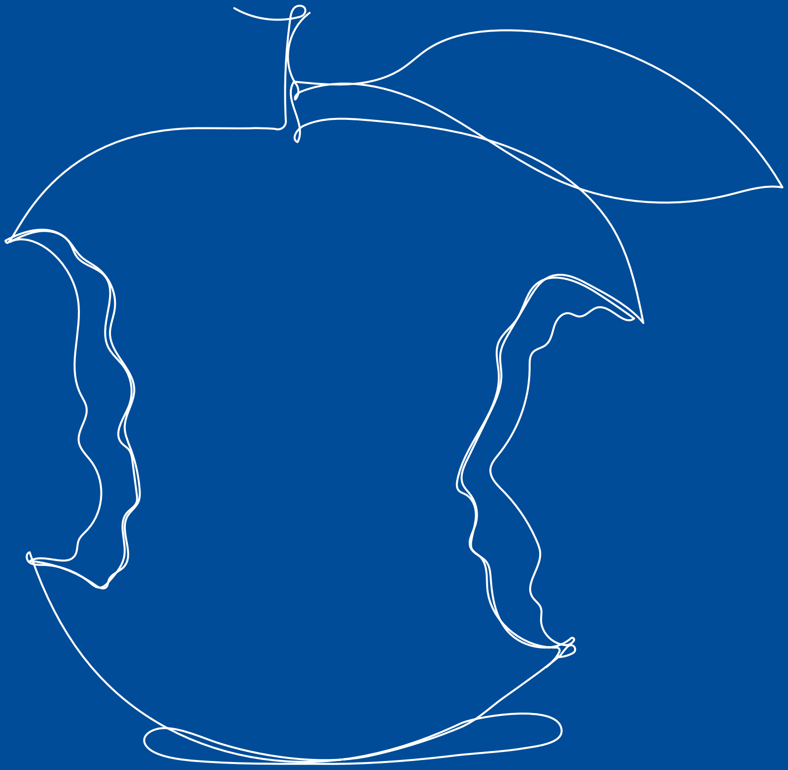
Invested In ——— What Matters

Pricoa Private Capital Insights

Second Bite at the Apple: Achieving Liquidity Today While Maintaining Control for Liquidity Tomorrow

The Pricoa Private Capital
Guide to Minority Recapitalisations



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Contributors

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What is a Minority Recapitalisation?

A minority recapitalisation, also known as a “minority buyout”, is an alternative means of raising capital to generate liquidity.

When an opportunity for growth or a general need for liquidity arises, various capital options exist to help private and family business owners achieve their objectives. Such owners could be looking to finance an acquisition, expand production, buy out a minority shareholder, or perhaps, fund a dividend or distribution. When the liquidity required for such events extends beyond the reach of cash-on-hand, traditional bank loans or senior debt, owners have turned to additional and larger pools of capital by issuing majority equity. However, with majority equity comes ceding majority ownership (and control) to third parties.

For those companies not interested in giving up control of their business, another option—minority equity, can be used to finance a minority recapitalisation, offering owners the ability to receive additional liquidity while keeping both hands on the wheel.

In a minority recapitalisation, leverage in the form of senior debt, mezzanine financing and/or minority, preferred equity is provided to the business, and the business owners maintain control.

“You get a little money off the table today, but you still get to run, operate and grow your business.”

- Anna Sabiston, Director, Pricoa Private Capital

The types of capital available

Private, middle-market companies seeking liquidity often turn to traditional sources along the capital structure from cheapest to most expensive, depending on the company's debt capacity, the amount of capital that is required, and the objective at hand. Beyond cash-on-hand, owners can contemplate the following types of capital, and should understand the advantages and inherent risks of each:

Asset-based loans

These traditional senior debt loan options come in two flavors. The first is a "loan-to-value" note secured by specific plants/facilities or equipment based on appraisal. The second is formula driven and based on metrics, such as working capital and receivables. These loans have the advantage of being relatively less expensive in terms of cost of capital but are limited in terms of the amount of capital that can be raised by the assets they are based on.

Cash-flow based traditional bank loans

Another type of senior debt are loans on offer by local, regional and national banks that provide negotiated amounts of capital secured by a blanket lien on the business. These loans have the advantage of offering potentially more capital than an asset-based loan, but come with more risk to the business in the event of financial difficulty.

Mezzanine is the last stop along the capital structure where owners can raise large amounts of liquidity without selling a stake in their company.

