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## Replacement Capital: The Other Exit Avenue

Article Date: Jan 05 2011

**Claire Madden, partner at private investment firm Connection Capital, explains how replacement capital can help owner-managers capture value while working towards an exit.**

The events of the past few years have undoubtedly made it harder for private companies and third-party private equity investors to achieve an exit.

Whenever debt providers come under pressure, deals become more difficult to finance. As a result they require more equity, which, in turn, has an adverse impact on potential returns for any purchaser. In such circumstances, the first thing to suffer is the enterprise value of the business. Consequently many private company shareholders prefer to trade through the tough times and delay exit plans until improved conditions return.

However, there is an alternative which can help private company owners and shareholders realise some of the value in their business whilst retaining a majority stake and potential upside in the value of their holding. There are a number of private equity houses who will consider funding shareholder reorganisations in return for a minority stake in the company.

For these private equity providers, this type of deal is less risky than management buy-outs or growth capital transactions where there is either a change of ownership or a step change within the business such as, for example, an acquisition.

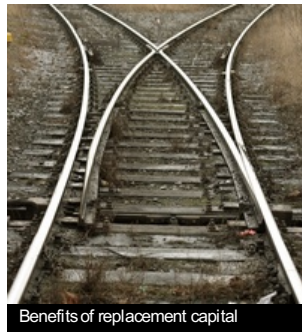
As long as the business still has promising growth prospects and the management team retains a large enough shareholding to ensure the motivation for a profitable exit is there, the deal should work for both parties. Of course the considerations when choosing which private equity investor to work with still apply: a decision based solely on terms, not teams, can be a dangerous one.

Management teams need to ensure that they can work with their new shareholder after the deal is done, and that all parties share the same vision for the business in terms of growth and eventual exit.

With replacement capital deals it is particularly important to consider the track record of investments the private equity house has under its belt. If most are based on majority stakes then a minority stake investment may present more of a challenge for an investor who is used to control.

You should also consider the value that your private equity backer can bring to the business such as further funding for growth or the ability to introduce new business and/or non executive capability.

In the past, many shareholder reorganisations would have been financed by bank debt, leaving the business overgeared and more susceptible to the downturn. Whatever the reason for owner managers wishing to realise part of the value that is tied up in their businesses – divorce or buying out a departing director's shares are common ones – it may be useful to consider a sensibly structured private equity solution that does not mean giving up control of the business and can very often result in a mutually rewarding partnership.



Benefits of replacement capital

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
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