The Alternative to Selling:

Private Company Recapitalization without Relinquishing Majority Ownership

by Samir Desai

One of the top issues faced by attorneys, accountants and other advisors involved in financial planning is how to help private business owners overcome the lack of liquidity of their company's private shares. Most are surprised to learn that their clients can liquefy a significant portion of shares without giving up control of their company or going public. It is a misconception that's not surprising, considering that the vast majority of financial investors do require a majority ownership – and that nearly all articles and information on the subject, written by those investors, state that transferring majority ownership is the only option.

However, a limited number of capital firms do offer ownership recapitalizations that require only a minority stake in the company. To finance such recaps, the firms use mezzanine securities, specifically subordinated debt and preferred stock. Mezzanine securities are a hybrid between senior debt and equity. Like senior debt, the securities are loans that earn interest, and like equity, they are unsecured and long term in duration. The overall cost of mezzanine securities is higher than senior debt, but lower than equity.

In terms of shareholder liquidity, mezzanine funds offer business owners the chance to have their cake and eat it too – they can take cash out of their business, and yet maintain a majority ownership and management control.

Why Consider a Minority Ownership Recap?

Private business owners nearly always face a lack of liquidity of their company shares. Regulations and restrictions imposed by shareholder agreements severely limit an owner's ability to exchange a portion of his ownership for cash. And, although the owner may take out nice salaries and benefits, the majority of his/her wealth is tied up in the company and dependent upon its continued success.

Therefore, the primary reason to consider a minority ownership recap is for wealth diversification purposes. Within the past few years, even some of the most seemingly secure companies have fallen upon severe financial distress. Changes in technology, consumer practices, or just a continuation of the world market's decline could devastate a business owner's financial security – if that security is 100 percent invested in his/her business.

A recap allows an owner to "take chips off the table." It provides the peace-of-mind that their financial security is ensured, but doesn't require them to withdraw from the game or miss future earnings.

Intergenerational Wealth Transfer

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Minority ownership recaps are also an effective way to transfer business ownership from one generation to the next. Normally, the same issue of liquidity of shares can be an obstacle to a business owner's desire to pass his/her company on to the next generation. If 100 percent of a company's shares are held by the business owner, how does he/she "sell" the business to the next generation without asking them to come up with the funds individually? A minority ownership recap allows the owner to withdraw a significant percentage of the cash value of the business, and yet leave the majority of the company's ownership to the next generation.

Unfortunately, as is the case with wealth diversification, most business owners and their financial advisors believe recaps require giving up control of the business. Therefore, they are left to choose from among other, often unattractive, options. These options might include selling the entire company, or at least a majority interest, or going public. The latter of which is not only a logistical challenge, it also equate in many owners' minds as just another way to give up control of their business.

Recaps Aren't for Everyone
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If there's "a catch" to minority ownership recaps, it's that it requires a willingness by the owner to enter a partnership with a financial investor. A well-conceived recap deal should be based on a mutual partnership to continue to grow the company. If it's the owner's wish to quit his business, either immediately, or within the next few years, either he or she should consider other options.

For their part, mezzanine partners are usually willing to take a non-controlling interest only when the owner has an emotional stake in the company's future. That stake can include passing the company on to the next generation, or to trusted management. Either way, investment firms don't want to have a non-controlling interest with a partner with diminished interest in the company's success.

Likewise, an owner must be willing to accept the new investors as partners in the business. Some mezzanine firms, like Key Principal Partners, take the role of advisor and resource, rather than controlling or demanding partner. Yet, some owners still find even the least intrusive partnerships difficult to accept.

In Real Numbers, How does a Recap Work?

My clients are usually the trusted advisors (corporate attorneys, financial planners, and bankers) of private business owners. Usually, once I describe a minority ownership recap using a hypothetical example, they begin to recognize how many of their own clients are in very similar situations.

The most common example I give is of a 45-year-old business owner. He's not yet interested in giving up control of his business, or in playing golf full-time. However, he wants to make sure he and his family is financially secure, independent of his company's continued success.

For our example, let's assume he owns a $40 million business, with $7 million/year in cash flow and a five percent annual rate of growth. In most instances, the owner can expect to take out $12 million from the business in exchange for 30 percent of his company. Whereas if he sold the company outright, he might only get $35 million for the entire business, and relinquish all equity and control.

After closing on a minority ownership recap, and using the worst-case taxation scenario, the owner now has about $7.5 million, and the financial independence and security that brings. He also has the resources and guidance of a financial partner, who, if he selected a quality firm, will work with him to grow the business without endeavoring to run the business.

How Does the Relationship End?

One interesting aspect of the partnership a mezzanine firm brings to an ownership recap is its desire to return its portion of the company back to the owner. If the partnership is successful, the owner should have multiple options to allow him to retire the mezzanine debt and regain 100 percent ownership of his company.

Most mezzanine deals have a life of about three to seven years. During that time period it's assumed the company will grow and increase revenues. Those earnings can be used to pay down existing senior debt, allowing the owner to replace the mezzanine debt with new traditional senior debt, at which point he regains complete ownership of his business. Or, increased earnings can be used to repay the mezzanine firm outright. At the same time, if the motivations of the business owner have changed, selling the entire company or an IPO are still options.

Selecting a Mezzanine Firm

Earlier I stated that if the partnership is successful, an owner should have multiple options to retire mezzanine debt and regain 100 percent ownership of his company. The quality of the partnership is the essential element of a well-structured minority-ownership recap. Not only will a good mezzanine firm contribute to a company's ability to grow (and thereby retire the mezzanine debt), it will first avoid entering a partnership that will have a negative impact on a business owner.

The defining difference among mezzanine firms is the amount of due diligence each performs – how much time each puts into researching a company and potential client. Business owners and their advisors should select firms that take the time to understand their individual businesses. A mezzanine firm will not enter a partnership if it doesn't believe the company's growth and success will make the deal beneficial to both parties. Without significant due diligence, a mezzanine firm cannot make an educated judgment about that potential.

Once in a partnership, a mezzanine firm should be more than just a capital provider. A good firm will contribute its human and other resources to help the owner overcome business challenges. As the old adage states, "you get what you pay for," so avoid selecting an investor based simply on cost.

Finally, since a partnership often lasts for three to seven years, it's essential to make sure the firm's culture is compatible to the company's and the business owner's. Toward this goal, take the time to get to know the firm's associates and consider talking with some of its other clients. Make it your role, as a trusted advisor, to bring an investor to the table that will work well with the business owner, not just provide capital.

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- **Debt financing**

Like the baking metaphor, there are several ingredients to building a fully funded business model. The debt component of the model has a multitude of ingredients to choose from. The Dillon advisor has the knowledge and experience to blend and layer many types of funding with different types of lenders. A partial list of funding options follows:

Asset based lenders	Private Debt Programs
Conventional Term Loans	* Private placement bonds Capital Leasing
Real Estate loans	* Private investment groups
Capital Leasing	* Mezzanine debt Read more
Working Capital Lines of Credit	* Angel investors
	* Venture capitalist

Government Programs
SBA - 7a
SBA - 504
USDA (pop. under 50,000)
State & local grants or bonds