White Paper
M&A Advisory

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Recapitalizations: An Alternative to a Company Sale

by Terry Bressler

Overview

Every business owner reaches a time when they want to develop a plan to unlock the value they have built in their business. In many cases, the company is the largest, most valuable property they own and represents a significant concentration of investment risk in one asset. Prudent retirement planning calls for diversification and a need for the business owner to harvest the value they have created in their business to invest in a broader portfolio of investments. Often, when we think of harvesting the value in a business, we think of a major shareholder transition transaction. A shareholder transition can be accomplished through the sale of the company to a strategic buyer, a private equity fund or an Employee Stock Ownership Plan ("ESOP"). While these are all commonly used, successful methods to achieve shareholder liquidity, there are times when another alternative should also be considered.

A ***recapitalization*** ("recap") transaction can be an important alternative to a company sale. A properly-structured recap can provide a business owner with a measure of liquidity in their investment while allowing the owner to maintain an equity interest in the company and share in the future financial success. Recaps allow the business owner to harvest a portion of their company's value so they can diversify their assets for retirement and other purposes. Recaps work best when a company is well-managed, has relatively consistent free cash flows and excess borrowing capacity so the company can attract sufficient financing to complete the transaction. This whitepaper will overview the important issues to consider before executing a recapitalization, highlight the types of recapitalizations, describe the recapitalization "capital building blocks" and discuss the steps in preparing and executing a recapitalization transaction.

Considerations

As with all other important, properly-designed and executed corporate finance transactions, the recap process begins with the determination of the shareholder ***goals and objectives.***

If the business owner's goals are to achieve the highest company value and maximize the cash proceeds, and if the owner is not interested in a continuing equity position in the business, then a well-orchestrated company sale process is the best way to achieve that objective. A sale through a competitive auction process will allow your advisor to position the business with strategic and financial buyers to highlight the company's important business characteristics and synergies. A well-executed process will attract multiple potential buyers so that competition for the deal will tease out the highest price and best terms.

If on the other hand, the highest company price is not the primary shareholder objective, then there are other alternatives to a sale. Perhaps the owner is more interested in keeping the business "in the family" or in the hands of a loyal management team. Maybe the owner is interested in "taking some of their money off the table" while maintaining ownership of the business. The owner might want to buy out a partner or have their partner purchase their equity in the company. All of these situations can be addressed with a properly-structured recapitalization transaction.

A recapitalization transaction, because of the use of debt and mezzanine capital, will increase the company's leverage and debt service costs. The increased leverage and its demands on the company's future cash flow will likely increase the company's financial risk. As a result, it is important to have a relatively successful, well-managed business that can support the increased leverage. Companies that are very seasonal, have high capital expenditure needs or are subject to extreme cyclicality are not ideal recap candidates. More limited recap options are available for these companies.

It is also important to consult with a good tax advisor to determine the tax consequences of the various options of distributing the cash proceeds generated by the recapitalization transaction. Typically, the cash is distributed through a dividend or share repurchase, and there may be ways to minimize the tax consequences of these distributions.

Once it is determined that a recapitalization best fits the goals and objectives, the next step is to determine the optimal recapitalization structure.

Recapitalization Types

In determining the optimal recapitalization structure, it is important to consider four variables:

