



M & A

Insider

Quarterly Guide of Trends and Information about Buying and Selling Mid-Size Companies

SELLING THE SAME BUSINESS *TWICE*

By Rob Slee

Most owners of private companies have nearly all of their wealth tied up in one asset - their business. Ultimately this lack of investment diversification causes many premature business sales. There is a way for shareholders to get liquid yet still participate heavily in the upside of their company's growth. They need to sell their business twice.

Selling twice means completing an equity recapitalization, or more simply stated, a recap. In a recap, an owner sells part of the equity of the business in order to take "some chips off the table," while still operating the business. The recap can entail a sale of any amount of company stock, but most involve a change-of-control. The following *real life* situations show how a recap can help business owners meet their goals:

- *Mitchell's Formal Wear*, an Atlanta based retailer, had become one of the largest tuxedo rental chains in the U.S. Management saw an opportunity to lead the consolidation of its fragmented industry. Mitchell's chose a recap

structure, partly because normal debt financing would not be sufficient to fund the deals, but also because the recap allowed key employees to participate in the creation of equity value.

- *Southern Weaving*, a Greenville, SC manufacturer of highly engineered narrow woven fabrics, chose a recap structure in order to have enough capital to consolidate a segment of the textile industry, plus have the chance to partner with a recap investor who had a successful track record of growing companies and creating maximizing exit plans.
- *Universal Protective Packaging*, a Pennsylvania manufacturer of rigid packaging, recapped the business because the ownership sought personal liquidity, but still had energy to manage the company for the foreseeable future.

As these scenarios show, recap's can have numerous benefits. By employing an equity recap

strategy, the owners hope to achieve some or all of the following: 1) increase personal liquidity, 2) continue operating the business while maintaining a large equity position, 3) reduce personal risk by eliminating borrowing guarantees, 4) gain access to financial professionals who have experience in growing and exiting from businesses, and 5) possibly receive non-diluting capital for growth. This fifth point is particularly important. For some recap's, the original owner's equity stake may not be diluted as more growth money is invested. This is a negotiated item between the parties.

The Mechanics

A typical change-of-control equity recap involves several steps. First, the company, let's call it ABCco., must be valued on an enterprise basis (100%). Recap valuations are typically conservative. Many recap investors will value a company by applying no more than a '5' multiple against adjusted earnings before interest and taxes (EBIT), less long-term

liabilities. Adjustments to EBIT include seller discretionary items and one time expenses. Potential deal synergies are not incorporated into the valuation. Assume ABCco. has adjusted EBIT of \$2 million per year. In this case, ABCco. might be valued at \$10 million. Further assume that a recap investor purchases 80% of the ABCco. for \$8 million. Thus, at the end of the first step, the owner gets \$8 million plus keeps 20% of the remaining equity of ABCco.

Second, as part of the recap strategy, the ABCco. original owner and the recap investor agree on a business plan that is fairly aggressive in terms of growth. This expansion is usually realized by one part organic growth and two parts add-on acquisitions. Recap investors normally expect to receive at least a 30% compounded rate of return on their investments, so the earnings growth of ABCco.-recap must be

strong enough to support this return. The recap investor commits to fund the business plan, which may have a 5 year horizon.

Finally, the investor and original owner plan a liquidity event, usually near the end of the business planning period. This event could include a sale of the business or executing an initial public offering (IPO). Assume that the ABCco. investor achieves its 30% return objective so that ABCco.-recap is sold at the end of the fifth year for about \$38 million. The original owner participates in this sale, and now their remaining 20% interest is worth \$7.6 million (20% of \$38 million). What a deal! The owner gets \$8 million in the original transaction, and then almost that much again in the ABCco.-recap sale. Of course, along the way the owner has received a market wage and, hopefully, performance bonuses.

There are now more than a

hundred institutional recap investors in the U.S. marketplace.

These investors break down by size. Most investors focus on recap investments of \$2-10 million, which represents the minimum size range for institutional support. Another group will invest primarily in deals with transactions between \$10-50 million. Finally, a few dozen investment firms will participate if the transaction is greater than \$50 million.

Due to their nature, recap's are not for everyone. But, if selling a business *once* is not enough for an owner, a recap just might be the answer.

Rob Slee is President of Robertson & Foley, an investment banking firm in Charlotte that provides corporate finance advice to middle market companies. He can be reached at 704/523-7888.

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