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Tommy-Toe Tomatoes: To Sell or Not to Sell

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Abstract

This case requires the student to provide an informed opinion on whether a private equity firm should now sell one of its principal investments at a substantial profit, but prior to obtaining its potential maximum value. The partners are considering the premature sale in order to bolster the firm's current track record in the hope of attracting potential investors to participate in a planned second fund. In working through this case, students will gain exposure to the operations of a private equity fund and become acquainted with mezzanine financing.

Prism Partners

Prism Capital Partners is a relatively new private equity firm providing mezzanine debt and equity to lower middle market companies with greater than $10 million in revenues for change of control transactions. It uses equity buyout strategies to help business owners achieve their liquidity, wealth transfer and ownership transaction goals. It seeks opportunities to partner with strong management teams at stable companies to drive value growth.

Prism is made up of three partners and one analyst. Clair Hamilton serves as Prism's CEO. Clair formerly was a senior managing director at one of the country's premier investment banking firms. She was weary of sixty-hour weeks and wanted to make a change in order to spend more quality time with her young children. Clair was tired of racing home in the evening with hopes of seeing her children before the nanny put them to bed. Bill Hoffman, another partner at Prism, was a partner at one of the "Big Four" accounting firms. As is typical at these firms, partners are forced into retirement at age 55 to make ownership positions available for senior managing directors. Bill, however, did not feel that he was ready for a life of golf and sitting on the beach. Elizabeth Young, the remaining partner, had previously worked in private placements at a major retirement investment company and joined Prism in search of the upside of a major income boost. The analyst, Marshall Thomas, is an MBA with a few years' experience at a New York hedge fund.

Fund Operations

Eight years ago, Prism raised $200 million from contacts the three partners had established in their previous professions. Using these funds along with debt provided by major lenders, Prism now controls ten companies. Prism's strategy is to "source, execute, and manage". The firm focuses on direct sourcing of opportunities presented to it by a large network of referral partners including accountants, advisors, attorneys, bankers, and private equity groups. It also employs a direct marketing initiative to originate opportunities through small market economic development organizations, business brokers, investment funds, and wealth advisors.

Once opportunities have been identified and evaluated, Prism designs customized buyout structures that include 1) a traditional equity buyout financed by the capital it raised, 2) mezzanine debt, and 3) funds borrowed from major banks. Prism only invests in companies in which the partners clearly see a significant possibility to greatly enhance company performance. Prism creates a "roadmap" of steps to be taken in the first few months of ownership to accelerate the process of value creation. Prism insists on majority representation on the board of directors and serves on the audit and compensation committees of the firms in its investment portfolio. It provides guidance and advice to the management teams on strategic, operational, and financial issues.

Prism provides venture capital to finance early stage companies that do not have sufficient access to conventional financing. It is also willing to provide growth capital to fund expansion of established companies unable to use their own assets as collateral for funding, as many have been previously mortgaged. Prism avoids distressed or turnaround situations.

Hedge Funds versus Private Equity Firms

While both hedge funds and private equity are limited to raising capital only from "qualified investors" that is where their similarities end. Qualified investors must be able to show an income of at least $200,000 for each of the last three years. They must also have investible assets (excluding their home) of a minimum of one million dollars. Private equity funds differ from hedge funds in they are focused on the long-term potential of the companies in their portfolio. Prism expects to hold their investments anywhere from eight to twelve years. This makes the time commitment of the fund's investors much longer than that of those who invest in hedge funds. Thus, the initial investors in private equity funds have a significantly longer lockup period than those who buy into hedge funds.

Rather than gaining control of sufficient stock to wage a proxy fight to get some representation on the target's board, private equity funds frequently purchase the entire company or at least a substantial majority stake with the use of senior lending, mezzanine financing, and the fund's own money. Mezzanine financing is a hybrid of debt and equity financing. It gives the lender the right to convert to an equity interest in case of default. The typical interest rate for mezzanine financing is 12% to 20% annually. This replaces part of the capital that equity investors would otherwise have to provide to a company. For a $100 million transaction, senior lenders might agree to provide $75 million, the private equity firm could secure $10 million in mezzanine financing and invest $15 million of its own funds.

Prism's Dilemma

Prism initially raised $200 million which they have leveraged to invest in a portfolio valued at close to $500 million. Most of the money that companies in their portfolio earn is reinvested back into those companies. Very little is siphoned off for new acquisitions. The partners feel that in order to accelerate growth they must open a second fund. Since investors are cautious in investing in relatively young funds, Prism is facing a dilemma. They feel that it is incumbent upon them to show potential new investors how their first fund has performed. While pondering how to accomplish this, they were approached by a very wealthy individual. This man is a part owner of one of the nation's most valuable sports franchises. He would like to diversify his investments and has offered to purchase one of Prisms' companies, Tommy-Toe Tomatoes.

Hydroponic Tomatoes

Tommy-Toe, is a grower of hydroponic tomatoes. It has been in business for almost fifty years. Prism acquired this firm seven years ago. It invested $25 million to acquire this operation. In addition to the Prism's fund investment, it secured both mezzanine financing at 12% along with a small bank loan. Both the mezzanine debt and bank loan have been repaid using Tommy-Toe's earnings.

Hydroponic tomatoes are grown in water rather than in soil. This allows the tomatoes to grow almost 50 percent faster. Harmful insects, pests, and diseases are not a major concern with hydroponic gardening. Since the tomatoes are grown in greenhouses, tomato species that are self-pollinating are grown. Lights that shine for longer periods than the sun shines are available to further accelerate tomato growth.

Located in California, it is the market leader in the western United States. Tommy-Toe's net 2019 revenue was $30 million. Its EBITD (earnings before interest, taxes, depreciation and amortization) was $6 million. Net income last year was $2.1 million.

While Prism had no intention of selling Tommy-Toe at the current time, it has been contacted by a potential buyer. This buyer claims that with the acquisition of this company, he will be the owner of more than half of the nation's supply of hydroponic tomatoes. The buyer has offered $77 million in cash for this acquisition. While this deal is attractive to Prism, it has created a dilemma for this private equity firm. If it sells the company now, for $77 million it will have funds to purchase additional companies. Further, it will also have a proven track record to attract investors for a second fund. Prism had planned to keep Tommy-Toe for a few more years and then sell it for considerably more than the current $77 million offer. Plans are underway to build two additional greenhouses during the first part of this investment's eighth year (2020). One would be constructed in Georgia and the other in Pennsylvania. It is expected that each project would cost approximately $3 million and take less than a year to complete. Once these facilities are in full production, Prism planned to sell Tommy-Toe at a price that would reflect a 28% internal rate of return over the life of the investment.

Assignment

The Partners are torn between selling Tommy-Toe now for $77 million so that they can have funds almost immediately to invest elsewhere and also have a success to show potential investors in the second fund or retain the company and sell it later at a substantially higher price. The partners have asked you to conduct a financial analysis of both options. Your analysis, among other things, should include the IRR of the Tommy-Toe investment should it be sold now for $77 million as well as the selling price in five years if Prism is to reap an IRR of 28% at the end of 12 years from the date of purchase. You should also compute the P/E ratio (using the most recent year's earnings) should they sell now for $77 million. Since forward earning P/E ratios are become a standard for determining value, what would the P/E ratio be assuming a 28% increase in earnings for each of the next five years (years eight through twelve). Compare the both of P/E ratios that you compute with the approximate 40 P/E of Google when it purchased Youtube.com in 2006.

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