1. Company Business Risk
2. Desired Liquidity
3. Ownership Dilution
4. Borrowing Capacity

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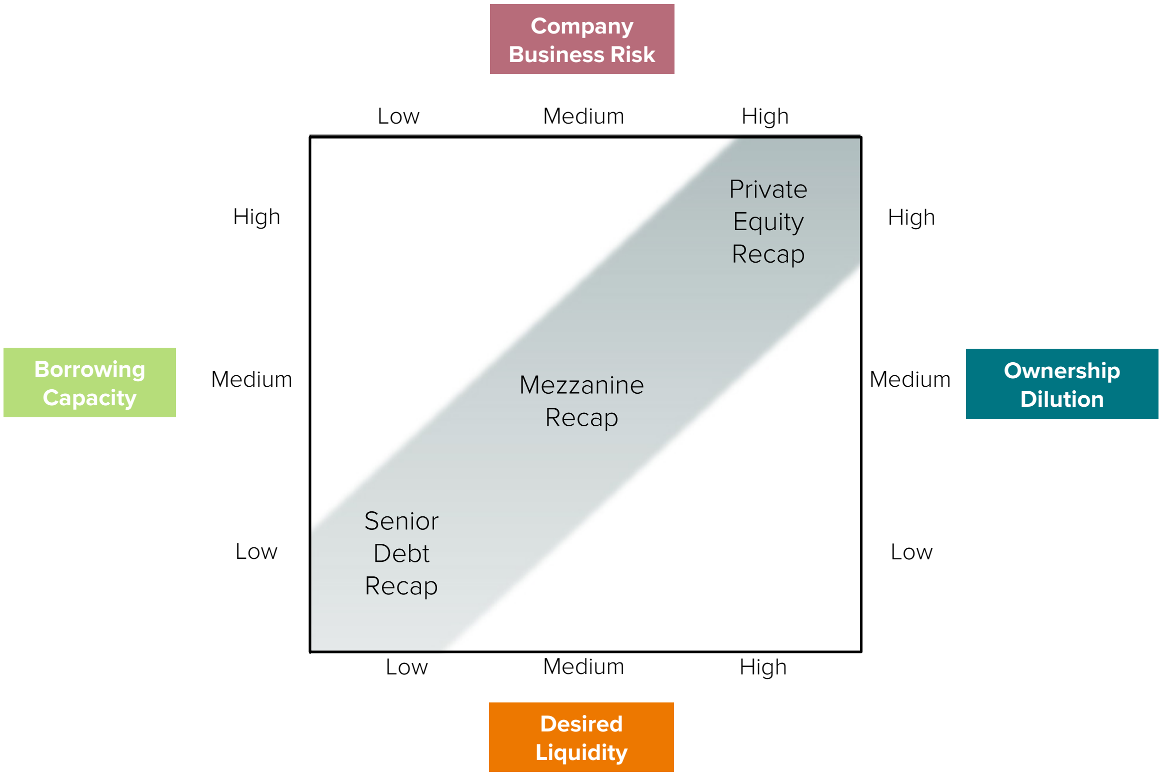

Each of these variables individually and collectively have an effect on the optimal recapitalization structure. Furthermore, the combination of these variables will determine the amount and type of capital required to complete the recap transaction.

The diagram on the previous page reflects how these four variables interrelate and how these variables help to determine the type of recapitalization transaction required for the specific situation.

The *Company Business Risk* is the variable that overlays the recapitalization transaction structure. Generally speaking, a company with higher *Company Business Risk* will have greater cash flow variability and, as a result, will have lower *Borrowing Capacity*. For example, recreational vehicle manufacturers are both cyclical and seasonal businesses, which results in high business risk. Generally, because of their high business risk, the RV companies have little borrowings and low debt leverage levels. Similarly, engineering consulting businesses have few assets beyond their human capital and, in many cases, have project based revenue models with little recurring revenues. Again, as a result of these characteristics, engineering consulting companies have greater business risk and will generally employ less debt financing than other businesses.

The *Desired Liquidity* is the one variable completely controlled by the company owner and probably the biggest factor in structuring a recapitalization. Generally, the *Desired Liquidity* combined with the company's available *Borrowing Capacity* (the amount of the borrowing capacity that is unused) will determine the form of recap and the type of capital that will be needed to close a transaction. Many times the *Desired Liquidity* will be adjusted based on how much *Ownership Dilution* and business control the owner is comfortable giving up to meet a desired level of liquidity.

Each unique situation requires the careful consideration of these four variables. Prudent structuring of the transaction is necessary so that the recapitalization does not place excessive financial risk on the company. Dramatically increased financial risk could make attracting financing for the recapitalization difficult. After carefully analyzing the specific situation and considering the four variables, one of the following recapitalization structures will likely be employed.

Senior Debt Recapitalization: As shown on the left side of the previous diagram, if a shareholder has a low liquidity need, the company has low business risk or the amount of the company's existing leverage is low, then the company can likely borrow the required capital from a senior lender such as a bank. This is a Senior Debt Recapitalization. The additional bank borrowing will marginally increase the company's financial leverage but provide the cash to make the shareholder distribution or buy back the stock of the shareholder(s).

