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Recapitalization: Have Your Cake and Eat it Too

A successful business owner nearing retirement faces a number of issues. Perhaps it is time to take some chips off the table, reduce personal exposure, attend more closely to the family, enjoy more leisure time and feel more secure. Wouldn't it be great if all of these objectives could be achieved while still retaining day-to-day control and a meaningful equity interest? And, get a trusted financial partner, reward a loyal management team with equity incentives, provide for the next generation, and get access to additional growth capital in the bargain. If all of this sounds like having your cake and eating it too, well, it is. The vehicle to reap these rewards is leveraged recapitalization.

A business recapitalization is a useful financial tool which can be applied to solve a myriad of ownership issues. A business recapitalization is much like a home equity line of credit. It allows the homeowner to retain ownership while unlocking market appreciation in the equity by employing additional debt. The same familiar principle applies to a business recapitalization when debt is employed to leverage the equity to meet business objectives or resolve ownership issues. These issues might include a younger partner buying out a retiring partner, cashing out contentious outside shareholders, settling disagreements among shareholders, asset diversification and liquidity for a majority shareholder or providing for a generational transition. A key objective might be reducing personal financial exposure to the business by refinancing without guarantees or personal collateral while all the while retaining control and a meaningful ownership position.

Since leverage has its limitations, most business recapitalizations include a sale of some portion of the equity to new investors. In recent years these investors have been found in the form of private equity groups looking to employ a mountain of capital. In addition to buyout capital, and in most cases, growth capital, the private equity group also provides professional investment management directed toward maximizing value to shareholders. Accordingly, the recapitalized company gains access to capital and expertise. Moreover, a company running at higher debt levels tends to be run more efficiently since attention to detail and strict operating controls are needed when dealing with long-term credit providers.

How it Works: A Case Study

Dan and Linda Spencer own a successful manufacturing business, Spencer Wire & Cable, in Kansas City. Linda is spending more time with the grandchildren at the couple's Florida home and Dan is thinking of a way to cut his workload and perhaps even retire. The Company has a good management team. Dan knows of several growth opportunities but is reluctant to pursue these because of capital constraints and his desire to slowdown.

From a financial perspective, the Company has enjoyed several years of steady and growing cash flow protected by a large amount of proprietary engineering content in the products. The Company was founded in 1985, and over the years has become debt free. With good cash flow and a strong balance sheet, Dan believes he could get $40 million for the business. As the eternal entrepreneur, however, he can't keep his mind off those opportunities and the well-being of his dedicated and loyal employees.

One day over lunch with a friendly local investment banker, Brett, Dan explains his thoughts and concerns about the Company. Brett suggests that he consider a leveraged recapitalization in partnership with Leverage Partners, a local private equity group.

Brett explains how Leverage Partners will buy 80% of the Company with debt, hence the name Leverage, and equity, mostly in the form of preferred stock. Leverage Partners proposes an asset purchase to buy 80% of the Company for $32 million using $20 million in debt, $10 million in preferred stock and $2 million in equity contribution. The before and after comparative balance sheets ($'s, 000's) for the transaction appear as follows:

Assets	**Before**	**After**		**Liabilities & Equity**	**Before**	**After**
Cash	500	500		Accounts Payable	2,465	2,465
Accounts Receivable	6,200	6,200		Accruals	480	480
Inventory	4,900	4,900		Total Current Liabilities	2,945	2,945
Prepaids	150	150				
Total Current Assets	11,750	11,750		Long Term Debt	0	20,000
Net Fixed Assets	8,000	14,000		Preferred Stock	0	10,000
Goodwill		9,195		Equity	16,805	2,000
Total Assets	19,750	34,945		**Total Debt & Equity**	19,750	34,945

On the asset side, fixed assets are "stepped up" to fair value and the transaction results in $9 million of goodwill. Note on the right side, the new long-term debt, preferred stock and equity of the new company post acquisition. Moreover, Leverage Partners likes Dan's ideas for new opportunities and has set aside $7 million of additional growth capital and agrees to a 10% management incentive equity interest for the existing management team.

Dan likes the idea of banking $32 million (before taxes and transaction costs), still owning 20% and having the nice folks at Leverage Partners as his new partners. Dan gets some time off, has a war chest of additional capital, and the very real prospect of a "second bite" at the apple when he and Leverage Partners make the next sale five years from now.

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