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Retained Interest in a Leveraged Recap: the Case of the Clueless Seller

(Based on a true story)

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Aerospace Critical Components, Inc. (ACC or Company) is a thriving, precision manufacturer and distributor of close tolerance components to the global aerospace industry from two locations in North America. The Company is owned equally by its founders Bob Case and Tom Clore, business partners, college roommates and lifelong friends. A recap of the income statement for the past 6 years and 2013 projected reflects the following:

ACC Year End December	2007	2008	2009	2010	2011	2012	2013
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Revenue	$ 38,100	$ 51,400	$ 51,900	$ 59,300	$ 46,200	$ 48,700	$ 58,440
Cost of Sales	23,400	31,800	35,500	45,000	24,200	26,300	32,726
Gross Profit	14,700	19,600	16,400	14,300	22,000	22,400	25,714
%	38.6%	38.1%	31.6%	24.1%	47.6%	46.0%	44.0%
Operating Expenses	11,600	15,900	16,700	16,800	13,000	14,250	15,600
%	30.4%	30.9%	32.2%	28.3%	28.1%	29.3%	26.7%
EBITDA*	3,100	3,700	-300	-2,500	9,000	8,150	10,114
%	8.1%	7.2%	-0.6%	-4.2%	19.5%	16.7%	17.3%

*earnings before interest, taxes , depreciation and amortization

The Story

Bob and Tom, both family men in their mid-forties with many productive work years remaining, had given little thought to the possibility of selling their business; until a foray into an unrelated engineering adventure five years prior resulted in two years of losses, a strained banking relationship and more than the usual number of sleepless nights. And although the business had fully recovered, paid off the bank (the Company has no long term debt) and was on a great growth trajectory, the memories of those dark nights and long days persisted.

The Approach

So it was that when Jared Farrell, an engaging recent MBA graduate from a prominent business school came knocking on behalf of a well known local private equity group, TriStar Capital Partners, Bob and Tom sat up and took notice. Jared explained the importance of partnership, fidelity, trust, integrity, honesty and the value added business insight, M&A expertise and capital that TriStar Capital could bring to the business. And that TriStar would be willing to do a leveraged recap of the business with Bob and

Tom retaining a 40% interest in the Company. Bob and Tom had no idea what a leveraged recap was, but a retained interest of 40% and the additional capital were especially interesting, since the business was fortunate to have a number of very high growth opportunities on its doorstep. Bob and Tom decided to pursue the TriStar opportunity.

A Non Disclosure Agreement was executed between the parties. Bob, Tom and key management team members, Karen and Gary, began providing a large volume of information to Jared and TriStar, followed by several day long meetings to bring the new potential partners up to speed on every aspect of the business. Bob and Tom were reluctant to get Karen and Gary involved but the extensive information requirements and subsequent follow up meetings with Jared and two of his partners, Randy and Mike, were more than could be handled without additional help. Of course, that meant that Karen and Gary, and the entire Company for that matter, were in on the plan to sell the business.

The Deal

After six weeks of this process, Jared called Bob and Tom with the good news that the TriStar investment committee had approved a deal for ACC with the following terms. The Company would be valued at $36.7 million (on a cash free, debt free basis) or 4.5 times the trailing twelve month EBITDA of $8.15 million. Bob and Tom would contribute 100% of the common stock of ACC to a new acquisition entity (Newco) formed by TriStar, in exchange for $22 million in cash ($36.7 million * 60%), and a 40% common stock interest in Newco, according to Jared worth $14.7 million or 40% of $36.7 million total value. Hummmm……

As for the cash sources and deal terms, TriStar would cause Newco to borrow 2 times EBITDA or $16.3 million in senior debt, plus $3 million in mezzanine debt with (dilutive) warrants (total debt $19.3 million), TriStar would contribute $2.7 million in cash equity (total $22 million). Additionally, the senior debt lender would provide a $4 million secured working capital line of credit for liquidity purposes and to fund TriStar's $700,000 closing fee plus deal expenses. The ongoing $500,000 TriStar management fee would be paid as a regular expense from Newco earnings. Lastly, TriStar would invest in the form of preferred shares convertible to common with a liquidation preference of return of capital plus 10% annually prior to any distributions to Bob and Tom, the common stock holders with a fully diluted 40% equity interest. Of course, with a 60% interest, TriStar would control the Company and its board of directors.

