

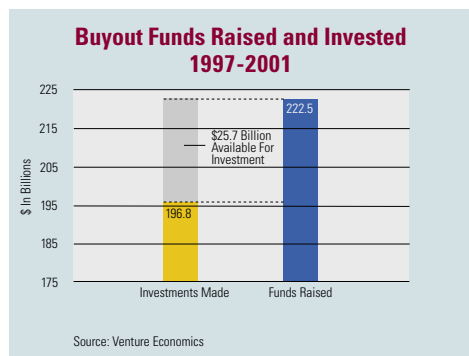


INSIGHT

Anatomy of a Leveraged Recap

A leveraged recapitalization is an alternative for unlocking illiquid wealth in private companies.

The mergers and acquisitions environment has slowed to a crawl. 12 to 18 months ago, business owners enjoyed an environment in which strategic buyers aggressively pursued acquisitions of privately held businesses. Armed with a mission of growth and highly priced stock as buyout currency, public companies aggressively gobbled up acquisitions, often at excessive prices. For most of a decade, there was a ready market for owners of privately held businesses to harvest the fruit of their entrepreneurial investments of capital and effort. Now, with the retrenchment in the stock market, strategic



buyers have refocused their energies on core business lines and have begun to sell businesses instead of adding. Efforts have been redirected towards slimming costs and improving profits in order to revitalize stock prices.

Until the mid-90's, many private company owners turned to private equity firms to lead leveraged recapitalization transactions to enable them to convert a portion of their illiquid equity interests in the business to cash. In recent years, private equity investors were often left on the sidelines as a result of not being able to compete with the values paid by strategic acquirers. Today, as strategic acquirers have pulled back in the midst of the economic downturn, private equity investors

COMMON SENSE AND NONSENSE

Certain fundamental corporate finance principles – common sense – seem to endure no matter what the business situation or economic climate. Likewise, there is a fair amount of nonsense that parades around as financial wisdom. From time to time, we like to share some of the common sense or nonsense that strikes us as either compelling or annoying.

Finance is not the cornerstone of corporate success. Real business results, and thus economic value, are created by the folks who design, manufacture, market and sell. Financial wizardry cannot turn a poorly conceived or implemented business model into a winner.

Cash is king; everything else is a poor substitute. There is a time tested rule, "You can run out of anything but cash." It seems that the window for a capital infusion always closes at the very time it is most urgently needed.

Just because someone will buy it doesn't mean it has value. Today's highly active financial markets provide an outlet for a fair amount of garbage. Just ask any investor that naively bought into the dot.com bubble. The landscape is littered with examples of investment hype touted by even the most "reputable" investment banks. Market value and intrinsic value are often quite different.

Since we certainly do not have a corner on financial wisdom, readers are invited to pass along their own pearls of common sense or nonsense to info@zacharyscott.com.

are licking their chops at the opportunity to make investments. With funds employed trailing funds being raised, financial investors have amassed significant war chests that they need to put to work.

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often conflicting objectives: (a) satisfying the business' need for capital to fund its continued growth and (b) reducing the owner's personal risk.

HOW DOES A RECAP WORK?

A recap is commonly used to monetize the illiquid wealth that has accumulated in many private businesses. In a recap, liquidity

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is unlocked by distributing to owners the proceeds of a combination of debt financing and equity provided by third-party financial investors. Unlike an outright sale, a leveraged recap enables selling shareholders to keep a meaningful share of the equity in the company and often continue to manage the business. The key elements of a recap include (a) an agreed value for the business, (b) access

to debt capital (possibly both senior and mezzanine), and (c) an equity investor. A typical transaction works as follows:

1. Consider a hypothetical company with the following attributes:

- Total enterprise value of \$100 million (amount of debt + value of equity), which represents a 5X multiple of cash flow (EBITDA) of \$20 million
- No debt on the balance sheet pre-transaction
- Modest future growth and reinvestment requirements

2. In today's credit markets, it would be possible to borrow senior debt equal to 2.5X EBITDA and another 1.0X of mezzanine debt. This implies the following debt structure:

	AMOUNT (MILLIONS)	EBITDA MULTIPLE
Senior Debt	\$50.0	2.5X
Mezzanine Debt*	20.0	1.0X
Total Debt	\$70.0	3.5X

*Includes warrants for 7.5% of the post transaction equity

3. The full \$70MM of debt financing would be paid out to the current owners, leaving an equity value of \$30 million (\$100 million enterprise value, less \$70 million of debt).