Mezzanine or subordinated debt

As the name implies, this type of financing sits in between senior debt and equity in the capital structure. This type of capital is typically unsecured and subordinate in terms of payback priority to any senior asset-based or bank loan debt on the books. Mezzanine is more expensive to borrow than senior debt, but it is also more patient; it is less expensive than equity. Mezzanine is the last stop along the capital structure where owners can raise large amounts of liquidity without selling a stake in their company.

Preferred equity or stock

For those companies that require capital and are open to involvement from an outside investor, selling an equity share in the company is an option. Such a transaction is typically completed by a private equity fund or institutional investor, and capital is exchanged for equity. The selling owners are generally expected to keep at least some equity in the company. Preferred equity, specifically, has a higher "first out" position than common stock with a preferred dividend attached to it.

Common equity or stock

Like preferred equity, common equity also involves selling an equity share of the business and is typically funded by a private equity fund or institutional investor. However, it has a slightly higher return requirement than preferred equity and a "last out" position, but often requires a control position.

Minority equity

If you're selling equity, you are either selling minority equity (minority control) or majority equity (majority control). Minority equity has similar return expectations as majority equity, but does not require business owners to forgo control of their company. It is typically provided by institutional investors; very few private equity funds are willing to take a minority position. Minority equity may require board representation or observation rights from the lender, but its minority position allows the business owners to ultimately maintain control.

Minority equity offers business owners a way to complement and extend the liquidity from traditional senior debt resources. Often structured as preferred equity in conjunction with mezzanine debt, this combination can be used to finance a minority recapitalisation. Both preferred equity and mezzanine debt are more patient than senior debt and less expensive than common equity. If owners need to achieve liquidity beyond their senior debt capacity, a minority recapitalisation comprised of preferred equity and/or mezzanine debt is generally recommended, as it will leave some "headroom" in their capital structure to provide flexibility for opportunities for future growth or unforeseen events.

Companies that are, typically, attractive candidates for a minority recapitalisation include those with experienced management teams who are looking to leverage their already strong and defensible business model with a source of patient, long-term capital.

Uses for a Minority Recapitalisation

Financing from a minority recapitalisation can be used for a variety of capital needs, while allowing the active shareholders to retain majority control of the business.

The company's future cash flow is then used to repay indebtedness in subsequent years.

Benefits of a Minority Recapitalisation

1

You do not need to rely on existing financing sources

A minority recapitalisation broadens your financing options and will provide more capital than simply relying on existing cash/liquidity and senior debt capacity.

2

It is customisable

The reasons
The reasons a shareholder or business might need additional liquidity are as varied as the owners and businesses themselves. A minority recapitalisation can be tailored to fit unique requirements and to meet a range of liquidity objectives.

3

Keep both hands on the wheel

Because liquidity does not come at the price of majority ownership, funding for shareholder consolidation or capital spending does not come at the expense of operational or cultural control.

A minority recapitalisation can help extend a company's borrowing ability for sustained growth.

4

Fund future growth

Growth, achieved organically or through acquisitions, requires capital; and fast growing companies can often outpace their ability to borrow through their usual channels. A minority recapitalisation can help extend a company's borrowing ability for sustained growth.

5

Less expensive than issuing common equity

The junior capital used to finance a minority recapitalisation sits between senior debt and common equity in the form of mezzanine or subordinated debt and/or preferred equity, and can provide a less dilutive, more cost effective and tax efficient structure, as opposed to issuing new common equity.

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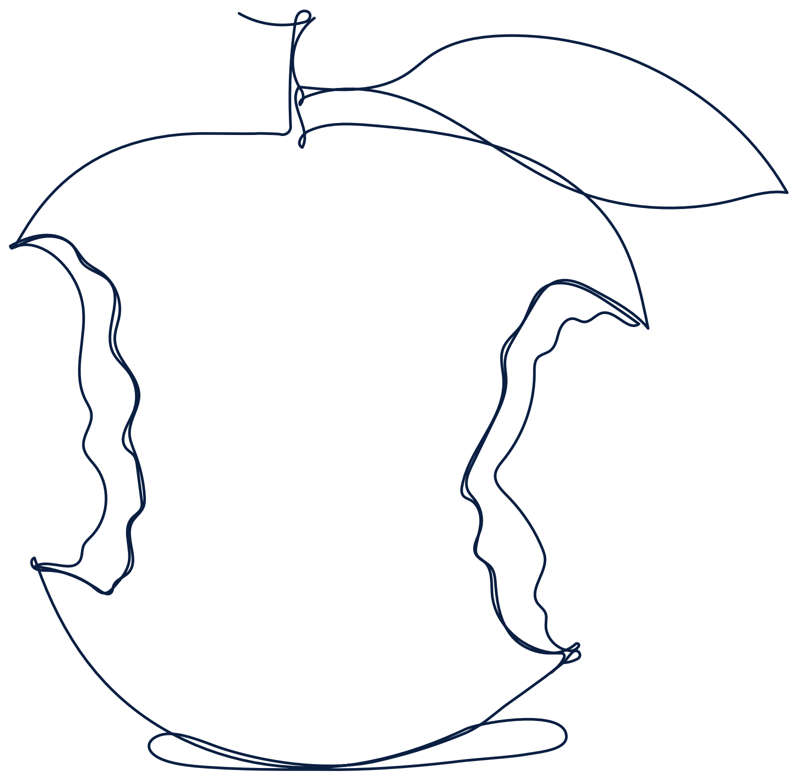
Participate more fully

