The McLean Group
INVESTMENT BANKING

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The McLean Group is a national, middle market investment bank serving businesses generating up to $500 million in annual revenue. For more information, visit www.mcleanllc.com.

Feature Article:
Recapitalization: Have Your Cake and Eat It, Too

By Ron Stacey, Managing Director, Dallas, Texas

A successful business owner nearing retirement faces a number of issues. Perhaps it is time to take some chips off the table, enjoy more leisure time and feel more secure. Wouldn't it be great if all of these objectives could be achieved while still retaining day to day control of the business and a meaningful equity interest? And, have a trusted financial partner, reward a loyal management team with equity incentives, provide for the next generation, and obtain access to additional growth capital? If all of this sounds like having your cake and eating it too, well, it is. The vehicle enabling successful business owners to reap these rewards is leveraged recapitalization.

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Expert's Corner:
Creating a Marketable Business

By Enrique Brito, Senior Managing Director, McLean, Virginia

Most business ventures begin with entrepreneurs who capitalize on their experience, skills and contacts. Typically, for the first few years the owner is the main engine behind the growth of the business with delegation being exercised grudgingly and sporadically. Consequently, as the business grows and succeeds in the marketplace, it becomes more and more difficult to separate the business from the owner.

The previous sequence of events is fairly common in service businesses. However, while the business may be very successful in its own right, it may not be worth much in terms of market value. This is because the knowledge, processes and skills are the own-

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Recapitalization is much like a home equity line of credit. By employing additional debt, recapitalization allows the homeowner to retain ownership while unlocking market appreciation in the equity. The same principle applies to a business recapitalization when debt is employed to leverage equity to meet business objectives or resolve ownership issues. These issues might include a younger partner buying out a retiring partner, cashing out contentious outside shareholders, settling shareholder disagreements, asset diversification and liquidity for a majority shareholder or providing for a generational transition. A key objective may be reducing the business owner's personal financial exposure by refinancing without guarantees or personal collateral while simultaneously retaining control and a meaningful ownership position.

Since leverage has its limitations, most business recapitalizations include a sale of some portion of the equity to new investors. In recent years, these investors have been private equity groups looking to employ a mountain of capital. In addition to buyout capital, and in most cases, growth capital, the private equity group also provides professional investment management to maximize shareholders' value. Accordingly, the recapitalized company gains access to capital and expertise. Moreover, a company operating at higher debt levels tends to run more efficiently since attention to detail and strict operating controls are required when dealing with long term credit providers.

How it Works: A Case Study

Dan and Linda Spencer own a successful manufacturing business, Spencer Wire & Cable, in Kansas City. Linda is spending more time with the grandchildren at the couple's Florida home and Dan is thinking of a way to cut his workload and perhaps even retire. The Company has a good management team. Dan knows of several growth opportunities but is reluctant to pursue these because of capital constraints and his desire to slow down.

From a financial perspective, the Company has enjoyed several years of steady and growing cash flow protected by a large amount of proprietary engineering content in the products. The Company was founded in 1985, and over the years has become debt-free. With good cash flow and a strong balance sheet, Dan believes he could get $40 million for the business. As the eternal entrepreneur, however, he can't keep his mind off those opportunities and the well-being of his dedicated and loyal employees.

One day over lunch with a friendly local investment banker, Brett, Dan explains his thoughts and concerns about the Company. Brett suggests that he consider a leveraged recapitalization in partnership with a local private equity group.

The private equity group proposes an asset purchase to buy 80% of the Company for $32 million using $20 million in debt, $10 million in preferred stock and $2 million in equity contribution. The transaction's before and after comparative balance sheet ($ 000s) appears as follows:

Assets	Before	After	Liabilities & Equity	Before	After
Cash	$ 500	$ 500	Accounts Payable	$ 2,465	$ 2,465
Accounts Receivable	6,200	6,200	Accruals	480	480
Inventory	4,900	4,900	Total Current Liabilities	2,945	2,945
Prepaids	150	150			
Total Current Assets	11,750	11,750	Long Term Debt	0	20,000
Net Fixed Assets	8,000	14,000	Preferred Stock	0	10,000
Goodwill	0	9,195	Equity	16,805	2,000
Total Assets	19,750	34,945	Total Debt & Equity	19,750	34,945

Fixed assets are "stepped up" to fair value and the transaction results in $9 million of goodwill. Note on the right side, the new long term debt, preferred stock and equity of the new company post acquisition. Moreover, the private equity group likes Dan's ideas for new opportunities and has set aside $7 million of additional growth capital and agrees to a 10% management incentive equity interest for the existing management team.