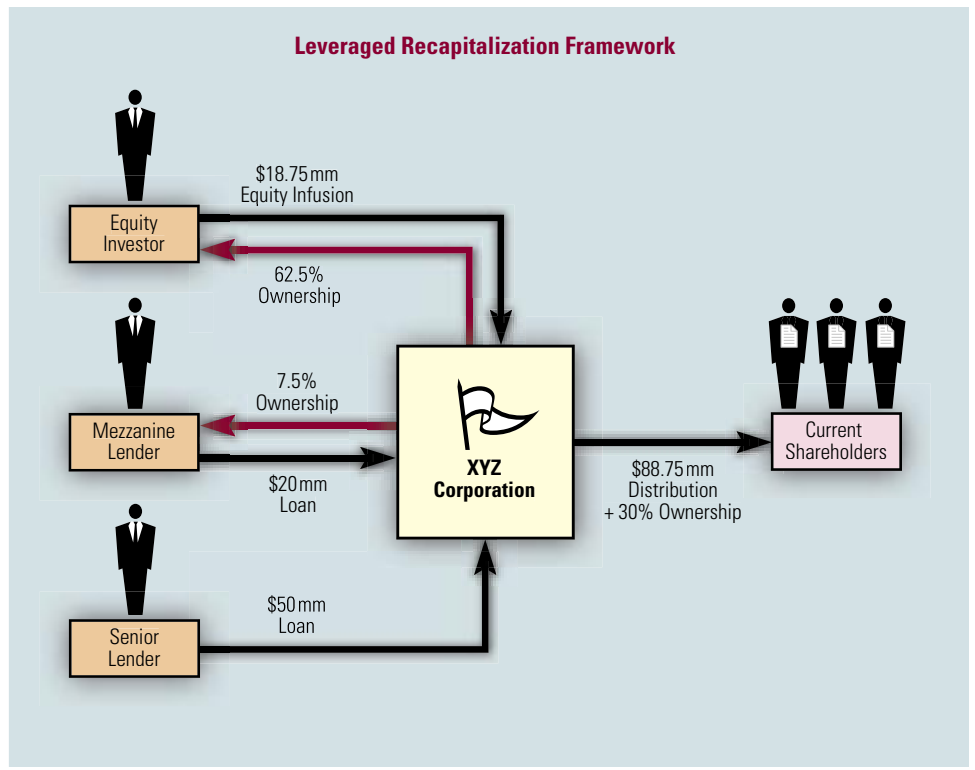
4. In order to fully compensate the mezzanine lenders, they would be granted a 7.5% equity position (typically in warrants). This leaves \$27.75 million (92.5% of \$30 million) of equity value for the owners. If the original owners wish to maintain a 30 percent equity interest, then new private equity investors will be required to invest \$18.75 million. In return, these investors will receive a 62.5% (92.5% less 30%) interest in the business. This \$18.75 million is also paid out to the original owners. The resulting ownership of the "recapped" company would be:

	VALUE OF HOLDINGS	OWNERSHIP	EBITDA MULTIPLE
Equity Investors	\$18.75MM	62.5%	.94X
Mezzanine Warrants	2.25MM	7.5%	.11X
Existing Shareholders	9.00MM	30.5%	.45X
Total Equity	\$30.00MM	100.0%	1.50X

5. As a consequence of the recap, the original owners are able to extract \$88.75MM in cash (debt proceeds of \$70MM and equity proceeds of \$18.75MM), while retaining a 30 percent equity interest.