Remaining, active shareholders can consolidate and maximise their ownership as well as benefit from future value created by the business down the road.



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Second bite at the apple

Owners looking to diversify their personal net worth can achieve partial liquidity today, while allowing the remaining equity value to grow prior to a future liquidity event or sale.

8

Facilitate the transition

When owners decide to step back from the business to transition to a new generation, management or ESOP, a prudent and patient capital structure that works for a diverse set of interests is required. A well-structured recapitalisation can enable a smoother handover.

9

Prelude to outright sale

Liquidity can be used to better position a company for an outright sale in the future—financing current growth initiatives or in some cases to pay down older, higher cost debt.

A well-structured minority recapitalisation can provide a much-needed infusion of capital where and when companies need it most.

10

Gain a long-term partner

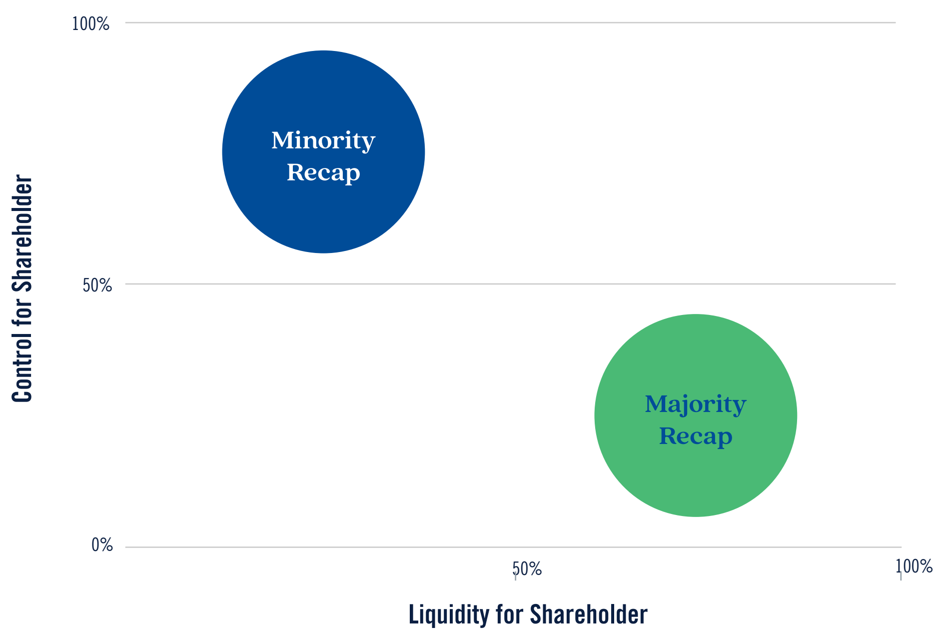
Typically, minority recapitalisations are facilitated by buy-and-hold investors who are able to partner with a company for the long term.

A well-structured minority recapitalisation can provide the much-needed infusion of capital where and when companies need it most. Finding the right capital provider who understands your liquidity objectives and can tailor the right structure for you takes time and research.

Minority Recapitalisation vs. Outright Sale & Other Alternatives

It is common for shareholders to be unfamiliar with minority recapitalisations. When faced with a liquidity need, remaining, active shareholders are often told their only option is a majority recapitalisation or outright sale of the business, which may be unattractive for shareholders seeking to maintain control of their business and achieve maximum benefits from future growth.