Being experienced negotiators, Bob and Tom knew better than simply take the first offer. So they proposed an "earn out" (a concept they learned at a seminar) of $4 million (for an approximate total valuation of $40.7 million) payable at a rate of 50% of the EBITDA over a base EBITDA of $8.15 million for the next 4 years or until reaching the $4 million cap. TriStar agreed provided, however, that any such earn out payment would be in the form of Newco debt, subordinate to the TriStar liquidation preference, issued to Bob and Tom.

A Letter of Intent was negotiated and signed between the parties and the deal moved into the due diligence phase. Since the Letter of Intent was "nonbinding," Bob and Tom felt it unnecessary to spend a lot of money on legal fees, so an attorney was not consulted.

Due Diligence

Due diligence went on for several months, during which time TriStar handily lined up commitments for the debt portion of the deal. Towards the end of the due diligence period, TriStar provided Bob and Tom with the Definitive Agreements and Schedules; imposing documents spanning well over 200 pages. At this point, Bob and Tom thought it prudent to bring in legal representation and hired a well know local transaction law firm, Jones Knight. Adam Anderson, a senior partner at the firm was given the assignment.

During the first meeting with Adam, Bob and Tom beamed with pride about getting such a great deal for the business, keeping their regular positions at the Company, and still retaining a 40% interest worth $14.7 million. Adam was skeptical. He suggested that Brett Shipley, an investment banker with the local M&A firm of Lebow and Lindsey with whom Adam had completed several deals, review the deal and provide an independent valuation of the proposed transaction. Bob and Tom demurred, saying a lot of time and money had already been spent, and the valuation was obvious, after all it was simply a matter of a purchase price; and besides, many years ago, they had spent tens of thousands of dollars for a valuation after attending a seminar, and nothing came of it. Adam insisted and the deal was shipped over the Brett.

Another Viewpoint

A few days later, Brett reports back to Adam that the deal, including the earn out, is worth, at best, $27.8 million to Bob and Tom or 3.4 times the trailing twelve month EBITDA How can that be? Brett explains that Bob and Tom are getting $22 million in cash, (value $22 million), plus a 40% minority interest in Newco which, by definition, is worth no more than $1.8 million simply because TriStar is paying $2.7 million for 60% and if 60% is worth $2.7 million, 40% is worth $1.8 million (not $14.7 million). Elaborating further, Brett explains that the minority 40% interest is subject to a discount since 40% does not control the Company; and that the liquidation preference in the TriStar preferred shares affords rights to the preferred not available to the common which reduces the value of the minority interest even further. Rather than complicate the analysis, Brett simply sticks with the $1.8 million value for the 40% interest.

As for the earn out, since Bob and Tom are being paid in additional Newco debt, they effectively have a priority claim on the cash flow over TriStar; but in that they already have a 40% claim on the cash flow as a function of their 40% interest, the earn out debt, if realized, is worth only 60% on a cash basis of the face value or $2.4 million without handicapping the probability that the earn out actually gets paid. Theoretically, if the earn out comes to fruition, the 40% interest would increase in paper value by $1.6 million to $3.4 million since TriStar is now paying $2.7 million in cash plus giving up a $2.4 million claim on the cash flow, total $5.1 million for 60%. The structure is not the same as if TriStar actually invested an additional $2.4 million for the 60% interest because the Company has to generate the cash flow to pay the debt. And with nearly $20 million in debt ahead of the earn out debt, any stumble in the business would likely wipe out the earn out debt.

So, the total value from Brett's perspective, including a 100% payment of the earn out (without considering present value) is roughly $27.8 million ($22 million cash, $1.8 million 40% interest and $4 million earn out, $2.4 million cash (when the debt pays), $1.6 million increase in value of the 40% interest.) Since the earn out is in the form of debt, Bob and Tom run the risk of the Company producing the cash flow to service the debt or that a liquidity event provides sufficient funding to pay off the debt, subsequent to the satisfaction of the liquidation preference. Of course, the senior lender demands the earn out debt to be subordinated to the senior debt, as does the mezzanine lender to the mezzanine debt. Adam sets up a meeting with Brett, Bob and Tom so that Brett can present his findings.

Bob and Tom Decide

Should Bob and Tom do this deal?

