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(see highlighted text for quotes from James T. Dwyer of MPI Securities)

Eat your cake and have it, too

The leveraged recap can be a viable alternative to selling the family business – especially when the company still has good years ahead.

BY MIKE COHN

Phil Burns had built his machine tooling business in southern California from modest beginnings in a rented warehouse. After 30 years, the private company was a leader in its industry, with more than \$100 million in sales. The company needed to expand and had identified an attractive business in Europe that could be acquired for a reasonable price. The target company also had relatively new equipment that could be easily modified to grow the company's burgeoning international business.

Phil's daughter was the company's CFO and in a few years would be ready to take over the company. Phil was excited about his company's prospects but also concerned that most of his net worth was tied up in the family business. At 67, Phil was approaching retirement and sometimes worried about having most of his financial chips still "in the game." He knew he could sell the business but wasn't ready to take that step. His company's potential European acquisition would require his personal guarantees for the financing. Uncharacteristically, Phil found himself waffling on the decision to buy the European company.

Across the U.S. in Connecticut, Jeff Horton confronted a different dilemma. His dad had been a brilliant entrepreneur who invented an ingenious box that preserves the freshness of bakery products. After running the business for some five years, Jeff (not his real name) grew increasingly concerned about his dad's procrastination regarding succession planning. Business was good, and the company was growing rapidly. But Jeff worried that if something happened to his dad, he'd have to buy out his five siblings who weren't involved in the business.

Something did happen. Jeff's dad died unexpectedly of a heart attack, leaving no estate plan. Suddenly, Jeff was in hock both to the IRS (for his father's estate taxes) and to his siblings (for their stock, if he hoped to continue running the company). Jeff's dream of growing the business into an industry leader seemed to be vanishing into a hopeless welter of family, tax and legal problems.

Not so hopeless after all. Instead of an all-or-nothing, buy-or-sell choice, both these cases were solved by a *leveraged recapitalization*, a financial device that enables strapped, entrepreneurs to eat their cake and have it, too. The leveraged recap is essentially the same transaction as selling the business, with one difference: The family is selling less than 100%.

For Phil Burns, the leveraged recap allowed him to sell 80% of his company and create personal liquidity, reduce his financial risks and diversify his assets. At the same time, Phil continued to run his company, acquired the European business, retain a 20% stake in his company's future and continue to prepare his daughter to succeed him as CEO.

Jeff Horton used the leveraged recap to raise capital to buy out his siblings. With the problem resolved, he negotiated with the IRS to finance the payment of his dad's estate tax over a 15-year period.

Leveraged recaps aren't exactly new. They emerged from the early leveraged buyout days of the 1980s. They're popular for two reasons, says Jim Dwyer of MPI Securities in Princeton, N.J.: First, equity investors have learned that a number of successful private company owners want liquidity but also want to participate in the future growth of their businesses.

Second, accounting rules historically have been more attractive to an investor group when a company did a leveraged recap as opposed to an outright sale (although these rules have changed). A leveraged recap didn't require goodwill to be recognized, which enhanced the value of a business if going public was a possibility. Alternatively (under the old Financial Accounting Standards Board rules), when a company was sold, goodwill was recorded and amortized over 40 years, with a negative impact on the income statement. (The new rules liberalized how goodwill is treated on sales of businesses; differences between goodwill and the income statement are called "impairments.")

Who are these people?

Leveraged recaps are often financed by private equity groups, such as the New York-based ZS Fund, which raises its capital in a series of funds, primarily from wealthy investors such as Pittsburgh's Hillman family and from institutional investors such as Chase Capital. Another private group, de Visscher & Co. of Greenwich, Conn., used the resources of Philadelphia's Pitcairn family to help launch its Family Capital Growth Partners limited partnership. Heritage Partners was formed by a group from BancBoston who saw an opportunity to invest in middle-market companies.

These equity groups are investors who generally seek 25% to 35% annualized rates of return on their investments. Most of the targeted return is projected from a "value-realizing event" by selling, refinancing or taking the company public after five to seven years. Up-front fees (1% to 2%) and an annual coupon or dividend during the investment period are two additional sources of return for the investment group but are generally a small portion of their overall return. A leveraged recap fund will invest in several companies in order to gain diversification for its own investors and reduce its risks. The minimum investment may be as low as \$3 million but typically is \$10 million or higher.

Bob Horne of the ZS group characterizes ZS and similar investor groups as strategic/financial partners, not operators. "We sit on the company's board and help with strategic decisions such as acquisitions, and through our resources we can provide growth capital," Horne says.

Are you a candidate?

