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Anatomy of a Leveraged Recap

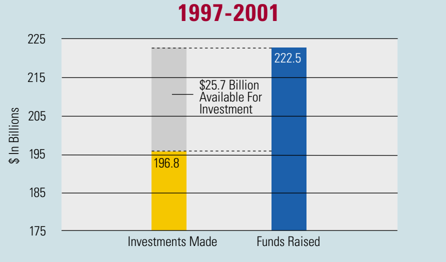
A leveraged recapitalization is an alternative for unlocking illiquid wealth in private companies.

by Mark D. Working

The mergers and acquisitions environment has slowed to a crawl. Twelve to eighteen months ago, business owners enjoyed an environment in which strategic buyers aggressively pursued acquisitions of privately held businesses. Armed with a mission of growth and highly priced stock as buyout currency, public companies aggressively gobbled up acquisitions, often at excessive prices. For most of a decade, there was a ready market for owners of privately held businesses to harvest the fruit of their entrepreneurial investments of capital and effort. Now, with the retrenchment in the stock market, strategic buyers have refocused their energies on core business lines and have begun to sell businesses instead of adding. Efforts have been redirected towards slimming costs and improving profits in order to revitalize stock prices.

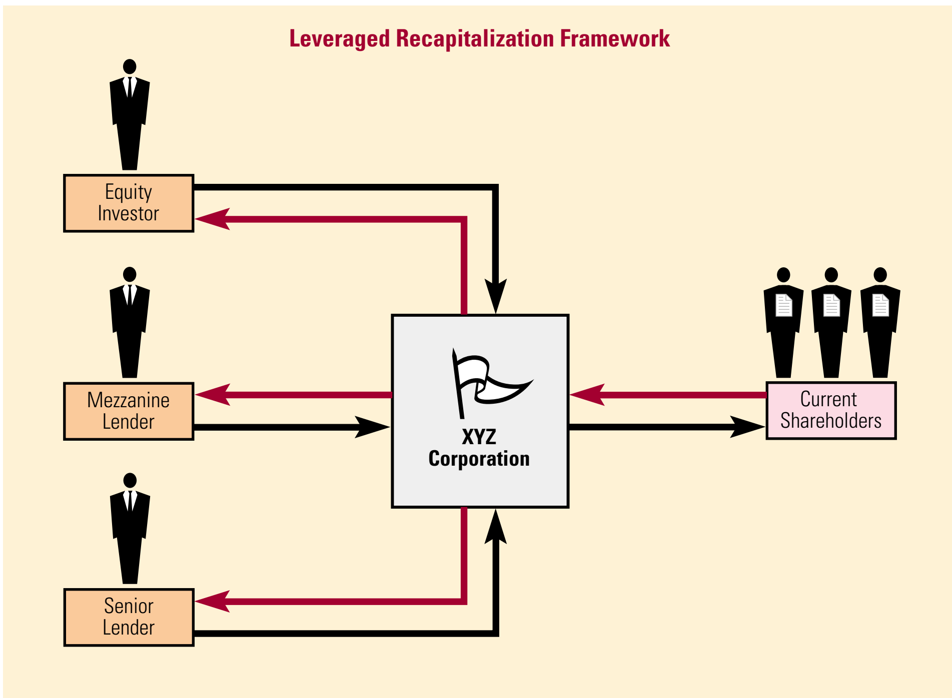
Until the mid-90's, many private company owners turned to private equity firms to lead leveraged recapitalization transactions to enable them to convert a portion of their illiquid equity interests in the business to cash. In recent years, private equity investors were often left on the sidelines as a result of not being able to compete with the values paid by strategic acquirers. Today, as strategic acquirers have pulled back in the midst of the economic downturn, private equity investors are licking their chops at the opportunity to make investments. With funds employed trailing funds being raised, financial investors have amassed significant war chests that they need to put to work.

Buyout Funds Raised and Invested 1997-2001



Source: Venture Economics

Leveraged Recapitalization Framework



A leverage recapitalization or "recap" offers owners an opportunity to achieve two often conflicting objectives: (a) satisfying the business' need for capital to fund its continued growth and (b) reducing the owner's personal risk.

HOW DOES A RECAP WORK?

