

Leveraging The Leveraged Recapitalization

Many business owners have spent decades building a business and now seek for the first time to reap some of the financial fruits of their labor. Often, middle-market business owners have the bulk of their personal net worth tied up in one asset—the company. Other times, groups of shareholders may have very different personal objectives, with some wanting to reinvest to grow the business and others wanting to exit and sell their shares. A leveraged recapitalization can solve many of these issues, including:

- transferring a business from one generation to the next and funding tax liabilities
- achieving portfolio diversification, when the majority of a shareholder's net worth is tied up in the business
- attracting growth capital
- solving differing shareholder objectives, allowing the buyout of select shareholders
- achieving shareholder liquidity, while still preserving the family business and protecting the jobs of employees

How Leveraged Recaps Work

In a leveraged recap, a business attracts new capital to provide significant liquidity to some or all of the existing shareholders. New capital can be in the form of debt, or a combination of both debt and equity or other related financial instruments such as mezzanine. In general, these transactions allow shareholders to:

- take substantial cash off the table
- retain significant ownership
- continue to run/manage the business
- obtain new growth capital

In most cases, a leveraged recap involves a private equity group (PEG). The PEG uses a combination of cash (from its investment fund) and bank debt to finance the acquisition. The business owner retains a meaningful equity position in the company (typically 20 to 40 percent), which is intended to provide a second liquidity event or "second bite of the apple" in the future. Finally, the PEG will likely provide some incentives to members of the management team, allowing key employees to invest alongside them, and perhaps, creating a stock option plan. Clearly there are some key attributes a company must have to make the leveraged recap attractive for the PEG who, by the way, will be looking to generate an internal rate of return (IRR) in excess of 25 percent on the investment. They include:

- a strong management team
- a history of growth and profitability
- realistic growth opportunities
- a defensible market position
- predictable cash flows (to support leverage)
- an un-levered balance sheet

- a viable exit strategy—sale to strategic buyer or initial public offering or another recap

Valuations for leveraged recaps are heavily influenced by the availability of debt financing, the future growth potential of the company, and the likely strategy for exiting the investment five to seven years down the road. In 2003, the average multiple of EBITDA paid in middle-market (< \$100M transaction value) leveraged buyouts was 6.3x EBITDA of which 3.8x was financed with debt instruments (senior debt, mezzanine etc.)

The Benefits

One thing to bear in mind, if the PEG is making a 25 percent IRR on its investment, so too is the business owner on his or her retained stake. This second bite of the apple, combined with the cash taken off the table at the time of the recap, can provide an overall value to the business owner far in excess of what might have been achieved had he or she sold the company outright to a strategic competitor. Furthermore, the owner has provided for continuity of the business, security for the employees, a significant ownership opportunity for the management, and at the same time, watched the company flourish and reach its full potential.

Leveraged recaps may not be suited to every situation, but if the circumstances are right, they can provide a viable, and valuable, alternative to business owners wrestling with the decision to sell their company.

Source: This article was written by Stephen McGee and Christopher Kampe, finance directors, [Grant Thornton](#), and originally appeared in Grant Thornton's Dealmaker publication.