WHEN DOES A RECAP TRANSACTION MAKE SENSE?

A recap, as opposed to an outright sale, is most appropriate when the owners of a business want to take some chips off the table but don't want out of the game. By setting aside some of the wealth they previously created, owners can focus on aggressively building the



business without risking everything. Often-times, the reduced pressure allows owners to take prudent risks that benefit the business in the long-term. And, when the business grows, they have an opportunity for a second payday when the business is sold.

Theoretically, a recap can be made to work on any business, but it is not a good fit in every situation. In reality, there are two critical variables that determine the feasibility of a recapitalization: (a) borrowing capacity, and (b) the value of the business relative to its current financial performance. Debt capacity is crucial because of its lower cost relative to other forms of capital. In most situations, funding for the recap is heavily weighted toward debt. In today's conservative credit markets, arranging financial leverage (senior and mezzanine debt) of greater than 3.5X EBITDA is difficult to accomplish. With this constraint, the higher the enterprise value is as a multiple of EBITDA, the greater the reliance on equity to fund the recap. As the proportion of the capital structure supplied by equity investors increases,

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the average cost of capital increases and this requires the business to generate an ever-higher expected growth rate in operating cash flow (and value) to pay investors the return that they require.

This doesn't mean that certain businesses

Business owners should bear in mind that a recap entails the formation of a long-term business relationship with an equity investor where all the attendant issues of personality and compatibility, control, and governance, investment horizon, and exit strategy will come into play.

are not worth a high multiple. It does, however, suggest that a leveraged recapitalization is more difficult to structure when valuation multiples much exceed 5X EBITDA.

Apart from basic economic feasibility, there are a number of design considerations and complexities associated with structuring recap transactions, including the appropriate level of financial leverage relative to ongoing capital investment needs, sustainability of the cash flow and /or cyclicity of the business. Finally, business owners should bear in mind that a recap entails the formation of a long-term business relationship with an equity investor where all of the attendant issues of personality and compatibility, control and governance, investment horizon, and exit strategy will come into play. The prospects for a successful recap are much stronger when there is a good philosophical fit among shareholders, management and equity investors. ♦

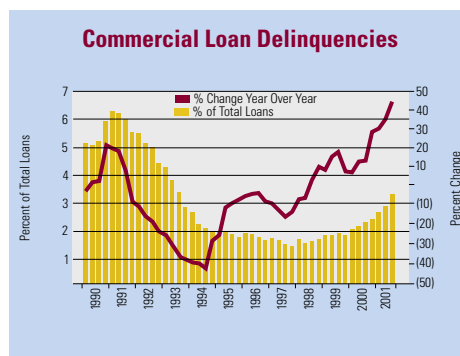
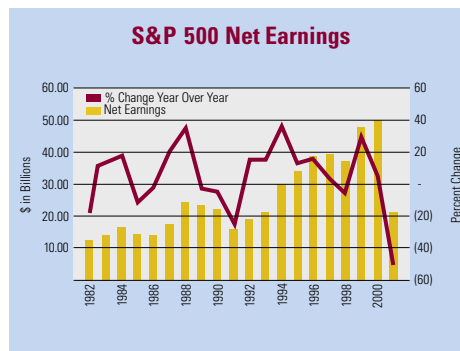
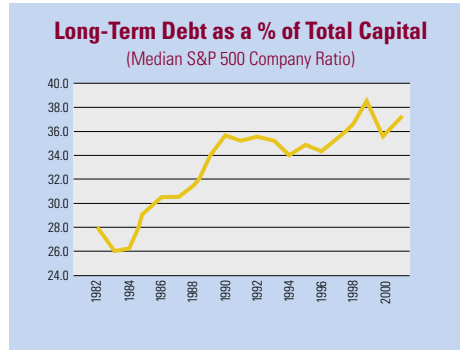
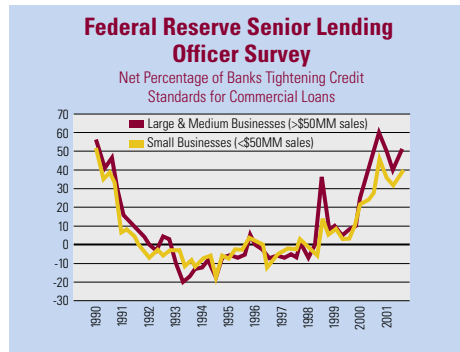
Market Update