Minority vs. Majority Recapitalisation



Another alternative to a minority recapitalisation would be an all-debt solution, which is likely to create limitations on future flexibility in the following ways:

- Maximising leverage at close, reducing availability on future debt capacity to support growth or operations
- Higher level of amortisation and fixed payments, limiting the company's ability to utilise cash flow for growth and to pay down senior debt
- Tighter covenants and restrictions on future growth events or shareholder distributions

By adding a patient layer of junior capital, such as mezzanine debt and/or preferred equity, into the financing structure, the business is able to preserve cash flow available to service operations and future growth needs. Mezzanine debt and preferred equity do not have required amortisation and are less dilutive than issuing new common equity.

Minority Recapitalisation Example

"You can accomplish a recapitalisation without private equity and without losing control of the business."

-Paul Meiring, Managing Director,
Pricoa Private Capital

Scenario

- John Sr. and his brother, Bob ("Uncle Bob") started a business together many years ago. John Sr. owned a majority of the equity (55%) historically. Bob has owned a healthy share as well
- John Jr. (John Sr.'s son) has been running the company for the past 20 years as CEO, growing the Company up to £20MM EBITDA
- Over time, John Jr., and John Jr.'s son, John III have inherited / acquired some shares. John Jr. currently owns 55% of the company's equity
- Neither John Sr. nor Uncle Bob have been involved in the business for many years

Objective

John Jr. would like to:

1. Monetise some of the value he has created
2. Buy out Uncle Bob
3. Pass control of the Company on to his son, John III

Options

A. Sell to private equity or a strategic buyer – maximum immediate payout, but family would lose control of a company they built over many years

B. Leveraged recapitalisation – use the available borrowing capacity of the business to leverage John III's equity to accomplish the objective

Current Capitalisation

EBITDA	£20MM
Multiple	6x
Enterprise Valuation	£120MM
Less: Existing Debt	(£20)MM
Equity Value	£100MM

Current Ownership

		Value
John Jr.	55%	£55
Uncle Bob	20%	£20
John III	25%	£25
Total	**100%**	

Sources

Senior Debt	£60	3x
Sub/Mezzanine Debt	£30	1.5x (4.5x)
New Equity	£0	
Rollover Equity – John Jr.	£8	
Rollover Equity – John III	£25	1.5x (6x)
Leverage	£123	**6x EBITDA**

Uses

Refinance Senior Debt	£20
Purchase Uncle Bob's Shares	£20
Partial Purchase John Jr's Shares	£47
Rollover Equity	£33
Fees	£3
Total	£123

New Ownership

John Jr.	23%
Uncle Bob	0%
John III	72%
Mezzanine Provider	5%
	100%

Additional Thoughts

In the example, John III could also be a management team (MBO) looking to increase its ownership in a transaction.

John Jr. will be able to participate in future growth/upside of the Company via his remaining 23% ownership stake, therefore potentially earning more £ overall vs. a private equity sale today.

Minority Recapitalisation Case Study: Polar Beverages

Polar Beverages, a Family That Grows Together

Capital is the lifeblood of every business. And for some, that lifeblood comes carbonated. Ten years ago, Polar Beverages was looking for a way to transition the business from fourth to fifth generation ownership. That meant simultaneously buying out minority shareholders and refinancing some senior debt, which would require a good deal of capital. The remaining family owners were not interested in selling or giving up control of the business, which has been in the Crowley family since 1882. They turned to Pricoa Private Capital for solutions to help them rebuild their capital structure, facilitate the buyout and help Polar grow under the new generation.

Pricoa Private Capital worked closely with Polar's senior family owners to complete a minority recapitalisation to help them rebuild their capital structure and facilitate the buyout. Pricoa Private Capital was also awarded a board seat and observer rights. A decade later, Polar continues to grow, and the relationship between Polar and Pricoa Private Capital remains strong.

"Mezzanine financing from Pricoa Private Capital provided capital to expand and grow the business which resulted in earnings growth and the ability of family owners to increase their equity stake," said Ralph Crowley, Jr., President and CEO of Polar Beverages.

Polar repaid the mezzanine financing in full, from earnings, in less than six years, and continues to have a strong relationship with Pricoa Private Capital.

Pricoa Private Capital

At Pricoa Private Capital, we understand that satisfying shareholders can be a pain point for business owners. When there is a large liquidity need, we can act in partnership with the existing management team to facilitate a cash-out with minimal dilution by means of a minority recapitalisation.

Pricoa Private Capital is the international side of PGIM Private Capital, the private placement investment arm of PGIM, Inc., the global investment management business of Prudential Financial, Inc. We've been investing in private placements for more than 75 years. Pricoa Private Capital purchases up to US$12 billion, annually, in predominantly senior and subordinated debt and equity.

Please visit pricoaprivatecapital.com for more information.