Let’s Eat Cake: How to Recapitalize Your Business And Retain Control

By Walt Lipski

How do you take cash out of your business without losing a majority of your equity or losing operational control? Or worse, signing all types of personal guarantees?

If you were able to take significant cash out of your business while retaining a majority ownership position and operational control, what could you do with the cash?

- Buy out a shareholder who may want to retire
- Diversify the financial exposure of running your business
- Fund a strategic acquisition or increase investment spending for growth and expansion, without putting your personal assets at risk
- Pay off the lake house, fund your near and long term retirement and estate planning needs

The fact is there are many smart things you could do, if only you could free up the liquidity that is tied up in the economic engine of your business, without losing your equity or control.

Can you have your cake and eat it too? Let’s take a look.

There is a potential solution – it’s called a Minority Recap

A minority recapitalization is a tool used to create liquidity for growth and shareholder financial diversification. Up until recently, this type of option was only available to companies with earnings in the $7MM to $10MM EBITDA range and above. The good news is there are now private equity funds looking to fund similar deal structures for solid, established companies with earnings in the $1.5MM EBITDA range and above. For companies that meet certain minimum parameters this may be a solution worth exploring.

How does it work?

As the name implies, a minority recap involves a selling minority equity position in a company for cash along with the blending of a portion of non-recourse, non-amortizing debt to achieve the liquidity levels needed to meet the shareholders’ objectives.

Who funds a transaction like this?

Recently, some forward thinking private equity and private family funds, which have a longer term investment focus, are embracing the perspective of taking a minority position coupled with non-recourse, interest-only debt as an efficient way to put their capital to work. These folks have come to understand that many established good middle market business have owners in their late 50s through their late 60s who are just not ready to sell or retire. Many of these owners want to continue working, they want to continue to receive income and they want to remain in control, yet they could use some liquidity for any of the numerous reasons mentioned earlier. An appealing aspect of this structure to a capital provider is that the original ownership still has a majority stake in the company, giving the capital provider confidence and a comfort level in the long-term success of the business.

A Straightforward Example

Let's say you and a partner own the Widget Manufacturing Company. In the most recent year, Widget earned $4MM dollars in EBITDA (earnings before interest taxes depreciation and amortization), and was appraised at $20 million (enterprise value). Your partner, Tom, owns 70% or $14MM of equity value and you own 30% or $6MM of the equity in the company.

Tom is in his early 70s and is ready to retire. You, on the other hand, are only in your late 50s and want to continue working and growing the business so you can accumulate significant wealth for your family's future financial security. You would like to buy Tom out, but Tom needs cash to fund his needs in retirement. You do not want to go into personal debt or mortgage your future at this point, and even if you did all that, you still may not be able to come up with enough cash to meet Tom's needs.

Solution

To come up with the $14 million needed to buy Tom out, you could entertain a minority recapitalization. A private capital source steps in and takes on the role of both lender and minority shareholder providing an interest only loan without scheduled amortization for half the value of Widget, say $10 million.

With the $10 million loan on the books at Widget, there is now half as much equity in the company, so the net equity value is now $10M, (enterprise value less the new debt). And, since you are not taking any money out, just buying out your partner, your equity in the company is still worth the original $6 million but it now represents 60% of the $10 million in net equity value. In concert with making the non-recourse loan, the private capital source will also purchase the remaining 40% equity in the company for $4 million. That $4 million, plus the $10 million from the loan, combine to add up to the $14 million needed to complete the tax efficient buyout of Tom's interest.

So what have you accomplished?

- First, you retained operational control and kept a majority interest in the company for yourself.
- Second, you bought your partner out for cash in a way that was tax efficient for him.
- You did it all without signing personal guarantees or mortgaging your personal assets.

What happens next?

You're in control; and you have gained an experienced contributing board member from a strategic vantage, whose interest is aligned with yours – the long-term profitable growth of the company. A few years pass, and you are now ready to consider your own lifestyle changes. Your kids are not interested in the business, the company has enjoyed a good growth run and you decide it's best to sell the entire company. The company has grown an average of 10% annually under your watch and as a result its value has appreciated significantly to $35 million. Additionally, over this growth period, through normal operations, the company has generated enough additional earnings to pay off the $10 million loan.

When the company is sold, your 60% stake is now worth $21 million, three and a half times the $6 million it was worth a few years ago and the private equity firm's stake is worth $14 million, a fair return on their original investment.

This is just one of many examples where the proactive and strategic use of outside capital can provide a powerful and creative solution for owners of lower middle market companies. Many of the private capital sources we work with have an advantageous access to capital through the U.S. Small Business Administration's, SBIC program, and, as a result, they have low cost capital to deploy to provide creative solutions for privately held companies.

So let me ask you…

What would you do if you could find significant liquidity in your business? Buy out a shareholder, diversify your personal financial position, increase investment spending for growth and expansion, fund an acquisition or simply take some cash out of your business for personal use and/or retirement and estate planning…

What would a liquidity scenario look like for your business? Let's run the numbers together.

You just might be able to have your cake and eat it too.

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