When your family is ready to sell its business (for whatever reason), you're probably better off selling the whole business instead of just a piece through a leveraged recap. And if the business still has "good years" left in it (as the leveraged recap investors envision), why not assemble a good board, get the right people to run the business, arrange the necessary financing and keep 100% of the equity for yourself? In these cases, the leveraged recap seems a rather expensive way to do the same thing, since it "costs" your family the upside appreciation on the 50% to 80% of the value of your business that's sold to the investor group. If your family can grow the company better than the leveraged recap people can (and why can't you, since the investors don't claim to be operators?), your family might as well keep 100% of the equity and enjoy the full appreciation for your efforts.

On the other hand, if some outsider is willing to pay your family a fair price for that 50% to 80% stake, and it will enable your relatives to sleep better and diversify their assets, that may be an important emotional reason to want a financial partner. What's more, the financial partner may push needed changes through the organization that the family, for whatever reason, cannot. If your company needs that kind of push, read on.

The criteria for attracting the attention of an investment group vary, but typically it takes \$5 million to \$25 million of pre-tax operating profit, a strong management team, a high return on capital relative to the company's industry peers and a strong market position.

Since most entrepreneurs are debt averse, they find the leveraged recap especially attractive, because it puts cash in the owner's pocket on a non-recourse basis. Non-recourse means the family receiving the funds won't be liable for any debt that the company incurs (although, to be sure, the family gives up a sizable chunk of its stock instead).

Horne warns that the leveraged recap is not for the entrepreneur who needs absolute control or believes his or her business has peaked. "Our ideal candidate is confident in their own abilities, is receptive to having a partner and welcomes what a partner can bring to them," he says. "They learn that, after the transaction, day-to-day life is the same."

Horne notes that only about 5% to 10% of the businesses in which ZS invests already have credible long-term business plans and forecasts. What matters most is an owner who knows her business, enjoys an industry niche and boasts a good track record. With those fundamentals in place, a business plan can usually be developed in the course of the due diligence process – for the bank, for the new equity partner and for management to understand expectations.

Due diligence

Due diligence is a two-way street. It serves both the business owner (to find the right partner) and the equity fund (to ensure that the investment makes sense).

For the business owner, it should involve a search to determine which investment group you can best "partner" with. Some equity funds will invest only if they can buy a majority interest –

usually 50% to 80% – in your business. Others will accept a minority interest. Some will want a more active role; others will be more of a silent partner. So, before you start shopping for an equity investor, you may want to hire an investment banker or assemble an advisory team to help you pick the right partner. You might want to work with a strategic partner instead of an equity investor to help you realize your goals, notes Jim Dwyer of MPI Securities. A partnership with a big company like Ford or IBM, for example, may provide certain strategic advantages in addition to capital, but there will likely be other tradeoffs (such as a loss of control) to consider.

Dwyer suggests a few questions to ask potential investors in your business so you can better understand *their* view of the world.

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

What's their relationship with their financing sources? Do they have long-term relationships with their own investors? Do they have the necessary experience with institutional lenders to get the deal done on a timely basis? New relationships can grow anxious if there is an economic downturn and may push for a faster exit than originally anticipated. On the other hand, if their investors keep rolling their money into new funds with the same group, that's a good sign of investor satisfaction.

What is their record of closing transactions? The transaction process can take up to six months – a lot of time to spend "courting" if you're not sure they can close a deal.

Will they let you talk to some of the companies they've invested in? What kind of partner have they been after the deal is done?

What's their portfolio strategy? Is it short- or long-term? Are they patient or activist investors? Can they offer other advantages such as helping you tap new markets or recruit key personnel?

After you have conducted a search and decided which investment group you want as your partner, *the investor's* due diligence process can take three months or more. They'll want to understand your company financials, so audited statements can be a plus here. They will also focus on your company's cash flow. Are you generating positive cash flow, or are your profits tied up in receivables or inventory?

Don't be surprised if they also raise questions about family issues. Jim Murphy of de Visscher & Co. notes that because his fund invests in family businesses, "We also want to get comfortable with the family stockholder group. Is there a family council? Is the family 'on board' with the plan?" Family conflict may be just the reason the leveraged recap is attractive – to rid the company of troublesome family shareholders. But make sure the family's decision makers are behind the buy-out idea before spending time and money pursuing an investment group.

The next step will likely be a letter of intent describing in general terms what you're trying to accomplish. Once you've signed this letter, you've committed to the process but not necessarily to the closing. Next comes detailed due diligence. The investor group will want to talk to your

CPA, your attorney and perhaps some of your customers and suppliers. Then they'll perform their own internal valuation analysis of your business. So it helps if you've already done some of your own modeling: It means you can anticipate their questions about your numbers.

Once the investors are satisfied, they'll bring in their own lenders to finance part of the transaction. There may be three sources of capital in structuring your particular deal. One source is obviously the investor group, which puts up its own money. But this group's investment may amount to only 25% to 35% of the total outlay.

