

Recapitalization offers companies an alternative way to finance growth

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Business owners looking to retire in three to five years sometimes have to let golden opportunities go by because they do not want to risk investing a large chunk of money that late in their career.

As an alternative, many of these corporate types turn to recapitalization, which allows them to go after additional earnings, while not “betting the farm” for their own future as they prepare to make their exit.

What is recapitalization? It entails finding a financial partner to buy a portion of an established company, in order to close on an attractive investment without expending personal capital. Companies that focus on recapitalization mostly look to invest in small to mid-sized, privately held businesses that offer more potential for growth in partnership with an experienced equity fund.

Eric Nass, president of Baltimore-based Executive Sounding Board, which specializes in mergers, acquisitions and divestitures, said while recapitalization is not a new concept, the recent economic slide has made it more difficult for middle-market companies to obtain loans. Therefore, many of these businesses turned to private equity funds that have better access to financing, and that forge strong relationships with major financial institutions.

Last year, the 38 U.S. members of the [International Merger and Acquisition Professionals](#) completed 121 transactions worth more than \$2.5 billion, according to a study released recently by the association. The group's 13 foreign members accounted for 61 transactions, worth more than \$611.8 million.

“A person does not necessarily have to be close to retirement, but recapitalization works nicely in that situation,” Nass said. “Ultimately, these are bankable, middle-market companies, but typically before recapitalization, the principals are guaranteeing bank loans. In contrast, after recapitalization, the financial partner is typically guaranteeing the bank loans”

Those who use

Companies that use recapitalization span all sectors of the economy, and often look for ways to grow their business by opening new factories, developing software or hiring additional employees. Companies



Eric Nass, president of Executive Sounding Board, says companies desiring to recapitalize look for private equity funds that have access to financing and have forged strong relationships with major financial institutions. In turn, the equity partners seek companies that have established themselves in their markets and demonstrate an ability to grow.

that obtain loans on their own retain the sole risk, and the result is sometimes dire if the strategy does not turn out as planned.

Equity funds often look to partner with companies that show steady growth and typically have more than \$25 million in revenue. The process gives businesses instant liquidity without having to take on huge amounts of debt.

“When someone is getting ready to retire, they often will shift to autopilot.” - Eric Nass

Nass said recapitalization also remains a viable option for those that are three to five years away from retirement and need to maintain the value of their companies before selling them outright.

“When someone is getting ready to retire, they often will shift to autopilot,” Nass said. “They do not want to risk the wealth they built up and their companies begin to get stagnant. Their earnings get flat and they wind up selling the company for much less than it’s worth.”

Essentially, if an entrepreneur wants to retain 25 percent ownership of a company worth \$20 million, and is willing to take on \$9 million of debt, recapitalization can work in his favor.

A new financial partner can invest \$6 million into the company, and arrange another \$9 million line of nonrecourse financing through an institutional lender.

This allows the owner of the company to receive \$15 million in cash, while retaining tax-free 25 percent ownership worth \$5 million.

How it works

With recapitalization, ownership of the company is often transferred to the financial partner, but day-to-day operations remain with management.

The seller, however, has access to personal liquidity.

Often after closing a recapitalization, a financial partner works closely with management and the company’s board of directors to provide advice or other assistance.

The investor also might position the company for further expansion through a merger or acquisition, and possibly even a public offering.

Recapitalization, however, does not work if management decides to cash out after the sale and leave the company.

It also will not work for startups that have not established themselves in their respective markets and have not demonstrated any ability to grow.

“These private equity funds want to see consistent earnings,” Nass said.