HighBank

Selling Your Business – How to Take Some Chips off the Table While Staying in the Game

"You've got to know when to hold 'em, know when to fold 'em," is a phrase we're all familiar with, made famous in the Kenny Rogers hit song *The Gambler*. The phrase has evolved to take on a context beyond the song, becoming an adage to inspire pause and self-reflection when reaching a serious crossroads and needing to a consider making a bold, definitive decision.

As a business owner, one of those crossroads presents itself when you begin to evaluate the future of your business. You may ask yourself: "Am I ready to retire?" "Is this the right time to sell my business?" "Am I losing anything if I don't cash out while the business is doing well?" As you evaluate your answers to these questions, it is important to realize that there are options other than the "hold 'em" or "fold 'em" extremes; there are alternatives that fall in between doing nothing or completing the outright sale of your business. These alternatives allow you to take some "chips off the table" (generating some liquidity) while still "staying in the game" (continuing to be involved in the operations of the business while maintaining some level of ownership).

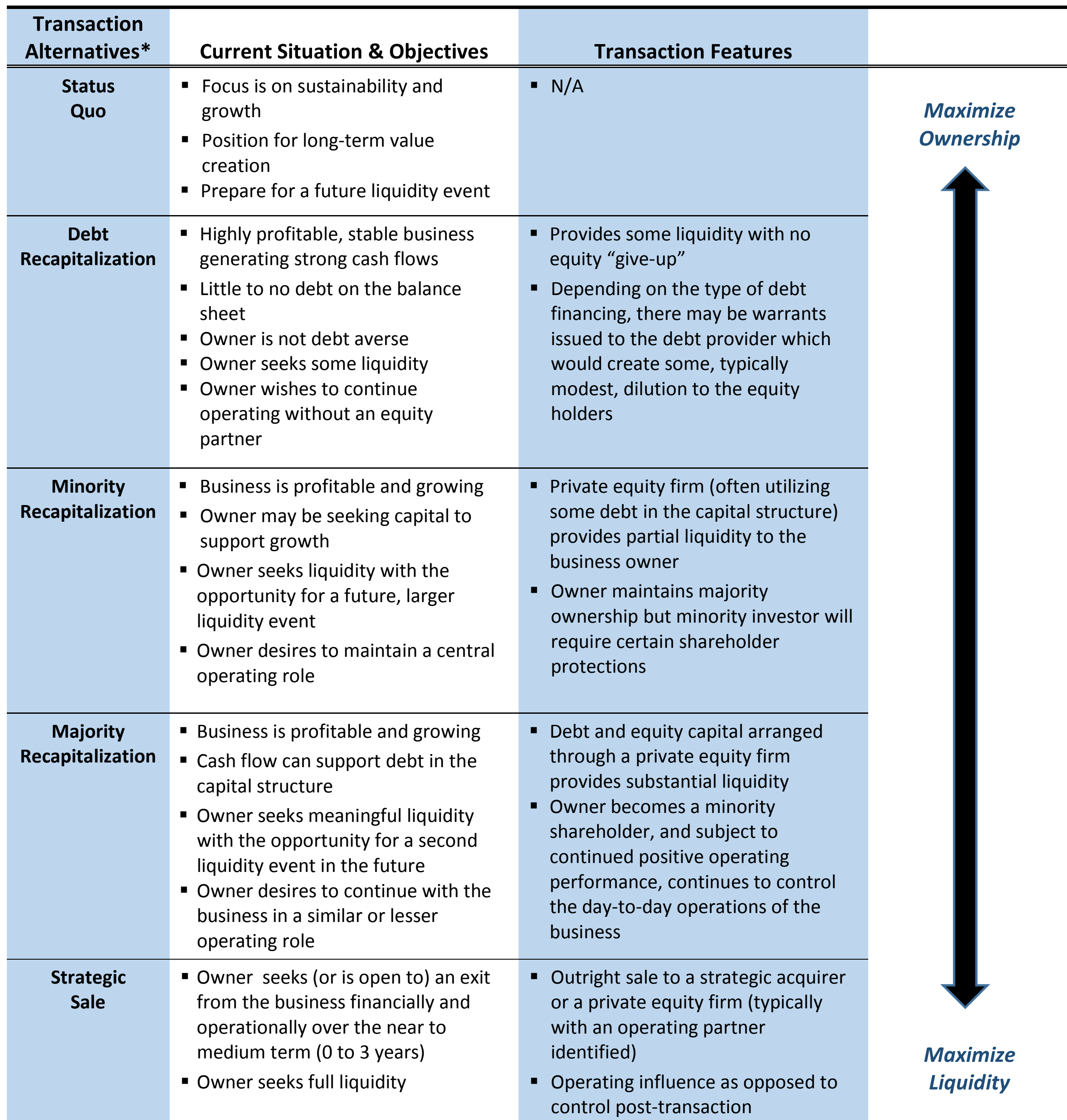
The figure below summarizes several transaction alternatives, including the continuum between generating liquidity from and retaining ownership of your business. As evidenced below, generating liquidity has a trade-off; maintaining a greater share of ownership offers less liquidity while decreasing ownership provides greater liquidity.