This debt portion of the deal will depend on a number of factors, like current market conditions and the bank's outlook for its own loan portfolio. For example, financing in 2002 is considerably tougher than it was in 2000. That means the amount of borrowing by the equity group will be somewhat lower (requiring more of their own money in the deal), and the cost of borrowing will be somewhat higher. Since the group's investors will still demand the 25% to 35% returns to justify their investment, it means a lower valuation on the portion of your business purchased by the investment group in order to make the deal work.

A lender like Fleet Capital in Boston may provide the senior financing, while a different mezzanine lender may provide subordinated debt (junior to the senior lender) or structure its "piece" as convertible preferred stock, which has characteristics of an equity investor and bank debt.

How deals may be structured

Bob Horne at ZS Fund describes a typical structure with an S corporation family business, a \$50 million market value and no debt. ZS Fund creates a new limited liability company (LLC) and initially capitalizes it with \$42 million of cash; the cash comes from a \$12 million investment by a ZS equity fund and \$30 million borrowed from ZS's lenders. Another \$8 million in "rollover equity" is contributed by the family business owners, using some of their S corporation stock – in this example, the \$8 million represents the portion of the family business retained. The LLC purchases the balance of the S corporation stock from its stockholders for \$42 million. The former owners will still own 40% of the *post-transaction equity* (\$8 million of rollover equity out of the \$20 million). In addition, they will have received \$42 million cash out of the deal. But keep in mind that the family business is now 60% leveraged with \$30 million of debt on its balance sheet.

What about taxes? By selling their company to the new LLC as described and rolling over part of their equity (16%, or \$8 million), the former owners realize taxable gain only to the extent of the *pro rata* amount sold in excess of the company's book value. In this example, the selling family would have a gain on 84% of the value realized in excess of the basis.

What about control? How patient are the investors?

Equity investors who provide capital to support a business growth plan may be content with a minority investment as long as no cash is going out to existing shareholders. When cash is being withdrawn to buy out family members or other shareholders, or simply to provide diversification

and reduce the owner's risk, the equity investor may get nervous – justifiably – and typically will want to acquire a controlling interest in the business. But even a minority investor will want some provisions to protect its investment.

"Protection" for the equity investor fund members may take several forms. One is a seat on the company's board. Alternatively, the investor group may want "observation rights": They are invited to attend meetings but don't vote (and therefore avoid liability). They may require a super-majority vote on certain issues, like corporate borrowing in excess of a stated amount, shareholder distributions, changes in compensation or bonus plans, capital expenditures, acquisitions and budget approvals.

Most equity investors will also want a "put" option, so they can sell their interest in the business back to the company after five or six years. Rarely do equity investors claim to exercise their put right, since the plan is to grow the company for five or six years and then sell it or do an initial public offering, a new leveraged recap with a new equity group, an employee stock ownership plan or a new refinancing.

Equity investors tend to remain patient as long as management achieves or exceeds the business plan. Good communication with the investor group is a must to keep everyone in the loop on how the business is performing – or failing to perform – after the deal is done.

When a company doesn't perform as projected, ZS's Bob Horne notes, the problem is typically (1) the company's market has changed, (2) the economy weakened and negatively affected the business, or (3) management isn't as strong as expected. In these cases the company may be asked to buy out the equity investor if the deal isn't working, although Horne insists that doesn't happen with his firm. "We are not heavy-handed," he says. "We work with management as our partners but we also have to protect the interests of our investors."

After the deal is done

Years down the road, are the former owners happy? If they had a good business and a good plan at the outset and know how to take advantage of the partnership that equity investors provide, the answer is generally "yes," for several reasons:

1. They feel the psychic pleasure of seeing their "baby" (the family business) grow.
2. The business may be more successful because the owners reduced their personal risk and as a result were willing to take more business risk. "It's like taking a thoroughbred race horse and entering it in more races," Horne suggests.
3. The owner's risk profile changes. When you're not using 100% of your own money, it's often easier to say "yes" to new ideas.
4. The investor group can help the business owner with acquisitions.

The leveraged recap can be a viable alternative to selling the family business – especially when the company still has good years ahead. Next-generation family members who want to run the business can learn discipline and gain important skills in the five- to six-year period of involvement by an investor group.

The process of considering the leveraged recap can also bring up unresolved issues about succession and the future viability of the business that need to be addressed. For families evolving toward an "owner-investor" model of ownership, the leveraged recap may be especially attractive as a way to diversify the family's assets.

Can the family business be leveraged with traditional financing to get the same result? In theory, yes, but traditional financing may require guarantees by the current, withdrawing owners – just the situation they want to avoid.

The family considering a leveraged recap needs to understand that (1) they are selling part of their business and (2) they are bringing a new partner to the table. An old saying applies here: "If you are going to invite an elephant trainer to dinner, be sure you have room for the elephant."

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