Mezzanine Recapitalization: If, on the other hand, a company has a moderate level of business risk, the shareholder desires greater liquidity than can be financed through bank financing or the company's existing leverage is already medium to high, then a more complex recapitalization is necessary. In this more complex structure, an issue of mezzanine capital might be required to supplement the capital provided by the senior debt or bank. This is known as a mezzanine recapitalization and is shown in the center column of the diagram.

Private Equity Recapitalization: Finally, if the company has high levels of business risk or if the combination of bank debt and mezzanine capital is inadequate to meet the desired liquidity need, then a Private Equity Recapitalization should be structured. As shown on the diagram's right column, this structure is used if the Company is unable to support the debt service that bank debt and mezzanine debt require to meet the desired liquidity. An additional issue of equity supplied by a private equity investor is used to supplement the company's diminished equity base and takes pressure off the debt service coverage ratios. Generally, this new equity investment will be made in the form of minority equity and may have rights for more control over the business if certain negative events occur.

When considering a recap, it is important to note that the increased use of mezzanine and equity capital in a recapitalization structure leads to the shareholder giving up more equity ownership and control to these new outside investors. An in-depth understanding of the owner's goals and objectives, thorough analysis and careful structuring can minimize surprises in the execution of a recap transaction.

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Capital Building Blocks

Fundamentally, a recapitalization transaction uses replacement capital to enable a company to either make a dividend distribution or buy back stock of the shareholders. Depending on the circumstances in the specific recap transaction, this replacement capital is comprised of senior debt, mezzanine debt or equity capital. The advantages and disadvantages of each type of capital are reflected in the Capital Building Blocks diagram on the next page.

As described earlier, the financial position and characteristics of the company subject to the recap transaction, coupled with the owner's transaction objectives, will determine which of these replacement capital components will be used and what amount of capital is needed. Companies with borrowing capacity and low business risk will be able to use more senior debt and mezzanine capital to execute a recap. These companies can tolerate more leverage and support more debt service. Companies with more cash flow volatility or high amounts of existing leverage will probably use less debt and mezzanine, instead using more equity capital.

The amount and type of each of these building blocks will be determined by careful analysis and the advice of the company's deal team.

Capital Building Blocks

	Senior Debt/ Bank Debt	**Mezzanine/ Subordinated Debt**	**Equity**
Advantages	• No equity dilution • Lowest short-term cost of debt • Relatively flexible • Availability of capital	• Lock-in fixed interest rate (predictable financing costs) • Low Equity dilution • Less restrictive covenants than bank debt	• No current cash payment requirements freeing up cash flow • Additional equity improves capital structure and reduces financial risk • Expands financial flexibility by increasing future debt capacity
Disadvantages	• Interest rate exposure if not swapped to a fixed rate • Financial covenants • Reporting requirements/ administrative burden	• High fixed interest costs • High prepayment costs • Somewhat restrictive covenants • Would likely require a small amount of equity dilution • Increases overall financial leverage	• Potentially significant equity dilution to current shareholders • Potential governance role (Board Seat) for investor

