

Private Equity Recapitalizations: Selling Your Business Twice

Enrique C. Brito, CFA, AVA, CM&A

INTRODUCTION

At some point in the lifecycle of a business, most owners wrestle with the decision of whether they should sell or remain working in their growing business. What most business owners probably do not realize is that there is a way of accomplishing both objectives, namely, to sell the business and still have the opportunity to participate in its future growth.

There is a financial technique known as private equity recapitalization ("recap") which allows business owners



ENRIQUE C. BRITO,
CFA, AVA, CM&A

the opportunity to cash out of their businesses while staying involved in the management and decision making if they so desire. Best of all, this technique also allows them the opportunity to take a 'second bite at the apple' when the business is sold in the future. As such, this

is an important tool that provides business owners with growth and liquidity options.

EQUITY RECAPITALIZATIONS DEFINED

A recapitalization is a transaction which results in the reallocation of the debt and equity in the capital structure of a business. It represents an attractive option for owners considering an exit because it lets them exchange some of their equity for cash and position the company for future growth.

In an equity recapitalization a private equity investor buys out most, but not all, of the owner's interest in the business. This allows the owner the opportunity to unlock some of the value tied up in the equity of the company and creates a liquidity event for what is probably the largest portion of his/her net worth. An added

benefit is that it gives the owner the opportunity to remain involved in the operation and decision making process of the company, or alternatively, to phase out over time. Moreover, when the investor sells the business at some point in the future, the owner sells the remaining equity thus participating in the upside of a second liquidity event.

In addition to the benefits to the owner, recaps also provide management teams the opportunity to participate in the equity of the business when they do not have the capital to do so. Since private equity investors usually require and actively seek the support of the management team, it is likely that they may offer top management the opportunity to participate in the equity of the business either in the form of a buy-in and/or earn-in basis.

Overall, equity recapitalizations as a financial strategy offer numerous advantages including increased owner liquidity, continued ownership, risk minimization and enhanced growth opportunities among others. Top management also benefits in this process as opportunities are created for them to become shareholders in the business.

THE PROCESS OF A RECAPITALIZATION

When a shareholder in a private company wants to liquidate his/her investment, the remaining shareholders are often first presented with the opportunity to purchase these shares. If the value of the ownership interest being sold exceeds the company's available cash resources, then another source of capital is required. In this situation, it is up to the remaining shareholders to determine whether they would prefer to finance the buyout with debt or with equity.

In the event that the company's capital structure and cash flow can support additional debt, the remaining shareholders are probably better off financing the buyout with debt, as this is usually the least expensive and easiest to ar-

range source of capital. However, if debt (senior or subordinated) is not available to the company, then the shareholders must find other source(s) of capital, often from an equity investor.

For the most part, private equity investors in a recap will seek to buy a controlling interest (at least 51%) in the company. To finance the deal, equity investors typically use "mezzanine debt securities" generally in the form of subordinated debt with equity-based options (warrants). In essence, mezzanine debt is a hybrid between senior debt and equity, both in terms of structure and cost. Under normal market conditions, subordinated mezzanine debt usually carries a coupon between 12% and 14% and is generally rated by Fitch within the 'B' category. It ranks junior to bank loans and (usually) high yield bonds. When the coupon rate is combined with the return from the equity warrants, the total cost/return of the mezzanine debt is usually in the low to mid twenty percent range. As the company grows, its earnings are used to pay off the mezzanine investment or to replace it with lower cost senior debt.

CONCLUSION

As baby boomers continue to retire in record numbers over the next five to ten years, many business owners will begin to consider alternatives to exit their businesses.

For some, an equity recapitalization will become a very viable option, enabling them to modify the company's capital structure in such a way that is consistent with their plans and objectives as well as those of the company.

As explained in this article, a private equity recapitalization makes it possible for business owners to achieve partial liquidity for their interest in the business, while continuing to participate in both the operations of the business and its upside potential. The management team also benefits as they can become shareholders in the company. And, most importantly, the business will have the financial resources required to support its future growth.

About the Author: Enrique C. Brito, MBA, CFA, AVA, CM&A is a managing director of The Mclean Group, a private investment bank providing merger and acquisition, valuation and private equity financing services. He has over 17 years of corporate finance and investment banking experience and lectures nationally on the subjects of business valuation and M&A. He can be reached via e-mail at ebrito@mcleanllc.com or call 703-827-5093