

Using Recapitalization To Unlock Value In Privately Owned Companies

Many business owners and their professional advisors often overlook a viable alternative when considering a transition in ownership—the leveraged recapitalization, typically referred to in industry parlance as a "recap."

With today's improved merger and acquisition market and increased valuations for privately owned companies, many business owners are considering selling their company to gain liquidity for the asset that usually represents the majority of their wealth.

Generally, most successful privately owned companies are worth more than their book value. This higher value or "going concern" value is attributable to a company's ability to generate consistent earnings and cash flow growth over an extended period of time. A recap can be a feasible alternative in the right circumstances to access this value.

Reconsidering Recaps

A recap can be very attractive for owners who are bullish on the future of their businesses and want to retain a meaningful ownership interest with the opportunity to receive yet another payoff in the future when the financial sponsor (private equity firm) sells its position. The proceeds from the recap and subsequent sale can often exceed the value obtained through a sale.

In addition to obtaining substantial liquidity to diversify personal assets, a business owner will continue to operate the business with considerable autonomy (many sponsors will even accept minority ownership positions) and gain access to capital needed to support future growth.

Simply put, a recap is a restructuring of a company's balance sheet. The financial sponsor will arrange new senior bank debt and perhaps subordinated debt in addition to providing the bulk of the equity to consummate the transaction. The owner's stock will be exchanged for cash and a portion of the capital stock of the newly capitalized entity. The end result is a substantially different capital structure for the company going forward.

Ample capital is readily available for recap transactions. The owner's continuing involvement in the business makes recaps of great interest to private equity firms. Today, many are actively pursuing recap investment opportunities.

Each private equity firm has its own unique investment criteria but, in general, they seek established companies with consistent revenue and earnings growth, a significant market share or niche position, experienced management teams and projected operating results that meet or exceed historical results.

It is particularly important to select the right private equity firm and make sure their interests are closely aligned with the owner's. It must be viewed by all concerned as a mutual partnership.

An all senior debt-based recapitalization may in some cases be feasible, but it is absolutely essential to make certain the resulting capital structure leaves the company properly positioned to conduct its operations with a satisfactory margin for error.

Favorable Market Conditions

Several positive trends indicate the continuation of a healthy leveraged recapitalization market, although rising interest rates could have a detrimental impact. Credit markets eased quite substantially during 2004, increasing the availability of financial leverage. Strategic acquirers continued to focus on divesting assets and reducing costs rather than acquisitions, to achieve earnings growth. Private equity firms and subordinated debt funds have available \$100+ billion in committed capital to deploy.

A Recap Scenario

The following is a common recapitalization scenario (Exhibit #1—A Recap Scenario):

A company with 7% annual revenue and earnings growth for the past six years is expecting 9% growth in the future having just added two major customers. EBITDA was \$5 million for the most recent fiscal year. In addition to solid operating margins and predictable cash flows, it has a defensible market position, minimal debt and capital expenditure requirements and working capital needs are moderate. Most important, it has a highly experienced management team.

A Recap Scenario		
<ul style="list-style-type: none">• Valuation of \$34 million for 100% of the company is acceptable to all parties• Owner desires to own 40% of the company which requires a reinvestment of \$5.2 million		
New Capital Structure		
Senior debt (3.2 X EBITDA)	\$16M	47.1%
Subordinated debt (1.0 X EBITDA)	\$5M	14.7%
Equity	\$13M	38.2%
Total	\$34M	100.0%

Exhibit 1

Assuming the business was debt-free at the time of the transaction, the owner would receive a pre-tax cash payment of \$28.8 million (\$34 million less the \$5.2 million reinvestment) and own 40% of the company. This 40% ownership position could be worth an additional \$21 million or more upon the sale of the company in year five if the projected growth is attained.

To Recap Or Not To Recap

A leveraged recapitalization is not suitable for every company. A sale to a strategic acquirer may still be preferable. However, as business owners and their professional advisors consider the merits of a sale of the company the many benefits of a leveraged recapitalization (liquidity, wealth diversification, continuing ownership, growth capital and a "second bite of the apple") should be given serious consideration.

Source: This article was written by Franz von Bradsky, President, [Green Tree Capital](#) and originally appeared in [ACG/Mergers & Acquisitions](#).