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Recapitalization can provide liquidity without selling assets

Austin Business Journal - by [Daryl Swarts](#) Contributing Writer

An entrepreneur is concerned about issues related to his business. He's spent more than 20 years building a successful and well-regarded operation, but he worries that more than 90 percent of his net worth is tied to it.

Should he sell to protect his retirement? He's not sure he wants to because he enjoys his job's challenges and thinks he would like to work at least another five years.

He also thinks about his children, who are near the age to decide whether they'd like to continue building the family business or pursue other dreams. How can he diversify his net worth, continue to work in the job he loves and still be in a position to pass the business to his children?

He's heard about recapitalization at a recent financial seminar and wonders if it could be used to help with his issues.

Recapitalization is essentially restructuring a company's balance sheet by using its operations, assets and cash flow to raise outside capital, which may include senior debt, mezzanine debt and/or equity.

In addition to the issues this owner hopes to address, recapitalization can be used to consolidate control by buying stock from minority shareholders, provide a vehicle for estate planning and provide a mechanism to reduce day-to-day involvement.

Other considerations

There can be disadvantages associated with recapitalization. Raising senior or mezzanine debt may result in a more leveraged balance sheet.

New equity will likely involve shareholders who want board-level participation and a structure that ensures they can convert their investments to cash. And new shareholders will dilute existing shares.

Finally, recapitalizing can be time-

consuming and expensive, since it normally involves lawyers, accountants and investment bankers.

Despite such concerns, recapitalization has become prevalent in today's market and is an attractive alternative for a business owner wishing to convert some value in his business to cash without selling it.

How to proceed?

Financing for recapitalizations can be obtained from a variety of sources, including banks, finance companies, insurance companies, private and public mezzanine funds, private and public equity funds and, in a few instances, the public financial markets.

The appropriate sources are determined by the type and amount of financing sought, the nature of the business and its financial characteristics.

Similarly, determining the kinds and amounts of financing to obtain involves a careful review of various questions:

- How much debt can the company's assets and cash flow reasonably support?
- What degree of leverage are the owners comfortable with?
- What are the financial markets' conditions and the impact of those conditions on the financing that is obtainable?
- Does the nature of the company's business, its financial condition and its business prospects suggest that mezzanine financing is obtainable?
- What does the company's valuation imply about how much equity can be raised, and what are the implications regarding dilution of existing shareholders?

There are pros and cons with each type of financing.

Senior debt financing is the least expensive to shareholders, but it places the greatest financial constraints on the company.

Equity will not require operating financial constraints and normally won't impose an immediate financial cost, but it ultimately is more expensive than debt. And as mentioned earlier, equity typically requires board representation and is dilutive to existing shareholders.

Mezzanine financing is less expensive than equity and less restrictive than debt, but it carries a current interest rate, which is more expensive than senior debt, and normally also requires equity participation.

Recapitalization process

An experienced financial adviser is important when reviewing these questions and deciding which sources to tap. When all such questions are answered and the issues regarding structure and approach are understood, a business owner who has decided to pursue recapitalization should:

- Seek counsel of someone well versed in these transactions, typically a securities lawyer, accountant

or investment banker.

- Prepare a plan describing the proposed transaction. Detailed information about the company, its history, its business, its financial information and its prospects must be compiled and arranged in a format that lenders and investors can use.
- Send the business plan to prospective financing sources for review. If it is viewed favorably, financial institutions will follow with management meetings and due diligence.
- If the results are still favorable, the institutions will issue financing proposals to analyze, negotiate and document.

It is a long process, but its results are worth the effort.

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