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Dan likes the idea of banking $32 million (before taxes and transaction costs), still owning 20% and having the private equity group as his new partners. Dan gets some time off, has a war chest of additional capital, and the very real prospect of a “second bite” at the apple when he and the private equity group make the next sale five years from now. ◆

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er’s and as a result, it is nearly impossible to transfer them without a management transition period that is likely to take several years.

Many people start consulting practices as solo practitioners, and while many remain that way, others bring in additional resources as the business grows. If the entrepreneur’s objective is to create a personally satisfying job that makes use of his/her talents, experience and skills, then developing a solo practice may enable them to fulfill that goal. If, however, the objective is to build a marketable business that can be sold in a few years, a different strategy will be needed.

In essence, the value of a business for a prospective buyer resides on the potential for the business to generate enough cash flows (revenues less operating expenses) to enable the buyer to recoup the original investment and realize (and probably exceed) a given rate of return. Of course, the business’ past performance will provide the buyer with anecdotal evidence about the enterprise’s potential to generate the earnings necessary to meet the buyer’s objectives. However, the risk for the buyer resides on whether or not that past performance can be repeated and even surpassed in the future.

Having a business that is too dependent on its owner is certainly one of the main factors affecting its marketability. However, this is not the only factor as there are other issues that will also have an impact on the potential marketability of a business such as:

- An inexperienced management team
- High customer concentration (having just a few large customers)
- Poorly maintained financial records
- Poorly maintained assets
- Contingent liabilities
- The threat of litigation

In the end, the acid test for an owner who wants to find out how marketable the business is revolves around the answer to a simple question: Can I afford to leave the business for a couple of months without any significant deterioration in its performance? The answer to this question not only can be quite revealing, but it also can point out to the need for a change in his/her leadership strategy. ◆

Our Locations:

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Anchorage, AK	907-277-3725
Asheville, NC	828-606-1101
Atlanta, GA	678-461-0775
Austin, TX	512-687-3485
Baltimore, MD	410-799-2053
Boston, MA	978-475-2511
Bozeman, MT	406-586-9746
Buffalo, NY	716-489-2048
Chicago, IL	312-994-2550
Cleveland, OH	440-484-1060
Columbia, MD	410-440-3189
Dallas,TX	214-705-9724
Erie, PA	814-397-7737
Halifax, Nova Scotia	902-832-2774
Hartford, CT	860-255-0107
Hattiesburg, MS	601-671-4098
Lafayette, LA	337-365-3979
Miami, FL	305-804-6181
Milwaukee, WI	262-646-6490
Phoenix, AZ	602-549-9946
Reno, NV	775-825-7637
Sacramento, CA	916-929-0900
San Diego, CA	858-245-0003
San Francisco	510-444-6195
Silicon Valley, CA	650-638-2310
St. Louis, MO	314-307-1090
Tulsa, OK	918-492-3388
Tallahassee, FL	904-219-5750
Tampa, FL	559-289-7878

* headquarters office

About The McLean Group

The McLean Group is a national, middle market investment bank providing mergers & acquisitions (M&A), capital formation, market intelligence, business valuation, litigation support and exit planning services. The McLean Group serves businesses generating up to $500 million in annual revenues. Headquartered in Northern Virginia's technology, communications and government contracting corridor, the firm is among the largest independent middle market investment banks in the Washington, DC area. The McLean Group is a FINRA Registered Broker/Dealer and Member FINRA/SIPC.

- M&A: The McLean Group uses its considerable expertise in a wide variety of industries to identify the most probable and suitable candidates to complete transactions under the most favorable terms for its clients.
- Capital Formation: The McLean Group arranges private equity, venture capital, senior debt and subordinated debt in amounts ranging from $5 million to $250 million to support clients' expansions, mergers & acquisitions (M&A), refinancings, recapitalizations, leveraged buyouts and shareholder liquidity objectives.
- Market Intelligence: By leveraging superior competitive analyses, the firm provides business executives with comprehensive market intelligence reports, which provide the market insight and analytical expertise required to reduce risk and uncertainty in strategic decision making.
- Business Valuation: As a core competency and complement to its M&A business, The McLean Group provides business valuation services, including intangible asset and financial security valuations for a variety of transactions, financial reporting and tax purposes.
- Litigation Support: From quantifying economic damages to valuing a minority interest in a business, the firm has the business valuation experience and credentials to support cases involving a variety of legal issues.
- Exit Planning Services: Based on its extensive experience advising owners of middle market businesses, The McLean Group has developed a proprietary process that analyzes more than 60 value/risk drivers that can have a significant impact on the value of a business.

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