

Market

EQUITY MANAGEMENT *Matthew J. Miller*

Is an equity recapitalization right for you?

Change continues to be a natural part of business. Does one or more of your partners want to exit, but you want to stay (or vice versa)? Do you want to unlock some of the value in your business, but continue to own a significant portion and enjoy the future upside? Or, do you need a retirement or succession plan?

If so, an equity recapitalization might be an attractive alternative. Simply put, it can enable you to take some chips off the table now, maximize the value of your business over time and sell the balance of your equity at a higher valuation in three to seven years.

Other benefits include:

Net worth diversification. For too many small business owners, the majority of their net worth is locked in their business, and privately held middle market businesses are considered to be riskier than many other assets.

Fresh capital and contacts. Your new partner might help fund capital expenditures to support organic growth or acquisitions to bolster management, growth, profitability or competitive advantage. They also could introduce you to new customers or suppliers who can help increase sales, decrease expenses or launch a new strategy.

Financial and operational expertise. Your new partner will

want to add value by sharing his or her general management experience and skills by implementing new procedures or processes. For example, a more robust cost accounting system or business planning process might help improve profits or take your business to the next level.

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Most equity recapitalizations are funded by private equity groups (PEGs) that raise and invest money from institutional investors like banks, insurance companies and pension funds. PEGs tend to invest in companies with strong management, growth, profitability and competitive advantage. However, some are interested in distressed or underperforming companies.

In the typical equity recapitalization, the PEG or its fund:

- Acquires 51 percent or more of

the target company (some will acquire a non-control equity interest);

- Takes a seat or two on the board of directors and works with management to grow and improve the business;

- Seeks liquidity (in three to seven years) through an initial public offering, recapitalization, or sale.

To illustrate the potential financial benefits to you, the selling shareholder, here's an oversimplified example:

Today

If your company generates \$2.5 million in earnings before interest, tax, depreciation and amortization (EBITDA) on \$25 million sales;

We value it using an enterprise value multiple of 5 X EBITDA and the balance sheet includes no interest-bearing debt or excess cash, then the equity value would equal \$12.5 million;

You agree to sell 51 percent of the equity to a PEG; and

You would realize \$6.375 million pre-tax.

Year 5

If in five years, your company generates \$5.0 million in EBITDA on \$50 million sales;

We value it using an enterprise value multiple of 5 X EBITDA, and the balance sheet includes no interest-bearing

debt or excess cash, then the equity value would equal \$25.0 million;

You agree to sell the remaining 49 percent of the equity to a strategic buyer; and

You would realize \$12.25 million pre-tax.

You and your management team maintain control of day-to-day decision making, leadership and operations, and your new partner provides advice or guidance as a board member. However, in most cases, you will lose control of the voting rights associated with equity, and, if not accustomed to it, you will need to learn how to work with a board of directors.

To many, the benefits of diversification, liquidity and succession outweigh any shortcomings associated with a recap. It can help you mitigate risk and put you on the path to retirement.

One never knows when the economy or a customer will upset your prospects, or you will get the itch to find your blue water — whether a personal mission in life or a lakeside cottage with beautiful sunsets.

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