Recapitalization can solve your problem

Why sell the company when devising a new stock class may keep everybody happy?

BY FRANÇOIS DE VISSCHER

A LONG-STANDING dispute came to a head last summer at Freedom Communications. Some third-generation members of the Hoiles family wanted to cash in their stock. Others wanted to retain control. But there seemed no way to raise the necessary funds short of selling the Irvine, Calif.-based company.

That's when the fourth-generation shareholders, most of whom don't currently work in the family business, stepped up to the plate. If the media company were sold to outsiders, they feared, its founder's distinctive libertarian philosophy would likely vanish from Freedom's 28 daily newspapers, 37 news weeklies and eight TV stations. As a middle-ground solution, they suggested a recapitalization—a solution that might just help family factions reconcile their disparate interests.

Recapitalizations used to be very handy estate- and succession-planning tools. By splitting stock into preferred voting shares (which would pay dividends to current owners) and common non-voting shares (which would transfer most of a company's value into the older generation's estate, thus preserving future appreciation), owners could greatly reduce their future estate taxes and generate some continuing liquidity for their retirement—all without giving up control of the company. But this mechanism subsequently lost some of its appeal, primarily because new IRS rules make it difficult to separate the transfer of equity from the transfer of votes.

So why are recaps making a comeback? In today's low-growth/low-inflation environment, the value of equity in family companies has stabilized. At the same time, more companies are chasing a shrinking pool of public capital. So the use of private debt or equity in any form of recapitalization has become much more attractive to investors and families.

There are many forms of recaps, depending upon the owners' needs for control, liquidity and growth. Each one dictates a different level of outside private debt or private equity capital.

A recap can be as simple as going to the bank and borrowing money to pay out some shareholders, or as complex as splitting up the equity into different stock classes with different votes, different dividends and different appreciation potential. Most recaps fall somewhere in between. The grid below outlines four categories of recaps.

Low Control/High Liquidity	High Control/High Liquidity
Structure: Leveraged recap in which private equity investors buy 100% of old company and pay owners a portion in cash and a portion in securities. **Benefit:** Shareholders receive liquidity and maintain minority stake in the company. **Tradeoff:** Loss of control.	**Structure:** All debt. **Benefit:** Current owners can pay off inactive shareholders and retain control of the company. **Tradeoff:** Impairs capital available for growth.
Low Control/Low Liquidity	**High Control/Low Liquidity**
Structure: Private equity investors put money into a growing company to sustain its growth. **Benefit:** Enhances company's ability to grow. **Tradeoff:** Giving up substantial control to outside investors without providing much liquidity to shareholders.	**Structure:** Stock split into voting and non-voting shares (or dividend and non-dividend, etc). **Benefit:** Existing owner-managers maintain control. **Tradeoff:** No capital available for liquidity or growth.

While each of these types of recaps requires some trade-off, they also can help business families fairly address diverging needs and interests.

For instance, if one group of relatives in't interested in control but wants higher dividends, the company can create a second class of non-voting shares that pay higher dividends. This recap (depicted in the lower-right quadrant of the grid) would require little, if any, outside capital to pay owners of non-voting shares additional annual dividends.

Or if some shareholders want to be bought out, the company could borrow money from the private debt market to buy out all or part of those shareholders' stake and exchange their remaining shares for a different security, such as subordinated debt (see the upper-right quadrant of the grid).

Whatever the form, recaps share several common themes. First, shareholders must clearly define the family vision and the business vision, to be espoused by all and communicated to the family and outside. That is: Do we want to grow or subsist? Do we want an exit now or later?

Second, any recap is a fine balancing act among the liquidity needs of some family members, the value-creation opportunities for other family members and the valuation and control needs of both relatives and outside capital sources.

Third, a recap's success stems from a discussion of all possible alternative structures among shareholders.

Each form of recapitalization carries different legal, tax and valuation implications. For instance, the IRS may view the buyout of a portion of a shareholder's individual stake as an "ordinary income" transaction and hence tax it at ordinary rates. But the purchase of a 100% stake of the same shareholder would be viewed as a capital transaction, taxed at lower capital gains rates. Even family stockholders who don't sell may be subject to "deemed dividend" taxes. Obviously, you shouldn't pursue a recap without first checking with your tax lawyer.

Some relatives want control. Others just want dividends. In that case...

Once you examine the various recap alternatives, sometimes you end up with different groups of sellers from what you originally anticipated. Yet whatever the result, the process is valuable. Providing the opportunity for active and inactive shareholders to express their desires will ultimately strengthen the bonds between them. That might be the case at Freedom. We'll just have to wait and see. FB

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