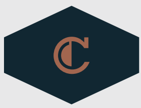

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Non-Control Capital for the Middle Market

Non-Control Capital Offers Liquidity Option for Family-Held Companies

STORY BY Mark Scott from *Smart Business Dealmakers*
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The sale of a minority equity stake or the issuance of junior capital securities — known as non-control capital — is a viable solution for family-held business owners who have a change of heart about completely exiting their company.

"From time to time, we are introduced to families who are prepared to sell for a variety of reasons," says Nicholas Stone, managing director at Cyprium Partners. "As that process moves forward, the shareholders fall back in love with their company and appreciate it's probably one of the best investments they'll ever make. So instead of selling control, they'll pivot halfway through that process and raise non-control capital to fund a sizable shareholder dividend as opposed to selling 80 to 100 percent of the company. That is not the norm, but it does happen among shareholders who believe they are too young to retire or don't feel they are being compensated for the future growth of their company."

One reason there aren't more non-control transactions is simply a function of the market.

"Many family-held businesses don't realize there are minority investors out there because many times, they are only presented with the option of selling their business to a financial or strategic buyer," Stone says.

We caught up with Stone to talk about important points to consider when exploring the sale of your business.

When opportunity knocks
When it comes to the sale of equity in a family-held business, each situation is unique, Stone says.

"You have circumstances where it's a first, second or third-generation business and the family members have no desire to ever sell the company," Stone says. "But they're presented with an opportunity where they need to raise capital to accomplish a given objective, one that is clearly part of their strategic vision for the company. At that point, these shareholders really don't waver on the idea of raising outside capital. They know that it is part of the process to ultimately accomplish whatever goal may be sitting in front of them."

It could be that they need capital to acquire a competitor, expand to another geography, transfer wealth between generations or buy out one or several absentee family members.

"In order to appropriately balance the cost of capital with future debt obligations, the shareholders should approach their bank to determine how much senior debt they may want to raise. If the capital need exceeds the bank's willingness to lend or the family's appetite for debt, then subordinated debt, preferred stock or minority equity are all viable options," Stone says.

Test the market
Things are a little different when you have shareholders who weren't planning to sell, but want to test the market. If they learn that their company is worth X, whatever X is, or if the market tells them their company is worth more than they think it is, they will likely explore selling control to either a financial or strategic buyer.

"Occasionally, the market value will fall short of shareholder expectations, then they'll look at raising non-control capital to fund a shareholder dividend," Stone says. "We see this a fair amount, especially in today's market with valuations being as high as they are. A lot of shareholders are testing the market to see what their company is worth. If they hit their number, they sell, and if not, they simply hold onto it."

At this point, the owners have already started to think about the money they could make from selling their business. Thus,

Non-Control Capital Offers Liquidity cont'd

if expectations are not met, it's unusual to just exit the process and maintain the status quo.

"Shareholders can sell a minority stake in their business or take a leveraged dividend to provide liquidity for themselves, diversifying their net worth or perhaps setting up a trust in their children's names or making a sizable donation to a nonprofit or whatever the case may be," Stone says.

Know what you want

The key thing to do before taking any decisive action is to decide what you would do with the incoming capital, whether you're selling all or part of your business.

Once that's done, build three sets of financial projections.

"One would be your forecast," Stone says. "What do I think my company will do over the next five years in a best-case scenario? The second forecast is a base-case scenario. It's not the best possible outcome, but it's still a very achievable and conservative set of assumptions. Usually it's two to three percent growth over the next five years."

It's also wise to formulate a downside scenario, which is especially important if your company has taken on any debt. If you get into a situation where it becomes difficult to make payments on your loan, it will make your need for capital much more urgent.

Once you have these sets of projections established, shareholders can determine what kind of capital they need to raise and how much equity they want to sell. The downside case is the stress test scenario, and the upside case gives them the ability to determine what their equity will be worth if all goes according to plan.

"Truth be told, the ultimate outcome will likely be somewhere in the middle," Stone says.

Transparency is crucial to a successful outcome as you consider bringing on an outside investor.

"If things go awry with a capital partner, it's because the shareholders and capital provider didn't enjoy an open and frank dialogue or the management team was hiding something from the investor," Stone says. "That naturally creates a breach of trust. When you have an open dialogue, regardless of the interval, whether it's weekly or monthly, it allows the two parties to work together to create solutions and manage the road ahead, wherever it may lead." •