A ***debt recapitalization*** transaction "cashes-out" equity by replacing it with debt (commonly referred to as leverage) provided by a bank, mezzanine or subordinated debt provider or other finance company. This option provides immediate liquidity to a business owner; however, the trade-off is that the company is then operating with a more leveraged balance sheet and is required to meet interest and principal payments, as well as operate within covenants established in the financing agreements. A debt recapitalization, therefore, may be an ideal undertaking for owners if their business maintains healthy cash flow and can service the debt. A debt recapitalization generates liquidity while allowing for continued complete ownership of the business.

Other alternatives for a business owner to access liquidity are through a ***minority*** or ***majority recapitalization***. These are often appealing options for many business owners because owners are rewarded now (in the form of liquidity) for having built a successful business with the opportunity for a second, additional future pay-out based on the value of a retained equity stake in the business. Minority or majority recapitalizations are typically arranged and funded in part by private equity firms.

So what is a private equity firm and who is involved in these transactions? ***A private equity firm (also referred to as a financial sponsor) refers to any professional investment firm or individual investing in private companies with the intent to grow these companies and then sell them at a higher valuation at some point in the future.*** The investment horizon (often referred to as the "hold period") for the private equity firm has traditionally been three to seven years. According to Preqin, a leading provider of data on private equity, as of the end of the first half of 2015, private equity firms globally had $1.3 trillion in committed, but not yet invested, capital (dubbed "dry powder"). This amount marks a record high since Preqin began tracking this data in 2000.

Transaction Options: Ownership vs. Liquidity



Transaction Alternatives*	Current Situation & Objectives	Transaction Features	
Status Quo	▪ Focus is on sustainability and growth ▪ Position for long-term value creation ▪ Prepare for a future liquidity event	▪ N/A	***Maximize Ownership***
Debt Recapitalization	▪ Highly profitable, stable business generating strong cash flows ▪ Little to no debt on the balance sheet ▪ Owner is not debt averse ▪ Owner seeks some liquidity ▪ Owner wishes to continue operating without an equity partner	▪ Provides some liquidity with no equity "give-up" ▪ Depending on the type of debt financing, there may be warrants issued to the debt provider which would create some, typically modest, dilution to the equity holders	
Minority Recapitalization	▪ Business is profitable and growing ▪ Owner may be seeking capital to support growth ▪ Owner seeks liquidity with the opportunity for a future, larger liquidity event ▪ Owner desires to maintain a central operating role	▪ Private equity firm (often utilizing some debt in the capital structure) provides partial liquidity to the business owner ▪ Owner maintains majority ownership but minority investor will require certain shareholder protections	
Majority Recapitalization	▪ Business is profitable and growing ▪ Cash flow can support debt in the capital structure ▪ Owner seeks meaningful liquidity with the opportunity for a second liquidity event in the future ▪ Owner desires to continue with the business in a similar or lesser operating role	▪ Debt and equity capital arranged through a private equity firm provides substantial liquidity ▪ Owner becomes a minority shareholder, and subject to continued positive operating performance, continues to control the day-to-day operations of the business	
Strategic Sale	▪ Owner seeks (or is open to) an exit from the business financially and operationally over the near to medium term (0 to 3 years) ▪ Owner seeks full liquidity	▪ Outright sale to a strategic acquirer or a private equity firm (typically with an operating partner identified) ▪ Operating influence as opposed to control post-transaction	***Maximize Liquidity***

