



Understanding the Private Equity Recapitalization Opportunity

Two powerful forces are meeting in the market today. One is the large number of business owners who are approaching the age where it makes sense to start planning for life beyond business ownership. The other is the vast quantity of investment capital available through Private Equity (PE) Groups. The purpose of this paper is to help the business owner understand the potential opportunities that working with a PE group can create.

Business owners may face what seem to be very conflicting objectives:

- It's important to get substantial cash out of the business in order to secure the family's financial future, but the fire is still burning to build the business.
- It would be great to see the next generation take over the business but they don't have enough money to buy the owner out.
- The owner would like to grow the business to the next level but doesn't want to take on personal debt in order to do so.

These seemingly contradictory objectives can often be realized by structuring a leveraged buyout with a Private Equity Group.

What is a PE Group?

PE Groups are businesses that exist to buy and sell other businesses. Today, there are thousands of PE groups investing trillions of dollars. About 20% of all businesses in the United States with sales of \$10 Million or more are owned by PE Groups. PE's raise money from investors with lots of cash such as pension funds, insurance companies and high net worth individuals. They buy companies; own them for typically 4-6 years and sell them. PE's almost always buy businesses through a Leveraged Buyout. This means that they use debt to fund a portion of the purchase price. For example, a business purchased for \$10 Million might only require \$4MM of the PE's capital. The rest is bank debt.

PE's try to increase the value of the business in two ways: First, they try to grow the earnings of the business through increased sales, reduced costs and through acquisitions. Second, they use the operating cash flow of the business to pay down the debt. If things go as planned, the business will have a much greater value when the PE sells it than when they purchased it.



Why does an LBO with a PE make sense?

An LBO can be the best solution for a business owner in several situations:

1. The owner wants get the best possible price for the business.
2. The owner wants to continue to run the business but get a substantial amount of cash out of the business today to diversify personal assets.
3. The owner wants to turn over the business to family members or a management team but the next generation lacks the capital to pay the owner the full value of the business.
4. The owner has plans to grow the company which require capital but thinks it unwise to put a lot of his/her net worth at risk, since so much is already tied up in the business.

Example

An example illustrates how an LBO can work. Mary is the owner of a logistics company, SKP logistics with Sales of \$11MM. Mary wants to continue to act as CEO for the next 2 years and then transition to her son, Jim who will operate the business after she retires. Mary and Jim agree to sell SKP to Luminous Capital, a PE group, for \$12 MM. As sole shareholder, Mary will receive this amount.

Luminous and the bankers determine that SKP will support a total of \$7 MM of debt. The remaining \$5 MM will be equity. Mary decides to invest \$1.5MM in the re-capitalized SKP. Since this represents 25% of the equity capital required for the recapitalization, she will still own 25% of SKP, even though she only re-invests 12.5% of her sale proceeds. Jim invests \$600,000 and owns 10% of the company. Luminous owns the rest.

As part of the restructuring, Luminous sets up an incentive equity pool for management. This represents 15% of the total equity of SKP. Mary and subsequently, Jim as CEO will be able to earn additional equity through this pool.

Due to good management and the availability of investment capital, SKP grew an average of 12% per year for the next five years. A new buyer offers to purchase SKP for \$20 MM. Mary's remaining equity in SKP is worth over \$6 MM and Jim's is worth more than \$3 MM.

Example: SKP Acquisition

Mary Receives	\$12.0 MM
Mary Invests – tax free	\$ 1.5 MM
Mary's Cash at closing	\$10.5 MM



Recapitalization	Ownership	
Total Price	\$12.0 MM	
Debt	\$ 7.0 MM	
Equity	\$ 5.0 MM	
Mary	\$ 1.5 MM	25.5%
Jim	\$.5 MM	8.5%
PE	\$ 3.0 MM	51.0%
Management Pool		15.00%

Exit	
EBITDA	\$3.5 MM
Exit Price	\$21.1 MM
Mary's Exit	\$5.9 MM
Jim's Exit	\$2.9 MM

When is an LBO with a PE not the right choice?

While the type of transaction discussed here can be a really good option, there are a few reasons why it may not be the right solution in all cases:

1. PE groups are interested in a lot of different industries and business sizes, yet almost all PE investments will have the following characteristics:
 - a. A history of consistent earnings
 - b. Participation in a growing industry
 - c. Low customer concentration.

If a business lacks these characteristics, it may be difficult to get PE's to take interest.

2. PE professionals will let you continue to run the business but they will be active at the board level. If you've truly been your own boss, it's important to understand whether you'll be able to accept having a board looking over your shoulder. The advice and experience can be wonderful but if the business misses its forecasts, you can expect your partners to become more active.
3. The PE controls the board. That means that they will decide when the best time is to exit the business. Selling your business to a PE group often means that the business will be sold again in 4-6 years. It's best to understand this when you get started.



Why not sell to a Strategic Buyer?

A strategic buyer is typically a larger company in the same or a related industry. Historically, sellers have gotten the highest valuation in sales to such buyers. Strategic buyers can still provide a very good exit option, however the tradeoffs between a sale to strategic buyers and PE groups are worth examining. Some issues:

1. Strategic buyers are not always available. The seller may believe that there is a strategic fit but have difficulty finding a buyer who shares the belief.
2. Courting strategic buyers substantially increases the risk that competitors and customers will find out that the business is for sale.
3. The strategic buyer may not have a role for the seller or other key executives after the sale.
4. These days, PE groups will often outbid strategic buyers.

Getting the Details Right

Private Equity professionals do deals for a living. This means that they understand the details of buying and selling businesses far better than most business owners ever will. They are backed up by a team of young MBA's and very capable attorneys and accountants. To get the details right, the business owner should surround himself with an experienced deal team. At the heart of this team is the investment bank that will represent the owner in recapitalizing the business. The investment banker will be responsible to:

- Understand the owner's objectives
- Present the company in the optimum manner
- Identify prospective buyers
- Guide the business owner through the process of choosing the right buyer
- Assuring that the details of the deal are done right and will accomplish the business owner's objectives.

It's also critical to engage an attorney who specializes in the sale and purchases of businesses. Many business owners have long standing relationships with a corporate attorney who they have come to trust. They assume that this attorney can do a good job of representing their interests in the recapitalization of their business. This is generally not the case. Most people who have a trusted family doctor understand that it's important to see a specialist when there are special situations. Similarly, it's important to find an attorney who specializes in Mergers and Acquisitions to assure that the critical details are handled properly.



Conclusion

Business owners can often achieve their financial objectives through a leveraged buyout with a private equity group. In the right circumstances, this type of transaction can achieve superior financial results.

Making it work to maximum advantage requires the guidance of an experienced investment banking team.

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