Well, we have made it through the first year of the new millennium. This year was more tumultuous than we could have imagined at the outset – marked by the start of a national (if not global) recession as the tech/telecom boom of the 1990's ground to a halt, followed by stunning acts of terrorism and then a war to root out the terrorists. These events, and others as well, have had a fairly severe impact on everyone's economic endeavors in the form of heightened uncertainty. There is almost a conspicuous sense of collective relief that 2001 is over. As difficult as the year proved to be for many, it succeeded in discrediting much of the investment hype that flourished during the boom and reacquainted most of us with the concept of risk.

Risk (risk) n 1. The chance of something going wrong; 2. The possibility or danger of suffering harm or loss; 3. The quantifiable probability of less-than-expected returns or loss; 4. The volatility of returns from an investment.

In case we had forgotten during the great run of the 1990's, 2001 reminded us that the American economic system is quite untidy. Lots of mistakes are made. Financial markets go down almost as readily as they go up. Certainly, the past year has been punctuated by a startling set of crash and burn stories – the demise of Enron, the dot-com implosion (which pulled under a host of formerly high flying Northwest companies), the telecom industry's unraveling, and the growing list of casualties within the retail, travel, aerospace, and insurance sectors due to the events of 9/11. In times such as these, the gut reaction of bankers and investors is to tighten up and eschew all opportunities with even a hint of uncertainty or controversy. Accordingly, business investment and lending has plunged.

To be fair, the conservatism that now defines the thinking of lenders and investors is to a degree appropriate. The signs of financial weakness are abundant. Corporate debt as a percentage of total capital has been steadily building for the past five years. At the same time, corporate earnings have been rocked. After taking into account the massive write-offs of non-productive investments made during the boom, net earnings were down more than 50 percent in 2001. Across the spectrum, default rates on corporate debt have surged. Obviously, the environment has been ripe for credit problems and they have been coming in waves. It is time to clean up the debris that always accumulates during a long period of economic expansion.



The solemnity of these financial train wrecks tend to obscure the fact that economic failures are often the foundation upon which future success is built. The key characteristic of economic growth is that it is an evolutionary process of building up, tearing down, and building up again. Two steps up, one step back, two steps up.

Economic progress is risky. To paraphrase the early 20th century social commentator, Gilbert Chesterton—capitalism is a danger-

ous trade. Recently, in the financial press, and even closer to home in conversations with local bankers, the word “risk” has joined the ranks of those other four-letter words that we were taught to avoid in our youth. One might easily conclude that risk must be shunned at all costs. The ideal state of affairs would be a tidy, highly predictable world in which risk and uncertainty are regulated into submission. In fact, for the past two years, the Treasury Department's Office of the Comptroller of the Currency has been working hard to regulate the risk out of commercial lending. No doubt, in the aftermath of a boom, there were lending excesses that needed to be addressed. Nevertheless, we have some fear that this regulatory effort has gone overboard by prodding already conservative lenders into rationing credit for small and middle-market businesses. Most private companies cannot borrow on the same basis that they could two years ago. If your business falters in the downturn, your lender may make a concerted effort to show you the door.

We have heard more than a few bankers suggest that they have an interest in making loans, but only in situations where there is no risk. Of course, there are few profitable opportunities that can pass through that fine screen. If, in the long-term, this view takes hold, the banking system will undergo radical change and the career prospects for bankers will be pretty dim. In reality, all business loans and investments are risky. They are based on guesses (most educated, some clearly not) about how the future will unfold—something that cannot be known with any certainty.

