is in a position to understand the requirements and structure a growth continuance that is a winning situation for management, Generation, and the community.

Management has financial goals that enable it to redeem the equity interest of Generation upon an agreed process. This creative approach allows management to best direct the operations of the Company while Generation is a non-controlling financial partner. Generation's interest may be redeemed without the Company having to be sold through an auction process that puts control of the Company into the hands of a potential buyer that may

JWBT754-c01 JWBT754-Miller Printer: Courier Westford June 16, 2012 10:55 Trim: 6in × 9in

over-leverage the business and destroy it. The flexibility provided by Generation is a lynchpin to the success of this management buyout. While a budgeted period of time has been planned to redeem the equity interest of Generation, that timeline is not absolute. If QAL requires additional time and resources to complete the transition, the partnership with Generation will provide for that. The management buyout of QAL in the middle of a recession is unusual. The overall structure of the transaction relates to a middle market company and it was accomplished with reasonable leverage. When so many buyouts of the 2000s are in trouble due to overly optimistic or unrealistic projections, having a pragmatic perspective will serve Generation well going forward.

The longer-term time horizon is already paying dividends. The flexibility accorded the management proved to be a tremendous benefit when QAL found an opportunity to acquire a complementary line of business in 2011. Just a short time following the leveraged buyout, QAL went back to its primary financial backers and secured additional resources to purchase what is now called QAL Medical. QAL Medical produces Continuous Passive Motion (CPM) devices that assist patients in the recovery following joint surgery such as knees, hips, ankles and toes. QAL did its financial homework demonstrating the strong complimentary fit with the acquisition and the current product line. QAL Medical completed the ISO 13485 certification further enhancing their commitment to quality. With the addition, approximately 20 new jobs were added at the Marinette plant. The acquisition is assisting QAL with some needed product diversification. While the QAL Medical acquisition was accomplished with additional debt, the added profitability of the CPM products puts QAL on track to manage all its financial obligations.

http://www.pbookshop.com

CASE STUDY—JUMBO HEATER & MANUFACTURING COMPANY, INC.

Founded in Cleveland, Ohio just after World War II, the company specialized in the design, manufacturing, and distribution of cast iron soil pipe plumbing specialty fittings. The founder returned from military service and was one of the few members of his generation to have a college degree. With modest financial assistance, Jumbo Heating and Manufacturing Company, Inc. (Jumbo) was started occupying an old building in the heart of the industrial landscape in Cleveland. Enjoying the economic bounce following the end of the war, the business steadily grew and an old but dedicated facility was purchased in 1957. Jumbo featured a line of proprietary soil pipe

JWBT754-c01 JWBT754-Miller Printer: Courier Westford June 16, 2012 10:55 Trim: 6in × 9in

fittings each designed and patterned after standard industry specifications. The process of bringing new products to market included rendering a design and delivering the hand-drawn design to a pattern maker to produce a master wood rendering of the product. The wood master is then used to produce aluminum production tooling that was shipped to cast iron foundries to make the rough green sand castings. The castings were shipped to the main facility where they were tapped and threaded as required and inventoried for eventual shipment to customers.

With time the cast iron soil pipe industry began to feel the pressure of competition from other types of materials, particularly PVC plastic. The cast iron foundries were coming under increasing scrutiny from the Environmental Protection Agency (EPA) as sources of air and ground pollution. At best Jumbo was going sideways financially during the 1960s, and the future was challenging. While the company was financially surviving, the family was able to provide outstanding educational opportunities for the children. The founder was a heavy smoker and living in industrial Cleveland compounded an already dire health environment. Upon graduation from an MBA program, the son had no interest in returning to Cleveland and assuming the leadership of Jumbo. He knew little about the business, and there was always friction with his father. As the founder's health began to fail, the son decided to return and learn the family business. Owning a business was a long-term goal of the son and there was this family company waiting for an heir apparent. The Company consisted of an antiquated manufacturing facility and a separate foundry in another state.

http://www.pbookshop.com

Tensions and Failure

The return of the son provided a brief respite from an otherwise bleak financial future. The product line was rapidly becoming obsolete, the EPA was proactive against most foundries for pollution related issues, there were few resources to invest in new products to remain competitive, and the health of the founder continued to deteriorate. The declining financial circumstances of Jumbo were a source of frustration for the son. The founder was hesitant to risk personal assets that had been carefully saved and set aside for retirement. Without such a commitment, the future of the company was particularly bleak. The son soon realized the lost cause and began to consider career options. After a promising start, the reality of a lack of attention to re-investment and the corresponding product obsolescence came back to haunt the family. Another opportunity presented itself and the son eventually resigned from Jumbo, moved to another state, and started a new career in business. Broken-hearted and in failing health, the founder succumbed to

cancer within another year. Before his demise Jumbo was sold to an investor for a bargain price with the assistance of an astute business intermediary that was knowledgeable about foundries.

LESSONS LEARNED

Not all of the case studies in this book have happy endings. If you have not guessed, the founder's name was George Miller, father of Scott Miller, the author of this book. From this personal tragedy, there are some strong take-away lessons. It is always helpful to try and see both sides of a story. Jumbo's demise is a result largely of failed communication.

Dad pulled back from his industry and did not attend a trade association meeting for countless years. Isolated and withdrawn, he lived in the past and could not imagine how to deal with changing circumstances. His key "advisor" was an old family attorney even more removed from the world of current trends and out of touch with the needs of a succession strategy. The attorney had known the family from the days of my grandfather and his plumbing and mechanical contracting company (circa 1920s).

Dad had developed a "circle the wagons" mentality. This is a perspective of just holding onto the financial resources that have been pulled out of the family business, never to reinvest them if at all possible. The risk appetite was gone, and Dad just wanted to coast and enjoy his remaining days at peace drawing a modest return from the business he spent his career building. It was not fair that the market was passing him and posing a threat to his hard-earned wealth. This is the creative destruction aspect of our market-based capitalistic economy. It was not fair to my dad that the market was migrating away from cast iron plumbing fittings; however, it was great news for injection molding companies manufacturing PVC plastic pipe.

My heartfelt advice to all business owners is replete throughout the pages of this book. It is essential that business owners address the topic of succession planning with earnest and focus. Fulfilling your personal dreams and goals is possible with diligence and an acute awareness that things do not stand still for very long in our dynamic economy. Surround yourself with the best advisors you can find and afford. I think they overwhelmingly pay for themselves if you elect to listen to the voice of experience.

Privately held middle market companies occupy a strategic position in our economy building wealth for owners, employment for associates, and a future of hope for our economy. I hope you enjoy this book. It is available because my decision was made years ago to flex my intellect, embrace my own dreams and work diligently and with passion for a cause that I fully embrace.

http://www.pbookshop.com

JWBT754-c01 JWBT754-Miller Printer: Courier Westford June 16, 2012 10:55 Trim: 6in × 9in

SUMMARY

This chapter should have you thinking about buyouts both from the standpoint of what is possible and also from the view of what can go terribly wrong. The emphasis is on the positive with special care to indicate some best practices that will lead to successful buyouts.

http://www.pbookshop.com

http://www.pbookshop.com