management solution

Recapitalization: An Alternative to the Traditional M&A Transaction

by Brooke Hollis

What is a Recap?

A "recap" is a vehicle used by Private Equity Groups (PEGs) and certain others as an alternative to a traditional 100% purchase of a company. The term implies that the capital structure on the balance sheet is changed or "recapitalized." In certain situations, this can be a very attractive option that owners might consider assessing with their advisors. Hopefully this brief introduction will provide some useful perspective on this alternative.

How Does It Work?

Private Equity Groups vary in the individual way they approach a deal – particularly regarding the level of involvement they seek in a company after a recap. However, besides receiving cash at closing, a common feature is that at least some company shareholders retain a level of equity ownership and involvement in ongoing company operations.

The goal of the PEG is to keep management involved and motivated. The PEG brings an infusion of capital plus additional management expertise and relationships that can help take the company to a new level of sales and profitability. To complete the recapitalization, the private equity investor invests equity capital on its own or in syndication with other groups and arranges debt-financing for the balance.

Following the recapitalization, company ownership will be held by some or all of the old shareholders plus the new financial partner. The owners/management team work to grow the business, with the financial partner generally providing assistance on financial, strategic and exit issues. At a later date, usually five to seven years, the company could either be sold to another firm, go public, or undertake another recapitalization. This longer time horizon can be preferable to the quarterly focus of most publicly traded companies. The structure is also intended to give the shareholders a "second bite of the apple."

A Hypothetical Recapitalization Example

1. The company and PEG agree on a value of $50 million.
2. All agree that the company can support senior debt of $25 million.
3. The parties agree to sell 70% of the equity to the PEG and management agrees to reinvest some of its equity on a tax-free basis.
4. The owners receive $42.5 million at closing, and then reinvest $7.5 million to maintain a 30% interest in the company.
5. Net cash in this case is $35 million, which is 70% of the $50 million valuation.
6. The goal is then to grow and later cash-out the 30% retained equity at a higher valuation.

What Are the Potential Benefits?

Recapitalizations offer owners many advantages. Recaps unlock the value that is tied up in owner's equity and create substantial liquidity. The owner also maintains the option of retaining an equity position and remaining involved. Alternatively, they may have the option of exiting. As mentioned earlier, if the owner chooses to stay, he/she could have a substantial second liquidity event.

Many owners feel that a recap allows them to take some "chips off the table" by turning stock into cash, while still having the potential for upside. The PEG is also in a position to consider augmenting growth via acquisition – something not always possible for smaller companies.

If things go well, this can be a very substantial benefit. For example, for one of our clients, Supplemental Health Care Ltd, we were ultimately able to get an agreement with a PEG on a recap structure that gave them an excellent valuation at closing, and a commitment for the financial and management resources to grow the company substantially. Within a few years via acquisition and internal growth, the company has grown tenfold. Management's small portion of retained equity, if sold, would probably now be worth more than the entire company at the time of the transaction. The recap definitely worked - they were recently named the fastest-growing health staffing company in the country.

What about the key employees or managers who are not owners?

Often, both employees and owners feel better because there is less of a feeling of "sell out." Rather, owners continue to have a significant stake in the business and want it to grow for everyone's benefit. A recapitalization typically will also provide the number of employees with stock option incentive plans, providing upside opportunities that might not otherwise exist. There may also be additional advancement opportunitites.

Getting the Proper Advice

For a recap transaction, it is important to work with an experienced team. As with any business venture, there are clearly risks. Further, PEGs come in many sizes and styles. Beyond the obvious financial and legal issues, the art of the deal is finding the right "match." Some factors to consider include: organizational cultures, expertise, personalities, leadership styles and exit goals. Owners should not attempt any such transaction without an experienced team including an M&A advisor, attorney, and tax professional who can help chart a course that considers both the benefits and potential difficulties associated with such transactions.

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