CSQ C-SUITE QUARTERLY
THE EXECUTIVE'S LEADERSHIP & LIFESTYLE MAGAZINE
C-SUITE ADVISORY

| RECAPITALIZATIONS |

Partial Liquidity Alternatives

An overview and critique of the options

Jeffrey R. Knakal
Managing Partner & Founder
GROWTH PARTNERS
Calabasas, CA

Jeffrey Knakal had a distinguished investment banking career in New York, having built successful practices for JP Morgan Chase, Credit Suisse and Daiwa Securities and achieving a number of "first-time" transactions for Fortune 500 companies. In 1994, Jeff founded Growth Partners to provide a next-generation investment banking offering. The firm provides a full array of liquidity event, buy-side acquisition, and capital formation execution services for companies, which are synergistically complemented by a set of strategic advisory offerings entailing, defining, and accelerating a company's "next-level" development, preparing for a transaction event, and determining the optimal timing and form of a liquidity event. Growth Partners is a unique turnkey resource, its configuration and proprietary practices afford superior outcomes for its clients, and Jeff is a premier investment banker and strategic engineering center-of-expertise (he founded two $100mm companies). Jeff has degrees from the Wharton School and New York University.

Owners typically work a lifetime building their companies and most have their wealth embedded within the stock of their enterprises. So what are their choices related to realizing some of the benefit from their hard work (vs. an outright liquidity event)? The top three partial liquidity options will be outlined.

Dividend Recaps

Overview. A company obtains debt funding and uses the proceeds to pay the owner a dividend. This has been a popular form of partial return for private equity firms, but now has become a vibrant alternative for owners of companies based on: 1) the low cost of debt, 2) capital availability, 3) bank demand for asset yield and cross-selling investment management services, and 4) the apparent paucity of growth-related investment opportunities (which is false). Large companies raised $70B (a record) for dividend recaps in 2014, and 2015 is on pace to match this result.

Requisites. A company should be achieving a relatively stable, if not strong, cash flow performance, while possessing excess debt capacity in order for the capital market to embrace the opportunity.

Pros. The pros include the ability to convert some equity value to cash without selling ownership (minimal dilution might be incurred via mezzanine capital) and with maintaining control, the low and tax-advantaged (interest deductibility) cost, the favorable tax treatment since dividends are taxed at the same rate as capital gains (20% Federal & 13.3% California), and the relative ease and expeditious execution.

Cons. The cons include the use of valuable debt capacity for effectively "unproductive" purposes (i.e., a non-value creating purpose), the increase in business risk associated with a more highly levered company, the creation of a taxable event, the limitation of the dividend amount, and the implication that the company does not have worthy investment opportunities to further build the business.

Opinion. Notwithstanding the prevailing sentiment, levering the company and increasing its enterprise risk via reduced flexibility to provide a dividend is not an option for which I am a strong advocate.

Recapitalizations

Overview. An owner sells a minority or majority interest of their holdings to a private equity firm in order to achieve some liquidity, and likely at the same time, obtains additional funding, including issuing new stock, to fund growth opportunities. This alternative is open to all companies with at least $1mm of EBITDA (yes, a vibrant market exists for minority interest transactions for small companies). Recapitalizations are considered the most traditional alternative for partial liquidity.

Requisites. A company needs to be a platform enterprise via characteristics of scalability and growth potential since sponsors are attracted by future IRR (the shareholder rights agreement is a key element).

Pros. The pros include the ability to diversify wealth and reduce risk via asset-class transformation, the opportunity to risk-share new build opportunities with a partner, the benefit of having an advocate with available resources, the chance to build new value and enjoy another transaction event, the possible maintenance of control, and capital gains tax treatment.

Cons. The cons include the sale of some ownership, the possible loss of control, the likely inability to retire or exit over the short-term based on sponsor considerations, the new modality of having a partner, albeit a passive partner, and the lacking applicability if a company is: 1) not a platform, and 2) a legacy enterprise (family succession) de-emphasizing earnings and value creation.

Opinion. This option can achieve multiple objectives related to both the owner(s) via risk reduction/sharing, and a company via a new supportive partner.

ESOPs

Overview. An ESOP is an employee benefit plan authorized by ERISA that is also a tax-advantaged liquidity alternative for owners. ESOPs may be leveraged or non-leveraged, partial or outright, funded or prefunded, etc. Owners can achieve partial (or full) liquidity by selling shares to the ESOP, which is created by establishing a trust controlled by a trustee (an executive or third party). The ESOP is initially funded by a loan from the company after the company obtains a loan from a bank (the selling owner(s) may also provide a seller note depending on the size of the sale). This is the source of the payment of to the owner(s). The sold shares are held in a "suspension" account until employee vesting in conjunction with the repayment of the debt.

Requisites. The most prevalent minimum EBITDA is $2mm and the same for employees is about 20, while available debt capacity and relatively reasonable business risk must be present.

Pros. The pros include providing a benefit to employees entailing an incentivizing element, an established venue for, and relative certainty of a sale event, the possibility of not relinquishing control, the tax deferral of the sale proceeds (1042 rollover) if 30% is sold and the company is a C-Corp enabling reinvestment returns from "qualified securities" before tax is paid, the tax deductibility of principal and interest related to the debt funding, and the ability to sequence share sales.

> **"Recapitalizations are considered the optimal partial liquidity event alternative given the diversity of benefits."**

Cons. The cons include establishing the FMV of a company by an appraiser, vs. the marketplace, which would encompass a strategic premium, the vehicle's highly complex nature and annual requirements (e.g., valuations, company payments to the ESOP, employee reporting, etc.), the use of valuable debt capacity for unproductive purposes, the creation of a new liability related to employee share repurchases, and the payment limitation given the exclusion of equity funding.

Opinion. While a partial ESOP does not hinder a recapitalization or outright liquidity event, it is fundamentally constituted as an employee benefit. The key drawback pertains to the abstract (and low) valuation, aside from the debt capacity consumption.

Summary Statement

Dividend recapitalizations are popular but consume debt capacity, and ESOPs entail the same issue plus possess a material valuation weakness. Thus, recapitalizations are considered the optimal partial liquidity event alternative given the diversity of benefits. Nothing less than a robust marketplace exists for majority, and minority interest recapitalization transactions, even for smaller companies.

CONTACT ME:

Phone 818/713.8000

Email jeff@growthpartners.net

Website growthpartners.net

Address 5023 N. Parkway Calabasas
Calabasas, CA 91302