How A Recapitalization Can Help Boost The Business

"If you don't know where you're going, you'll wind up somewhere else." – Yogi Berra, former Major League Baseball catcher, manager, and coach

So what's next? Many business owners picture their ultimate goal – a successful sale, transitioning ownership to the next generation, a comfortable retirement. Expecting to manage day-to-day operations for another seven years or more, they may not be thinking about – or know – how to best achieve that outcome.

A recapitalization can be a key part of the transition to the "next" chapter, for both the business and its owner.

"Owners should at least go through the thought process – they should know what a recap is and how it could play a role in helping them grow their business, reduce personal risk, and ensure they don't get stuck holding the company when they can least afford to," says Lou Kenter of Prospect Partners.

Recapitalization: *A financing technique that shifts business risk to an outside financial partner. Through a partial sale, an owner sells equity in the business to the outside investor, and then reinvests part of the cash proceeds in the restructured company in return for a continuing and significant ownership stake.*

By recapitalizing with an experienced financial partner, owners share business risk with another investor. In the process, they gain capital resources as well as access to professional strategic counsel that will help them maximize the value of the business for when they eventually do leave.

"Owners often think a recapitalization means they will lose control of the business. With the right partner, it is actually the opposite," explains Prospect Partners' Rick Tuttle. "Private equity firms are business owner-backers, experts in the overall process of growing a company. They are not experts in running a particular business, and don't want to become one. That's why recaps are perfect for owners who still have the energy, vision, and drive to build their business."

Different Ways To Think About Recaps

Investment strategy counsels managing portfolio risk by holding a mix of stocks, bonds, and other assets, so one's eggs are not concentrated in a single basket.

For business owners, diversifying is particularly crucial. They started their company and invested tremendous time and personal savings into growing it. Now may be the moment to establish a safety net, freeing up hard-earned wealth for other needs, like retirement and children's education. A recapitalization is one way to accomplish these important goals.

There are many reasons why owners might recapitalize. Here are six common ones.

1. As part of a considered strategy to build a strong company. A recapitalization five to 10 years before an owner ultimately wants to leave can position the company for a strong exit when the time is right.

Private equity partners know how to help entrepreneurs put into place all the pieces needed to build a great business, increase its value, and provide the potential for financial reward at the other end.

That means a well-planned succession strategy, a strong and well-rounded management team, a solid infrastructure, and the right business systems and accounting processes. Plus help growing the size or breadth of the business and successfully reducing risk factors like customer concentration, cyclicality, and supplier reliance.

Alternatively, owners in their career "mid-life" who need outside support to achieve an ambitious business plan can pursue multiple recapitalizations with different financial partners as a way to finance their desired growth.

"It is not uncommon for a business owner to work with one partner to build a company through one growth phase and then recapitalize with another partner four to seven years later when the company reaches a different level of needs for investment and other support," says Tuttle. "PE firms often have specific expertise in companies of a particular size."

In a subsequent sale, whether a complete exit to a strategic buyer or another recapitalization, management should benefit financially by receiving the second chunk of the proverbial "two bites of the apple." They earned a cash payout after the original sale, and will now receive another after the second.

Often, the additional years of investment in a growing company can significantly raise the owner's equity value above the amount sold in the first transaction.

2. To professionalize a company in an entrepreneurial phase. John Zaruka, founder and CEO of Wedgewood Wedding & Banquet Center, had dramatically grown his full-service wedding event business by investing in ceremony and reception venues in picturesque locations throughout the western United States.

In the process, he established a different company for each venue, ultimately owning 23 different units, each with its own financial structure.

Wedgewood was thriving, but its structure limited Zaruka's ability to scale the business and access liquidity. In early 2014, needing more investment capital as well as strategic guidance, he recapitalized Wedgewood with Prospect Partners.

Prospect Partners invested in legal resources to help Wedgewood solve its complicated financial planning issues and establish a single operating umbrella that would allow

the company to grow more easily and provide greater ownership equity to emerging leaders, including John's son, Bill, so they could benefit from Wedgewood's growth.

"Our partnership allows us to continue to invest both in our team and in new venues as well as put into place the tools we need to manage, monitor, and finance our growth," Zaruka says. "Working with a partner also frees me up so I can spend more time finding our next great location."

3. To fulfill the company's potential. Many times owners are not pursuing logical growth strategies like geographic expansion, new product development, and other initiatives. They may not have the additional cash. Or they may feel uncomfortable assuming even more risk.

But the inability to invest to pursue growth can stall their company and leave it vulnerable to competitors with deeper pockets.

Back in 2007, Mike Church, President of swimming pool builder Cody Pools, ran two successful, fully-staffed branch offices in Austin, Texas.

"Demand for new pools was through the roof," Church remembers. "Opening more offices would provide a tremendous opportunity to expand our reach to San Antonio, Dallas/Ft. Worth and Houston, surpass our competitors, and take Cody to an entirely different level. I had the vision and knew what we were capable of, but could not handle that risk or investment myself. I needed a partner."

Recapitalizing allowed Church to continue to run Cody, while Prospect Partners provided the additional investment resources needed. Church expanded his team and opened eight more offices. By 2014, Cody was the country's leading builder of custom pools for the second year in a row, and had been voted one of the best companies to work for in Texas.

"Relying on a partner to invest in new growth provides a layer of insurance, since start-up phases can be both costly and risky," says Kenter. "The partner, whose interest is in the big picture – increasing the value of the business over time – can withstand operating losses incurred in the initial phases of expansion."