Despite last year's economic shocks, the economy seems to have stabilized and is probably already on the road to recovery. The recuperative power of our system of capitalism should not be underestimated. From our vantage point, it is hard to see how the economy will return in the near term to the robust growth that we enjoyed prior to 2001. We are inclined to believe that the economy will gather strength slowly over the next year but will not shift into high gear until lenders and investors regain an appetite for new opportunities. Walter Wriston, the former CEO of Citicorp and a legendary figure in banking circles, once wrote, “If wages come from work, rent from real estate, and interest from savings—where do profits come from? The answer is that profits come from taking risk.” If the economy is to regain its full measure of vigor, as it surely will, lenders and investors will have to meaningfully re-embrace risk as an essential element of capitalism. ♦

The Guiding Wisdom of a CFO

More than a numbers cruncher, a CFO should provide a forward vision for company strategy.

Contrary to conventional wisdom, the Chief Financial Officer's (CFO) principal role is not as a "scorekeeper" of past results. Rather, the CFO is the keeper and interpreter of company data, tasked with providing a disciplined quantitative approach to management decisions. The ideal CFO has a deep understanding of the economics and dynamics of the business and knows what data, both operational and financial, is required to illuminate critical performance metrics and provide a forward view of the direction of the company. The difference is a basic matter of perspective—the CFO's gaze is directed through the front windshield on the future, as opposed to being fixed on history through the rear view mirror.

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the optimal business model for the company and provides guidance on the impact of different strategic decisions. To do this, the CFO must be fluent in accounting, finance, tax, and information systems. Technical skills are important, but a top-notch CFO is distinguished by an ability to employ them in sophisticated analyses.

CASH FLOW, WHAT A CFO WAKES UP THINKING ABOUT

No matter how good a business plan, the quality of products and services, or the people, the life blood of a private company is its liquidity—cash is king and little can be accomplished without it. In the leveraged middle-market company, the CFO's job centers around the question, "How will the company fund itself today?" Managing the cash position, borrowing capacity, and cash forecasting process to insure adequate cash availability to fund the business plan is perhaps the single most important function of the CFO.

The CFO need not be a capital markets expert, but should have the ability to routinely deal and communicate with banks and other capital providers to promote confidence in the company and its strategy. Communication skills and credibility are vital attributes of success.

DATA INTEGRITY, AND QUANTITATIVE DISCIPLINE

Every business has certain metrics that best measure its economic performance. This includes the financial and operating data that is required to manage different parts of the organization. The CFO is charged with assuring integrity in the collection process and the overall accuracy of the data used for all corporate decisions.

The CFO's contribution should be in the design, implementation and oversight of the management information system, which is far more than preparation of monthly financial statements. The CFO's role is to determine what financial and operational data is routinely collected, organized, and disseminated to managers across the company in order to effectively manage revenue, margins, credit, inventory, capital spending, and other aspects of the business. In short, a top-notch CFO should drive the constant improvement of data collection, analysis, and evaluation and the effective use of the information gathered to enhance decision-making.

THE INVESTOR'S PERSPECTIVE

Ultimately, a business exists for the

primary purpose of earning a return for the suppliers of capital. The bank wouldn't make a loan if it didn't expect to receive an adequate interest rate and the shareholders wouldn't invest unless they expected the value of their investment to increase. Like an investor, the CFO's focus must be forward looking.

Interestingly, many people view financial professionals as having a backward, or "historical" perspective, primarily because that is the nature of financial statements. But, in reality, the CFO views financial statements as valuable knowledge that is useful in planning for the future. To be effective, planning must reflect a thorough understanding of the economics of the

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business. In addition, this function must include a disciplined process for evaluating strategic alternatives and capital investment plans with the focus of investment return and the effect on value.

A great CFO keeps management and ownership focused on the objective of value creation and defines an appropriate balance between growth and prudence. This ability is often the single trait that sets apart a top-notch CFO from a "scorekeeper." ♦

ABOUT ZACHARY SCOTT

Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated planning and analytical capabilities and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott go to www.zacharyscott.com.

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