

The Leveraged Recapitalization



PRESTWICK
Partners

By Ingo Schulz and Fritz Richards

An Alternative Path to Liquidity

Most business owners have invested considerable time and effort in growing their organizations into valuable entities. As a consequence, much of an entrepreneur's net worth is often tied up in his/her illiquid business. Most business owners hope to one day cash in on their hard work and generate liquidity, but it is not always black and white. In some cases, the business owner is not ready to retire, and his/her business is just beginning to approach a level of profitability that would justify an outright sale. In other situations, the business is family-owned, and ensuring succession and continuity of the enterprise is a top priority. Other issues arise when the business owner needs liquidity, but does not want to lose operational control, or is concerned about the future of the enterprise under new ownership.

Conventionally, creating liquidity for a business owner can be accomplished by taking the company public, selling to a strategic or financial firm, establishing an employee stock ownership plan, or executing a debt recapitalization. Each of these strategies, while creating a cash payout, has drawbacks such as loss of control and increased regulation. As a result, many business owners end up doing nothing or forestalling an exit plan, thereby leaving their personal net worth at risk.

An often overlooked strategy for reducing risk while providing liquidity is a leveraged recapitalization ("recap") transaction. The leveraged recap is a financial transaction that provides liquidity to existing shareholders by reconfiguring the capital structure of the company's balance sheet. Generally, the business owner partners with an outside financial investor or private equity group that recapitalizes the balance sheet with an infusion of equity and bank debt. Typically, the existing shareholders exchange 30 percent to 80 percent of their equity for cash, while the private equity group acquires the remaining ownership of the company. The resulting scenario allows the business owner to diversify the composition of his/her net worth and reduce his/her risk profile, while maintaining significant ownership and operational interest in the company.

What are the Benefits of a Leveraged Recap?

The leveraged recapitalization has become a favored transaction for both business owners and private equity investors in today's deal environment for a number of reasons:

- **Liquidity** – Often, business owners need liquidity for estate-planning purposes or retirement, but they do not have a desire to sell the company outright. A leveraged recap provides the owner significant liquidity, and allows the owner to diversify personal assets while maintaining a significant ownership stake in the business.
- **Retained Management and Control** – A common drawback to the outright sale of a business is the loss of operational control and/or loyal management and employees. When a business is sold to a strategic acquirer, the company is often

absorbed and the need for the management team goes away. Similarly, financial buyers sometimes like to install new management teams with industry experience. Private equity groups that participate in recapitalizations usually require the management team to stay with the company in order to achieve continued growth. The private equity group generally has board representation, but the day-to-day operating control is almost always vested in the existing management team.

- **Elimination of Personal Liability** – Partnering with a well-capitalized private equity sponsor and accepting a minority equity position allows a business owner to eliminate personal liability. Because the business owner usually has personally guaranteed the bank debt held by the company, the leveraged recap shifts the debt liability of the business into the hands of the private equity group post-recapitalization.
- **Favorable Succession Planning** – Family and closely controlled businesses account for over 80 percent of all businesses in the United States. A common theme for family business succession revolves around the founder’s retirement and his/her children and/or family members seeking to run the business afterwards. In a leveraged recap, the founding equity holder is able to liquidate his/her equity in the company while allowing his/her family to partner with a new equity sponsor who can provide stewardship for the next generation of owners.
- **Opportunity for a Subsequent Liquidity Event** – Because the business owner retains a meaningful ownership stake in the company post-recapitalization, he/she stands to generate a second liquidity event when the company is re-sold. In general, the private equity group wishes to hold the company for three to seven years before exiting the investment. Depending on the performance of the company during the investment period, this second payday can be substantially larger than the cash payment the business owner received from the initial recap transaction.
- **Partnership With an Experienced, Growth-Oriented Private Equity Group** – A lot of business owners pass up growth opportunities because of lack of capital or willingness to take on additional exposure. A private equity group’s business is to recognize and capitalize on growth opportunities, and they will provide continuous guidance and capital to pursue growth initiatives.

How does a Leveraged Recap Work?

The preceding benefits of a leveraged recapitalization can be better demonstrated through the following example:

Assume ABC, Inc. is a private, family-owned manufacturing company with sales of \$38 million and earnings before interest, taxes, depreciation and amortization (“EBITDA”) of \$5 million. The main shareholder of ABC, Mr. Smith, is 65 years old, nearing retirement, and his personal investment in the company represents the majority of his net worth.