A recap is commonly used to monetize the illiquid wealth that has accumulated in many private businesses. In a recap, liquidity is unlocked by distributing to owners the proceeds of a combination of debt financing and equity provided by third-party financial investors. Unlike an outright sale, a leveraged recap enables selling shareholders to keep a meaningful share of the equity in the company and often continue to manage the business. The key elements of a recap include (a) an agreed value for the business, (b) access to debt capital (possibly both senior and mezzanine), and (c) an equity investor. A typical transaction works as follows:

1. Consider a hypothetical company with the following attributes:

- Total enterprise value of $100 million (amount of debt + value of equity), which represents a 5X multiple of cash flow (EBITDA) of $20 million
- No debt on the balance sheet pre-transaction
- Modest future growth and reinvestment requirements

2. In today's credit markets, it would be possible to borrow senior debt equal to 2.5X EBITDA and another 1.0X of mezzanine debt. This implies the following debt structure:

	AMOUNT (MILLIONS)	EBITDA MULTIPLE
Senior Debt	$50.0	2.5X
Mezzanine Debt*	20.0	1.0X
Total Debt	$70.0	3.5X

*Includes warrants for 7.5% of the post transaction equity

3. The full $70MM of debt financing would be paid out to the current owners, leaving an equity value of $30 million ($100 million enterprise value, less $70 million of debt).

(continued p.2)

4. In order to fully compensate the mezzanine lenders, they would be granted a 7.5% equity position (typically in warrants). This leaves $27.75 million (92.5% of $30 million) of equity value for the owners. If the original owners wish to maintain a 30 percent equity interest, then new private equity investors will be required to invest $18.75 million. In return, these investors will receive a 62.5% (92.5% less 30%) interest in the business. This $18.75 million is also paid out to the original owners. The resulting ownership of the "recapped" company would be:

	VALUE OF HOLDINGS	OWNERSHIP	EBITDA MULTIPLE
Equity Investors	$18.75MM	62.5%	.94X
Mezzanine Warrants	2.25MM	7.5%	.11X
Existing Shareholders	9.00MM	30.5%	.45X
Total Equity	$30.00MM	100.0%	1.50X

5. As a consequence of the recap, the original owners are able to extract $88.75MM in cash (debt proceeds of $70MM and equity proceeds of $18.75MM), while retaining a 30 percent equity interest.

WHEN DOES A RECAP TRANSACTION MAKE SENSE?

A recap, as opposed to an outright sale, is most appropriate when the owners of a business want to take some chips off the table but don't want out of the game. By setting aside some of the wealth they previously created, owners can focus on aggressively building the business without risking everything.

Theoretically, a recap can be made to work on any business, but it is not a good fit in every situation.

Oftentimes, the reduced pressure allows owners to take prudent risks that benefit the business in the long-term. And, when the business grows, they have an opportunity for a second payday when the business is sold.

Theoretically, a recap can be made to work on any business, but it is not a good fit in every situation. In reality, there are two critical variables that determine the feasibility of a recapitalization: (a) borrowing capacity, and (b) the value of the business relative to its current financial performance. Debt capacity is crucial because of its lower cost relative to other forms of capital. In most situations, funding for the recap is heavily weighted toward debt. In today's conservative credit markets, arranging financial leverage (senior and mezzanine debt) of greater than 3.5X EBITDA is difficult to accomplish. With this constraint, the higher the enterprise value is as a multiple of EBITDA, the greater the reliance on equity to fund the recap. As the proportion of the capital structure supplied by equity investors increases, the average cost of capital increases and this requires the business to generate an ever-higher expected growth rate in operating cash flow (and value) to pay investors the return that they require.

Business owners should bear in mind that a recap entails the formation of a long-term business relationship with an equity investor where all the attendant issues of personality and compatibility, control, and governance, investment horizon, and exit strategy will come into play.

This doesn't mean that certain businesses are not worth a high multiple. It does, however, suggest that a leveraged recapitalization is more difficult to structure when valuation multiples much exceed 5X EBITDA.

Apart from basic economic feasibility, there are a number of design considerations and complexities associated with structuring recap transactions, including the appropriate level of financial leverage relative to ongoing capital investment needs, sustainability of the cash flow and /or cyclicity of the business. Finally, business owners should bear in mind that a recap entails the formation of a long-term business relationship with an equity investor where all of the attendant issues of personality and compatibility, control and governance, investment horizon, and exit strategy will come into play. The prospects for a successful recap are much stronger when there is a good philosophical fit among shareholders, management and equity investors. ❖

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ABOUT ZACHARY SCOTT

Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities, and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott, please go to ZacharyScott.com.

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