4. To achieve a desired strategy when ownership is spread among many stakeholders. Important business decisions can come to a standstill if majority ownership rests with many stakeholders, as is often the case with family-owned companies. The stakeholders may not all actually work at the company or share the same goals for it.

A minority shareholder may, in fact, be CEO, but unable to pursue major initiatives – be it an acquisition, a capacity expansion, or an operational expense – without affecting profitability.

Says Tuttle: "Affecting short-term profitability can rock the boat if the majority owners are satisfied with the status quo. They won't vote to support the initiative."

Here, a recapitalization can serve to satisfy all owners, since the partner will step in to provide investments to finance the growth that, hopefully, will ultimately improve the company's bottom line and benefit everyone. Buying out the passive shareholders focuses ownership with people active in the business and committed to its growth.

When A Recap Is Not The Right Choice

A recapitalization is not a "one-size-fits-all" financing strategy. It does not make sense for owners who:

• **want to retire a year or two after the transaction.** Short-term interest signals lack of commitment. To PE firms, this sounds like, "I want to sell and get out."

• **are eyeing other careers.** Owners too young to retire but interested in running different businesses represent a flight risk. PE firms prefer to back current management typically for four to seven years.

• **prefer all-cash to equity deals.** Owners who desire cash project a "live for today" mantra. PE firms want to build business value over time.

• **do not really want to give up majority control.** Owners who feel they should own at least 51 percent of the business may have a hard time working with partners, even though the owner remains in charge after a recapitalization.

• **run companies that are not well-positioned.** PE firms often prefer to invest in firms with strong management teams, market leadership, and a history of consistent earnings.

• **want to pass ownership down through the family.** Owners more focused on passing the business down to the next generation have different goals than PE firms, which want to partner with management looking to maximize business value and eventually realize that increase in value.

5. For a network of peers who care deeply about the business. Running a business can be a lonely vocation, especially for owners without a like-minded network.

"Your financial partner has a vested interest in your business and will know you and understand your situation," Kenter remarks. "Having someone 100 percent committed to increasing business value and who has successfully achieved that many times with different types of companies – we have found that owners really appreciate that perspective."

6. As protection from Black Swan events. While sustained economic downturns, Category 5 hurricanes, and terrorist acts are rare, unforeseen events can affect a business's operations, profitability, and appeal to a potential buyer.

Recapitalizing helps insulate the company from going under and protects personal assets.

Both were true for fire protection services provider Summit Fire Protection of St. Paul, Minn. The company experienced a dramatic decline in revenue and profits during the 2007-2009 recession.

Says President Quint Rubald: "If we hadn't recapitalized when we did in 2006, Summit wouldn't be here today."

He continues: "Prospect Partners continued to invest and got us through. We are now doing better than ever and have made nine acquisitions as part of our regional consolidation strategy."

The Danger Of Waiting

If an owner waits to sell until he is absolutely ready to retire, he will need to sell 100 percent of his business to a buyer that will need to both own and run it.

That can affect the company's worth for two reasons. First, many prospective buyers can envision the business being as valuable only if the same person runs it. Without that person at the helm, unless a succession plan is in place, perception of the business risk increases.

Second, he may be stuck selling during unfavorable market conditions.

"Even minor economic downturns are usually unexpected, so that is one reason to recapitalize when the environment is healthy and your company is in a good place," says Tuttle.

Would-be sellers aged 55 to 65 who wanted to sell in 2008 might have had to take their business off the market and run it for years more than they wanted in order to recover the value the business once had, Tuttle points out.

His advice to owners considering a recap? Talk to others who have been through one.

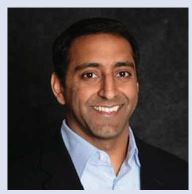
"Your financial partner should provide a full roster of references. Ask each to walk through exactly how the recap worked for them. If you choose a good partner, the reference will say, 'Yes, they had a large equity stake but counted on me to make the business decisions with their support, believed in what I wanted to do, and were there for me when I needed them.'"

About Prospect Partners

Prospect Partners is a leading private equity firm that invests in smaller lower-middle-market companies, focusing exclusively on management-led leveraged recapitalizations and acquisitions of niche market leaders with revenues typically under $75 million. Since 1998, Prospect Partners has invested opportunistically nationwide in nearly 120 unique companies in a broad range of niche manufacturing, distribution, and specialty service markets. The Chicago-based firm also has an office in Menlo Park, Calif.

Reach Out To Our Team

Prospect Partners is actively investing our $200 million Fund III. If you know about an interesting company you think will interest us, please call us today at 312.782.7400, visit www.prospect-partners.com, or contact a team member:



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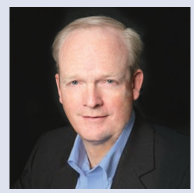

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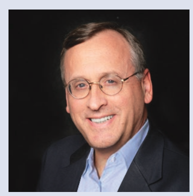

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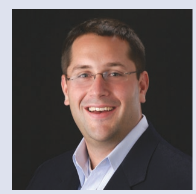

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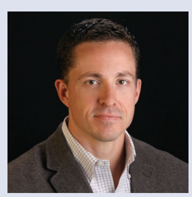

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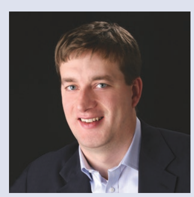

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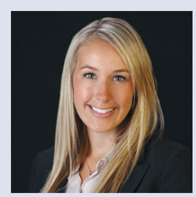

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