Although Mr. Smith believes ABC has strong growth prospects, he has become risk-averse when faced with new growth opportunities due to his significant financial exposure. In addition, Mr. Smith has four capable family members who are employed by ABC, and are fully expecting to take over the business when he retires. ABC currently has \$6 million of senior bank-debt on its balance sheet, which Mr. Smith has personally guaranteed.

Mr. Smith engages Prestwick Partners to perform a market-based valuation of ABC, Inc. and identify a well-capitalized private equity group interested in partnering with him to affect a recapitalization transaction. Prestwick Partners advises Mr. Smith that \$30 million (6.0x EBITDA) is a full and fair valuation for his company. Prestwick Partners and Mr. Smith interview several private equity groups that are interested in sponsoring the recap transaction. Mr. Smith ultimately decides to partner with PE Partners, a private equity group that shares his strategic vision for ABC's future.

It is determined that ABC can support total debt of \$18 million, consisting of \$12 million of senior debt and \$6 million of mezzanine debt. The equity required to finance the transaction is \$12 million – \$8 million (66.7 percent) will come from PE Partners as a cash purchase of new equity of ABC and \$4 million (33.3 percent) will be Mr. Smith's retained equity in ABC.

Leveraged Recapitalization of ABC, Inc.
(\$ in Thousands)

ABC Company Value	\$30,000	100.0%
 Capital Structure of Recapitalized ABC:		
New Senior Debt	12,000	40.0%
New Subordinated (Mezzanine) Debt	6,000	20.0%
Total Debt	18,000	60.0%
New Equity: PE Partners (66.7%)	8,000	26.7%
New Equity: Business Owner (33.3%)	4,000	13.3%
Total Equity	12,000	40.0%
Total Capital	\$30,000	100.0%

Mr. Smith's pre-tax cash distribution from the transaction is \$20 million – \$30 million less the \$6 million of existing bank debt and his \$4 million investment in ABC.

Pre-Tax Proceeds to Seller
(\$ in Thousands)

Transaction Value	\$30,000
Less:	
Existing Bank Debt (Pre-Recap)	6,000
Retained Interest in ABC	4,000
Pre-Tax Proceeds to Seller	\$20,000

In the foregoing example, Mr. Smith receives \$20 million in cash, retains 33.3 percent of the recapitalized company, and is freed from personal guarantees of bank debt. PE Partners now owns 66.7 percent of ABC and is looking to Mr. Smith's family to run the company and ultimately grow ABC over the next three to seven years, at which time the enterprise will be sold.

Immediately following the recap, ABC has \$18 million of debt. The management team and PE Partners believe that over the next five years, ABC's EBITDA will grow at a compound annual rate of 10 percent to reach approximately \$8.0 million. PE Partners conservatively estimates that ABC will have approximately \$4 million of remaining debt at that time. If the company is sold, the business owner stands to receive 33.3 percent of the equity value of ABC. Assuming ABC is sold at the end of year five for \$48 million (6.0x EBITDA of \$8.0 million), the resulting equity value after paying off the \$4 million of debt is \$44 million. Mr. Smith's 33.3 percent share equates to \$14.7 million, representing 3.7x his \$4 million retained interest (an annual return on investment of approximately 30 percent).

Is a Leveraged Recap Right for my Business?

The leveraged recapitalization is a useful financial tool that can be used to meet the specific needs of business owners seeking both liquidity and retained ownership. It is estimated that the private equity community controls over \$450 billion of uninvested capital, much of which is earmarked for investments in leveraged recapitalizations. In addition, there is a strong interest among the nation's lending institutions in this investment class, as lenders are more willing to provide capital when the business owner is financially devoted to the investment. However, business owners should be well advised when contemplating a recap. Choosing financial partners and a capital structure that will allow a business to grow and prosper are critical to the success of any financial transaction, particularly those involving debt financing.

About Prestwick Partners

Prestwick Partners is a boutique investment-banking firm founded to provide middle-market companies with merger and acquisition advisory services. Prestwick represents companies in a variety of transactions, including (i) sales of entrepreneur-owned businesses, (ii) private equity group divestitures, (iii) corporate divestitures, and (iv) strategic and financial advisory assignments, including acquisitions and business valuations.

For more information about our firm and our practice, please contact us or visit our website at www.prestwickpartners.net.

PRESTWICK PARTNERS, LLC

212 Third Avenue North ~ Suite 535 ~ Minneapolis, MN 55401

Fax 612.339.6124

Ingo Schulz
612.339.4232
ingo@prestwickpartners.net

Mike Groppetti
612.339.2118
mike@prestwickpartners.net

Fritz Richards
612.339.6115
fritz@prestwickpartners.net

David Santoni
612.339.3130
david@prestwickpartners.net