



Leveraged Recapitalization

An Alternative Liquidity Tool for Private Business Owners



BDO Dunwoody Limited
Transaction Advisory Services



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A leveraged recapitalization can be a useful tool in solving a number of transaction related objectives often faced by private business owners, including:

- *Providing wealth diversification when an owner's net worth is tied up in only one asset;*
- *Facilitating the transfer of the business to the next generation;*
- *Funding tax liabilities associated with family succession;*
- *Allowing for the buyout of selected shareholders with differing objectives; and,*
- *Attracting outside capital to fund future growth.*



Business characteristics that determine suitability usually include:

- *Demonstrated history of positive cash flows;*
- *Evidence of a strong management team;*
- *A defensible market position;*
- *The ability to increase market share through inorganic growth (acquisitions);*
- *Realizable future growth plans;*
- *Positive market dynamics – participating in a fragmented industry and/or the ability to enter untapped markets; and,*
- *A clear exit strategy.*

Private business owners, who in many cases have spent their entire adult lives building their companies, have the opportunity to realize a significant return on their efforts without having to sell 100% of their ownership. The combination of strong middle-market valuations and the continued availability of leveraged debt and equity mean that shareholders can consider transactions other than an outright sale to a financial or strategic acquirer.

In particular, owners faced with: (a) the majority of their wealth concentrated in their businesses, (b) retirement age approaching with potential succession issues, or (c) fellow shareholders with different personal objectives such as reinvestment for growth versus sale, are prime candidates for a leveraged recapitalization transaction.

What is a Leveraged Recapitalization?

A leveraged recapitalization is a transaction that introduces outside capital from a debt provider, and potentially an equity sponsor (i.e., a private equity firm), allowing a private company owner to create liquidity and diversify holdings while at the same time maintaining either a majority or minority ownership in a company. The residual ownership also allows the seller to financially share in the upside of the company via a “second bite of the apple” in the event of a future sale or liquidity event.

Recapitalization Criteria

Leveraged recapitalizations are generally financed based upon the future potential of a company. Private equity investors, in particular, need to see that the business has considerable future prospects in order to achieve their required returns.

Not every business is a viable leveraged recapitalization candidate. The primary requirement is the ability to utilize debt, including asset-based and cash-flow based (mezzanine) financing, to fund the transaction. This means companies, which already have a highly leveraged capital structure, or that operates in an industry where debt is difficult to obtain, should carefully consider all options prior to pursuing a recapitalization transaction.

Example of a Leveraged Recapitalization

The following example of a leveraged recapitalization offers further insight into mechanics of the transaction.

Company XYZ is a privately held corporation that manufactures laboratory equipment. The company is owned by five shareholders, each having 20% of the outstanding stock. Two of the owners, who are in their late 60's, have stopped participating in the day-to-day operations of the company and would now like to exit their position. The company is using only a small portion of a revolving line of credit, and has no other debt obligations. An outside advisor suggested to the ownership team that a leveraged recapitalization might provide the available capital to cash out the two departing shareholders without significantly impacting future operations.

From a financial standpoint, the business has \$80 million of annual revenue, \$12 million of Earnings before Interest, Taxes, Depreciation and Amortization (“EBITDA”) and \$5 million of outstanding long-term debt. The company has experienced steady growth over inflation in the past several years but remains susceptible to annual price cuts due to strong competition in the marketplace. An outside firm provided a third-party valuation, placing the enterprise value (value of equity, less cash, plus long-term debt) of the company at \$70 million.

After assessing the situation, the advisor has recommended that the recapitalization transaction be funded through a combination of senior bank debt and mezzanine financing. Given the valuation and a lack of leverage in the business, the remaining

shareholders do not need to introduce outside equity into the transaction. The debt financing would be as follows:

- \$15.5 million in a revolving credit facility;
- \$11.5 million term loan amortized over 5 years; and
- \$9 million of mezzanine financing with principal payments due in years 6 and 7.

Together this package will leave the company with a total debt-to-trailing twelve month EBITDA ratio of 3.0 times.

The final recapitalization transaction results in \$26 million paid to the two shareholders for their 40% equity interest (\$70 million enterprise value less \$5 million in debt, multiplied by 40%). The remaining \$10 million in debt is used to cover current working capital needs of \$5 million and \$5 million is set aside for any further capital requirements.

Private Equity Investors

In many situations, senior debt alone will not provide sufficient capital to satisfy the liquidity needs of ownership as well as the growth requirements of the business. In such cases, an outside equity and/or mezzanine provider can be brought into the transaction. The most prominent class of outside investors is middle market focused private equity funds. Due to the proliferation of funds that target the middle market, both the pricing and the quality of the terms have improved recently.

The typical equity investor will seek a majority ownership in a company, but will allow the owner or existing management to maintain day-to-day control. A private equity investor may consider a minority stake, but would usually require voting control or agreements providing for control in the event of major decline of the business. Depending on the risk associated with the investment, they may invest through a secured convertible debenture that would provide them with additional remedies in the event of default.

Private Equity Firm Analysis

In the event that private equity is required, business owners should ensure that the selected equity partner provides more than the best dollar terms. Below are questions which will help to establish whether the selected investor will not only close the transaction, but also add value after the closing.

What is their transaction record? How long have they been in business; what types of companies do they invest in; for how long; and with what experience?

What is their relationship with their financing sources and limited partners? New relationships can become anxious if there is an economic downturn, resulting in a push for a faster exit than originally anticipated. On the other hand, if investor capital is continually reinvested into a private equity firm's new funds and financing relationships are long-term, then patience will be exercised in the event of short-term negative results.

What is their record of closing transactions? With the length and complexity of due diligence process, how often and why have transactions not closed?

Will they let you talk to the companies they have invested in? What kind of partner have they been once the transaction is completed?

What is their portfolio strategy? Is it short term or long term? Are they hands-off or activist investors? Can they tap foreign markets? Do they have in-house experts who can assist in building the business?

The Benefits

Beyond providing liquidity to selling shareholders or diversifying wealth for a sole, private business owner, a leveraged recapitalization's largest benefit lies in the opportunity to share in the future success of the company. This second bite of the apple, combined with the cash taken off the table at the time of the recapitalization, 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. Furthermore, the owner has provided for continuity of the business, security for the employees, and a significant ownership opportunity for the management team.

Ultimately a leveraged recapitalization transaction 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 a decision to sell their company.



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