Practitioner Perspectives

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Top 10 Liquidity Lessons From Thoroughbred Racing

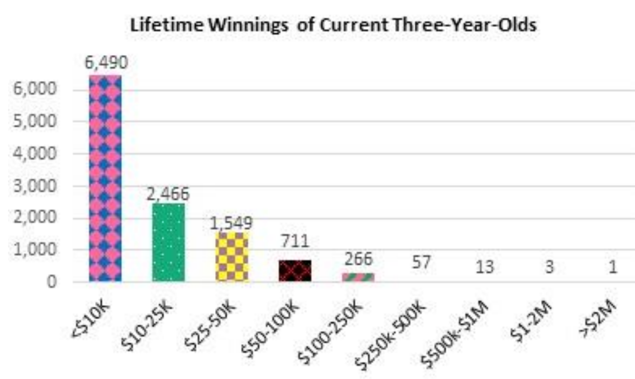
1. ***Define your goals: do you want to win the Triple Crown, or just enjoy the Owners' Box?***
2. ***Understand your risk tolerance; even promising horses catch bad breaks***
3. ***Educate yourself on the total cost of achieving your goals weighed against expected returns***
4. ***Handicap ability to get there: Do you have the right team and resources?***
5. ***Price in opportunity cost; investing in one area precludes placing other bets***
6. ***Pedigree isn't everything; modest bloodlines have produced big winners***
7. ***Mix it up; what got you to this point may not get you where you want to go***
8. ***Increase your odds of success by bringing in outside capital and expertise***
9. ***Time the market to come out when you have the best mix of results and visibility***
10. ***Have a backup plan; plenty of great turf horses began as Kentucky Derby hopefuls***

Handicapping Liquidity Options for Small Business Owners

- Small business set-asides helped start a lot of businesses, but a lack of clear transition paths has orphaned many of the best performers
- Increased buyer scrutiny of SBSA work and novation uncertainty are resulting in lower purchase multiples and more deal structure
- With cash at closing converging with the expected cash flows from the backlog, owners are seeking alternative paths to liquidity
- ESOPs are a popular option, with their noble "employee-owned" claims and ability to pass administrative costs on to the government
- Maintaining a "lifestyle" business below the SBSA thresholds and pursuing a dividend recap are simpler ways to get cash out the business
- Mergers of equals, management buyouts, and growth equity infusions can help achieve both liquidity and enterprise value accretion goals

Running for the Roses

Each May, owners of promising three-year-old Thoroughbreds find themselves dreaming that they have a legitimate shot at winning the Triple Crown and go all-in. Others, acknowledging the extremely long odds of winning it all, count their blessings that they have made it this far and approach the spring meet with an eye on opportunities to take money off the table. It is no different in federal contracting, where owners of small businesses appreciate the challenges of transitioning to a prime, full and open (F&O) portfolio on their own, and are increasingly looking for paths to liquidity beyond an outright sale. Buyers are skeptical of any small business set-aside (SBSA) work, with some even saying they prefer being a sub on F&O work over priming SBSA awards, and are employing lower multiples and/or deal structure if they bid at all.



Represents total lifetime winnings for the 11,556 Thoroughbred horses foaled in 2014 with at least one North American start as of May 1, 2017. The distribution mirrors that of federal contractors segmented by total revenue.
Source: Equibase

Fractional Ownership

Horse owners pay large sums of money for yearling horses, and then compound that with the cost to feed, care for, and train a Thoroughbred horse. Knowing how hard it is to beat the odds – defying injury and bad luck – many owners choose to syndicate their holdings by selling fractional shares in individual horses. Syndication enables an owner to trade some immediate liquidity (downside protection) in exchange for less upside potential (because it is now shared with additional owners). The horses have the same odds of success after the transaction, but payouts have been reset. This is analogous to federal contractors contemplating an ESOP transaction. The ESOP limits their upside, but provides near-term liquidity by sharing the risk with their employee shareholders. Employees, like smaller horse syndicate owners, are buying a piece of the upside they could not have had on their own.

Switching Stables

If a horse is not living up to expectations or progressing fast enough on the path to Churchill Downs, owners often change trainers and/or jockeys, mixing styles to find the right combination. Similarly, in federal contracting, companies often realize that the team that has gotten them this far will not get them where they want to go. Other owners try to compensate for weakness in their organization by actively courting merger of equals transactions, in hopes that – like coupled entry horses – the two contenders can compete better together than either could on their own. If all else fails, owners can move the horse to shorter distances or turf races where the purses are smaller, but the competition is lighter. Likewise, some federal contractors are shrinking back under the SBSA thresholds to increase odds of a return, albeit a smaller one.

Stripping the Bond

In addition to purses, the breeding rights for Thoroughbred horses can be quite lucrative and in some cases, they can be worth many times a horse's lifetime winnings. Owners of several high-profile horses, most notably *American Pharoah* in 2015 and *Irish War Cry* in 2017, have sold off breeding rights on the eve of big races in order to hedge their bets. Owners of federal contractors similarly are turning to dividend recaps – taking on debt to pay themselves a dividend – to take chips off the table. More exotic moves – like management buyouts and growth equity infusions – can accomplish these liquidity goals, while also bringing new partners to the table to help with growing the business. *American Pharoah* went on to win the Triple Crown, leaving money on the table, but when *Irish War Cry* drew a terrible post in The Kentucky Derby and finished out of the money, the move looked prescient.

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