****The term "recapitalization" refers to any significant change in a company's capital structure, typically involving the introduction of new debt or equity.***

The percentage of your business that you sell in an equity recapitalization transaction can fall within a broad range, with a typical minority recapitalization ranging from between 35% and 45% and a majority recapitalization ranging between 60% and 90%. Ultimately, the percentage of your business that you

decide to retain will be driven by your objectives in pursuing a transaction (liquidity versus retained ownership) and the relative attractiveness of the offers presented by the private equity firms.

Completing a majority or minority recapitalization can be worth evaluating for many reasons, including:

Utilizing Debt in the Capital Structure Generates Higher Relative Liquidity. In addition to a change in ownership, a minority or majority recapitalization will alter the capital structure of your business. New equity is provided by financial sponsors who will likely also utilize debt as a meaningful part of the new capital structure. A deal structured with more debt benefits you (the seller) because it reduces the (relatively more expensive) equity portion of the capital structure, thereby allowing you to generate higher liquidity while maintaining the same or greater ownership percentage in the new company if debt were not utilized.

Further, limiting the amount of equity (relative to debt) in the capital structure amplifies the financial returns for the private equity investor. This ”financially engineered” structure was the impetus behind the creation and then rise of leveraged buyouts in the 1980s, and plays a large part today in the investment appeal of private equity funds.

The amount of leverage used in a transaction is entirely dependent on company dynamics and the comfort level of the owner and their private equity firm investor. Leverage is typically relatively higher with larger businesses that maintain stable cash flows, and relatively lower with smaller businesses or where significant capital is needed to fund future growth. Frequently, a majority recapitalization is structured with more leverage than a minority recapitalization, where often excess liquidity is retained in the business to fund future growth.

Maintaining an Equity Stake Creates Incentive. After a minority or majority recapitalization transaction is complete and you've generated liquidity, you still have a "stake in the game" (continued ownership). The private equity investor will expect you to remain focused on driving the growth of the business, as its success will greatly impact the value of the future payout (which is your second, but the equity firm's first!). The attractiveness of this structure is evidenced in proprietary data from GF Data which shows that of the completed private equity investments in the first half of 2015, 93% included retained equity by the business owner/seller in the new business.

Establishing a Productive Partnership. One of the concerns a business owner may have in recapitalizing their business in partnership with a private equity firm is losing operating autonomy. You now have an investor and part owner that is party to all aspects of "your" business. As a business owner you will need to be prepare for some changes to your role in the business, even if you still maintain majority control. A critical component of the equity recapitalization process is to ensure that you have found a private equity investor that you are confident you can move forward with in partnership. Further, another key element of the transaction is negotiating the operating agreement. This agreement will establish the "rules" by which all parties operate and interact, including reporting requirements and corporate decision making.

A private equity investor adds value beyond just providing the initial liquidity. Growing the business (which can meaningfully impact the size of your second payout) requires capital and the private equity firm will often provide the required capital to fund this growth, including investments in working capital, business infrastructure, greenfield expansions, or strategic acquisitions. Further, the experience and relationships of a private equity firm can help fill gaps in your business by providing access to talent and resources that

would not otherwise be available to you, including identifying new management team members or industry, strategic or marketing alliance partners.

Although you may not currently envision taking on a private equity investor, it can be an attractive option providing both continuing ownership and immediate liquidity. A minority or majority recapitalization with a private equity firm can be an optimal strategic alternative for a business owner looking to take advantage of high, current valuations (see our recent article "Selling your business: Why you may be waiting too long" which highlights the factors influencing business valuations). Such a transaction will provide liquidity today (capitalizing on the successful business you have built to date), diversify your overall personal financial holdings thereby lowering future risks, while providing the opportunity for a second pay-out when you're ready to cash out completely.

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