BDO CANADA TRANSACTION ADVISORY SERVICES INC.

# LEVERAGED RECAPITALIZATIONS

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# PRIVATE BUSINESS OWNERS SPEND MUCH OF THEIR WORK LIVES BUILDING THEIR COMPANIES. WHEN IT COMES TIME TO RETIRE, THEY MAY BE ABLE TO REALIZE A SIGNIFICANT RETURN — WITHOUT SELLING 100 PERCENT OF THEIR OWNERSHIP.

A leveraged recapitalization uses new third-party debt and, potentially, equity from a private equity investor to facilitate a partial liquidity event. If a private equity investor is involved, ownership will transfer. The proceeds of the transaction can be invested by the owners as a way of wealth diversification, and the owners may share in a future liquidity event based on their retained ownership.

Owners are particularly prime candidates for a leveraged recapitalization transaction when:

- The majority of their wealth concentrated in their businesses
- Retirement age is approaching and there is not a clear succession plan
- Fellow shareholders have different personal objectives, such as reinvestment for growth

## Recapitalization criteria

Leveraged recapitalizations are generally financed based on the future potential of a company. Private equity investors must see that the business has considerable future prospects to achieve their required returns.

Not every business is a viable candidate. The primary requirement is its ability to utilize debt, including asset-based and cash flow-based financing, to fund the transaction. Companies that already have a highly leveraged capital structure, or operate in an industry where debt is difficult to obtain, are not good candidates.

### A USEFUL TOOL

A leveraged recapitalization can help solve several transaction-related objectives for private business owners, including:

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

## Private equity investors

When senior debt alone will not provide sufficient capital to satisfy the liquidity needs of ownership, and the growth requirements of the business, an outside equity and/or mezzanine provider can be brought into the transaction. Due to the proliferation of funds that target the middle market, combined with the limited number of recent transactions, both pricing and terms of mid market-focused private equity funds have improved recently.

Typical equity investors usually seek a majority ownership in a company, but allow the owner or existing management to maintain day-to-day control. Private equity investors who consider a minority stake would usually require voting control or agreements providing for control in the event that the business suffers a major decline. Depending on the risks associated, they may invest through a secured convertible debenture that would provide additional remedies if there is a default.

## Private equity firm assessment

If private equity is required, business owners should ensure that the selected equity partner provides more than the best dollar terms. To help establish whether the selected investors will add value after the closing, one may consider the following:

- What is their transaction completion record?
- How long have they been in business?
- In what types of companies do they invest, for how long, and with what experience?
- How are their relationships with their financing sources and limited partners?
- Can you speak with the management of the companies in which they have invested?
- What kind of partners are they once transactions are completed?

## CASE STUDY: LEVERAGED RECAPITALIZATION

Company XYZ is a privately-held corporation that manufactures laboratory equipment. It is owned equally by five shareholders, two of whom would like to exit their positions. Since the company is using only a small portion of a revolving line of credit and has no other debt obligations, an outside advisor suggested that a leveraged recapitalization might provide the available capital to cash out the departing shareholders without significantly impacting future operations.

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. Despite steady growth over inflation in the past several years, the company is susceptible to annual price cuts due to strong market competition. A third-party valuation from an outside firm placed the enterprise value (value of equity, less cash, plus long-term debt) $70 million.

The advisor recommended that the recapitalization transaction be funded through a combination of senior bank debt and mezzanine financing. Given the valuation and lack of leverage in the business, the remaining shareholders do not need to introduce private equity into the transaction, and the debt financing would be as follows:

- $15.5 million in a revolving credit facility
- $11.5 million term loan amortized over five years
- $9 million of mezzanine financing with principal payments due in years six and seven

Together, this package will leave the company with a total debt-to-trailing 12-month EBITDA ratio of 3.0 times. The final recapitalization transaction results in $26 million paid to the two shareholders for their 40 percent equity interest ($70 million enterprise value, less $5 million in debt, multiplied by 40 percent). The remaining $10 million in debt is used to cover current working capital needs of $5 million, and the remaining $5 million is set aside for any further capital requirements.

- What are their portfolio strategies — are they 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 quicker?

### The benefits

A leveraged recapitalization's largest benefit is the opportunity to share in the future success of the company. Future sale proceeds, combined with money received at the time of recapitalization, can provide an overall far greater value to the business owner than if 100 percent of the company was sold initially.

### CHARACTERISTICS OF SUITABLE BUSINESSES

- Demonstrated history of positive cash flows
- Lack of pre existing bank debt
- Evidence of a strong management team
- A defensible market position
- Ability to increase market share through acquisitions
- Realizable future growth plans
- Positive market dynamics

Until the final liquidity event, the owner provides for continuity of the business, security for the employees, and a significant ownership opportunity for the management team. A leveraged recapitalization transaction may not be suited to every situation but, if the circumstances are right, it can provide a better alternative to debating whether or not to sell your company.

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