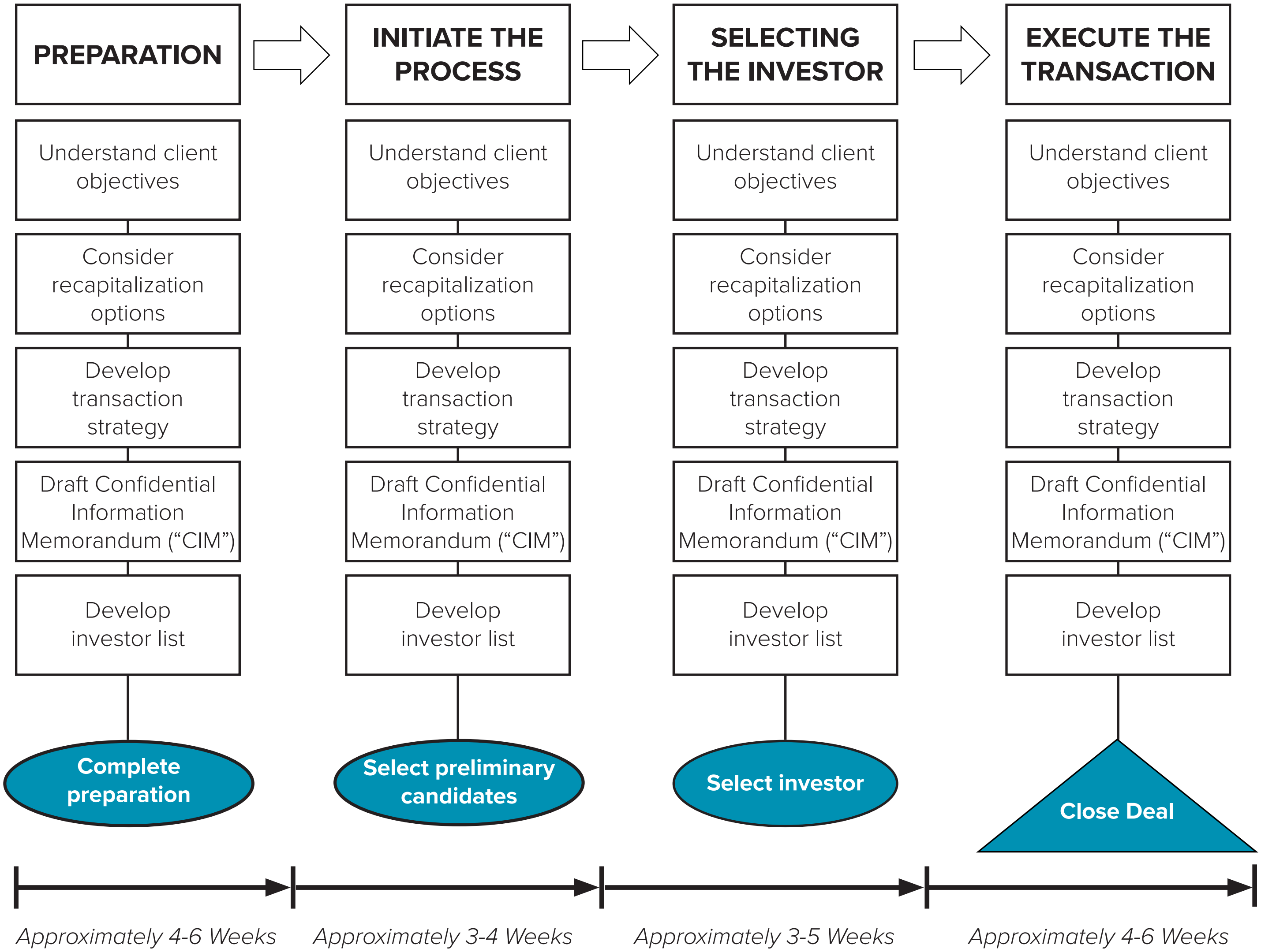
Transaction Preparation & Execution

Many of these recap structures require complex modeling and are highly dependent on the state of the capital markets at the time a recap is consummated. An experienced capital markets investment banker is essential to optimize a recap transaction, structure and attract the required capital and achieve the shareholder goals and objectives.

The recapitalization process typically involves four distinct stages as shown in the diagram below.

Overall, a recap transaction will take between three and six months to complete the process and close a transaction.

Recapitalization Process



Summary

A recapitalization transaction is an important alternative to a company sale when the business owner wants a measure of liquidity but wants to continue to own or play a role in the company's future. While using a recap structure will not maximize the company's valuation vis-à-vis a company sale, the owner will be able to have the potential for two significant liquidity events: the first of these liquidity events being the recapitalization transaction and the second liquidity event being the later company sale. Frequently, the total proceeds from both transactions might be greater that a company sale at the time of the recap. As is the case with most corporate finance transactions, it is essential to have a strong advisory team, including an experienced investment banker, to successfully meet the company transaction objectives.

About Prairie Capital Advisors

Prairie Capital Advisors offers investment banking, ESOP advisory, valuation advisory and financial reporting valuations to support the growth and ownership transition strategies of middle-market companies. Headquartered in Oakbrook Terrace, Illinois, the company is a leading advisor to closely-held companies nationwide. For more information, call 630.413.5574 or visit www.prairiecap.com.

Securities transactions are offered through Prairie Capital Markets, LLC. Member of FINRA/SIPC.

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