After setting out the rationale for the $27.8 million valuation, Brett reviews the theoretical upside potential for the TriStar strategy and explains a number of alternatives to the TriStar leveraged recap available to Bob and Tom.

Brett points out that what TriStar brings to the party is access to capital (debt and equity), and expertise in mergers and acquisitions. Employing a buy and build strategy and using ACC as a "platform" company, TriStar could make a number of acquisitions and grow the business to a point where purchase price multiple arbitrage takes effect (bigger companies sell for higher multiples) and outsized returns are realized. For example, TriStar makes four (non dilutive) "add on" acquisitions over the next five years, growing the Company through acquisitions to $100 million in sales and $18 million in EIBTDA; at which point TriStar either takes the Company public (less common than it once was), or more likely sells the Company to a strategic acquirer for 8 times EBITDA or $144 million. Without fine tuning for transaction costs, fees, recapture taxes, capital gains taxes, or present value, the 40% interest at exit is worth $57.6 million to Bob and Tom. So they get $27.8 million for 60% and $57.6 million (total 83.8 million) for the 40% at the second bite of the apple; if all goes as planned in a perfect world. Of course, the TriStar 60% interest on the same assumptions is worth $86.4 million, a very nice return on a $2.7 million investment.

Alternatively, Brett suggests that Bob and Tom could keep the business, and if they can grow the EBITDA at 10% annually, in five years they would have a roughly $80 million sales business with $14 million in EBITDA that they could handily sell for 6 times EBITDA or $84 million and come out in the same place. Anything more than a 6 times exit and or better than 10% growth and they are theoretically ahead of the game. Moreover, there is nothing preventing Bob and Tom from borrowing money, engaging Brett and going on their own acquisition strategy.

A third alternative, Brett mentions, is to hire him and take the Company to market today. He estimates the business could bring between $40 and $50 million without benefit of the above average growth trajectory or potential synergies with the ideal buyer. But then, what would Bob and Tom do all day?

At the end of the day, Bob and Tom miss sleep and like the upside so they move ahead with TriStar.

Mistakes

Although Bob and Tom ended up with a deal they found acceptable, they made a number of mistakes that, if avoided, may have resulted in an even more acceptable deal.

1. When approached by TriStar, Bob and Tom engaged with a single buyer without the benefit of a broader exposure to the relevant market. In private equity deal parlance, this situation is referred to as "proprietary deal flow." A single buyer is typically reluctant to bid against themselves. Any deal made in a public company with a proprietary buyer is typically subject to a "go shop" provision.

2. Without the benefit of an investment banking professional, Bob and Tom: really didn't have a good understanding of the proposed transaction, got overly "invested" in the deal too early, blew the confidentiality axiom, did not generate competing offers, failed to address legitimate alternatives to a leveraged recap, and could have avoided the earn out and negotiated a better deal more efficiently with professional help. More specifically, Bob and Tom should not have accepted nearly $20 million in debt leverage in the deal; even if the lenders were willing to provide it.

3. During the pre screen process, Bob and Tom did not maintain confidentiality by introducing their management team to the deal. While this misstep may seem innocuous, it creates a serious negotiation deficit for everything that follows.

4. Although the Letter of Intent is “nonbinding” it has significant ramifications with respect to deal terms and the Definitive Agreements. Bob and Tom should have retained legal counsel prior to entering into the Letter of Intent. (For more on the Letter of Intent see here)

Summary

When pursuing a leveraged recap transaction with a private equity group, the seller needs to fully understand the deal, recognize that a minority interest means just that, no longer in control, and having partners is having partners; good chemistry is important. Bear in mind that although a minority partner, the seller is also a regular W2 employee in the strictest sense, subject to termination within the confines of the obligatory Employment Agreement. The seller must recognize that running the business with a heavy debt load is not the same as running the business debt free; borrowed money comes with absolute oversight. Bob and Tom already knew about bank behavior when things were going poorly. Going it alone without professional advice is, well, unadvisable.

That said, a leverage recap with a private equity firm provides a number of advantages and may be the best solution for a properly represented business seller under the right circumstances. The seller is able to reduce risk by taking chips off the table while maintaining an equity interest that could provide big upside. The private equity sponsor brings capital and, more importantly, M&A expertise and capability that otherwise might not be available to the buyer. Then there is that sleep too.

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