Private equity firms say recap is just one tool

BY CHUCK GREEN
SPECIAL TO THE JOURNAL

Over the past several years, dividend recapitalization — when owners of a company pay themselves a dividend, typically by having the business take on debt that's expected to be repaid when the company is sold or goes public — has spiked in popularity among private equity firms.

To **Summit Partners** in Boston, it's simply one of a host of tools.

"It's not a new class of investment or something you would build a business around; the structure of the transaction is just one of (many alternatives.) Sometimes the answer is a dividend recap, other times it's something else," said **Bruce Evans**, a managing partner in Summit Partners' Boston office.

Dividend recapitalizations have remained steady in recent years, but the amount of money involved has gotten heftier. According to **Standard & Poor's**, there were 90 dividend deals so far this year, compared with 102 in 2005 and 96 in 2004. Year to date for 2006, the total loan volume so far is $38.4 billion, compared to $34.8 billion in 2005 and $28.5 billion in 2004.

Dividend recapitalization, Evans noted, "is something we consider when it makes sense and fulfills the desires of the companies that are raising capital." He added Summit, a private equity firm that has raised nearly $9 billion in capital since its formation in 1984, views dividend recapitalization as an "alternative to a share repurchase. If the shareholders of a company have a proportionate or a pro rata desire for liquidity, Summit structures its investments as either a stock repurchase or as a dividend."

Often, he said, these types of structures are used in close proximity to a public offering: In this situation, companies use leverage to pay a dividend or to repurchase stock. As a result of this type of transaction, the owners of a business are able to take out cash and put it in their pockets. Then the company goes public and repays the money which was borrowed to fund the dividend recapitalization out of the proceeds of the public offering."

In any event, there's an element of timing in the dividend recapitalization, according to **Steven Bavaria**, vice president and head of loan ratings at Standard & Poor's.

"Private equity firms have a choice regarding how quickly they want to try to get their money out of their investments and at what risk. If they take too much money out too soon, by replacing equity with debt — which is what a dividend recap is — then they get the cash out but at the risk of owning a weaker company that has a greater chance of defaulting and, as a result, losing the remaining equity value that the PE firm still has in it."

However, he added, "if they call it just right, they take the dividend out now and still get to take more money out later when they IPO it and sell their equity. But if they take too much

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Bruce Evans of Summit says the dividend recap is one of many alternatives.

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RECAP: One arrow in the quiver

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money out and the company gets in trouble, then they've killed the golden goose."

Perhaps, but **Geoff Rehnert**, co-CEO of **Audax Group**, a money management firm that has an office in Boston, doesn't believe recaps make companies "any less healthy. What makes companies less healthy is when they are operated poorly and their earnings decline."

Recaps, he added, are "getting larger in part because the debt markets are larger, deeper, more sophisticated and efficient, and in part because, on average, because buyouts are getting much larger." Consequently, he noted, "you'd expect much larger subsequent recaps."

While by some accounts dividend recapitalization is raising concern over portfolio companies' ability to survive a misstep or economic downturn, Rehnert, whose firm manages in excess of $2.3 billion in equity and mezzanine debt capital, is fairly unmoved.

"In any economic downturn, balance sheets of companies will typically need to be restructured, since companies are less likely to meet their debt obligations. I don't believe much will be needed within our portfolio," said Rehnert. "But there will certainly be more companies which don't meet their obligations when an economy goes in to a downturn then there will be when an economy is expanding and growing."

Given the "strength, depth, efficiency and sophistication that has developed within the debt markets, however, I believe that restructurings can and will for the most part be accomplished with less destruction of the enterprise value of the businesses than in past credit crunches where there was less depth to the debt markets and less information and sophistication in general."

Since Evans believes dividend recaps are no different from any number of options, he's also not particularly disturbed by the prospect of a possible a misstep or downturn.

"A dividend recap is a narrow form of a leveraged buyout. If a company gets overlevered and the economy turns down and its business got weaker, then that company might have a problem paying interest or principal related to that debt." He said. However, he added, "I don't think it is a problem that is confined to the concept of a dividend recap, because a dividend recap is just one form of a broad range of leverage financings that may be available to companies in today's market."

Despite their appeal, a dividend recapitalization doesn't always meet expectations, Evans said.

"You take your money out now. If the public offering or subsequent transaction doesn't happen, you still have your money in your pocket, which is a good thing," he said. "But your company remains saddled with debt that it may or may not be able to repay."

HEDGE FUNDS: Competition

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Technologies of Boxborough. The tiny firm consisting of two founders, produced an on-demand server for cable television. Broadbus was acquired two years later by Motorola Inc. of Schaumburg, Il., for a "nice return," said Stjernfeldt, who wouldn't release financial details about the deal.

Hedge fund managers by and large try to stay under the radar screen. One exception is the **Cue Ball Group** of Boston, which rolled out the Cue Ball Discovery Fund in July, a fund-of-hedge funds that targets hedge funds with smaller asset bases — $300 million and under.

According to the fund's portfolio manager, **Brad Balter**, an advantage of hedge funds is their flexibility to bet on stocks when prices go down, making them theoretically" able to profit "in an up or down market."

In July speculation was flying over which hedge funds were backing the production company of Tom Cruise after his much ballyhooed parting with Paramount Pictures. Though Cruise/Wagner Productions was looking for $100 million, current reports say the company came up short. A partnership for the Washington Redskins gave Cruise less than $10 million.

But you can't blame company officials for trying.

"Not only do (hedge funds) have more money, but there's more activity in the private market," said Barrett. "There are juicier private deals. That's a fact."

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