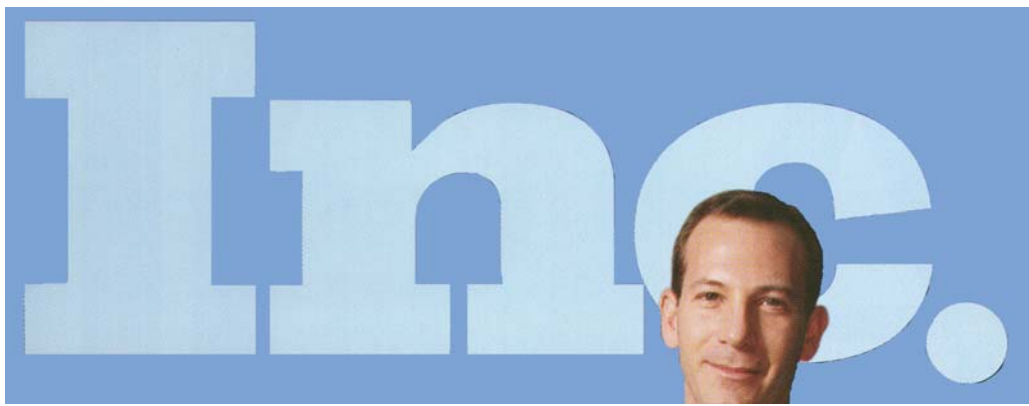



**April 2006**

# Want money and power?

## Recapitalizations let business owners raise capital without losing control

KURT KOLOSEIKE AND JAMES SAMTER were at a crossroads. The partners founded FlagZone, based in Pottstown, Pennsylvania, in 1999. By 2005, sales of the company's flags and banners reached $14.5 million—and Samter, age 60, was ready to retire. For 37-year-old Koloseike, however, it was just the beginning. He was determined to turn FlagZone into the nation's top flag maker. "We were at different points in our careers," Koloseike recalls.

The partners mulled their options for months. Koloseike couldn't afford to buy out Samter, who owned a 55 percent stake in FlagZone. Discouraged, they considered selling the business altogether. Then, their financial adviser suggested a recapitalization. It seemed like a perfect solution: Koloseike could raise capital by selling a minority stake in FlagZone to private equity investors, then use the cash to buy out Samter. The investors would have a say in the business, but Koloseike would still control daily operations.

Recapitalizing—the reorganization of a firm's capital structure—allows business owners to take cash out of their companies while maintaining a meaningful ownership stake. The strategy often involves a combination of debt financing and equity capital from third-party investors, such as private equity firms. Depending on how the recapitalization is structured, the strategy can offer business owners more control than they might have with other forms of financing, such as venture capital. Business owners can use the capital raised to invest in operations, buy out a partner, or even pad their own bank accounts. And, unlike VCs, who are notorious for stacking company boards and seizing control of daily operations, private equity firms involved in recapitalizations are often content with a seat on the board, monthly financial updates, and a say in strategic decisions, as long as certain benchmarks are met along the way.

**Free at Last**
**By recapitalizing, Kurt Koloseike was able to buy out his older partner and refocus on growth.**

Companies have been using the strategy for decades, but recapitalizations have become increasingly popular the past few years, thanks in large part to the fast-growing private equity market. The number of private equity firms in the U.S. has increased 16 percent, to 1,600, since 2000, according to New York City research firm Thomson Venture Economics. Thanks to heated competition among firms, many businesses find that they can negotiate more favorable terms

and give away less equity, says Howard Ross, managing partner of Philadelphia private equity firm LLR Partners. "The equity dollar buys less than it did five years ago," says Ross, who now works on twice as many recapitalizations as he did back then.

After deciding to recapitalize, Koloseike spent three months creating a 20-page proposal that included a detailed description of FlagZone's manufacturing process, profiles of the company's major clients, historical financial records, and sales projections. He sent the proposal to five private equity firms and received two bids.

For Koloseike, finding investors who shared his vision was key. "It's not just a funding source," he says. "You're looking for a financial partner who understands your business." In October, after vetting candidates for months, he raised $8 million in both debt and equity from Philadelphia-based TRF Private Equity; NewSpring Mezzanine Capital, a private equity firm in King of Prussia, Pennsylvania; and Wachovia Bank. Koloseike used the bulk of the money to buy out Samter. Next he redistributed his partner's shares. Koloseike now owns 55 percent of FlagZone; his private equity investors own 45 percent.

Recapitalizing can also mitigate personal risk for business owners. That appealed to William Loftus, who co-founded Gestalt, a Philadelphia-based IT consulting firm, in 2001. The company had turned a profit each year and boasted annual sales of $8 million in 2003. Still, Loftus was concerned that so much of his personal wealth—and that of his shareholders—was tied up in the business. He wanted the freedom to take risks with Gestalt without worrying about his personal stake.

Three months later, Loftus sold less than half of Gestalt to LLR Partners for $10 million. The process was relatively simple. An M&A lawyer helped Loftus identify several potential private equity investors. After vetting a handful of bids, he signed the $10 million deal with LLR Partners in April 2004. Loftus plowed $6 million back into Gestalt, and distributed the rest among the company's four founders, including himself. "That's mostly for my kids' future," he says. LLR holds one seat on Gestalt's five-person board of directors. Loftus sends Gestalt's monthly financial reports to his investors, but, for the most part, they leave daily operations to him.

Of course, achieving significant returns remains the top priority for private equity firms. Some contracts stipulate that companies must hand over additional board seats if financial goals are not met. Most firms plan to cash out within three to seven years, often through the sale of the company. Koloseike, for his part, hopes to buy out his investors by then, or sell FlagZone.

The good news is that many firms have lowered their ROI expectations, says Barron Fletcher, managing director of Parallel Investment Partners, a private equity firm in Dallas. These days, most private equity investors expect annual returns of between 20 and 35 percent, compared with between 25 and 40 percent several years ago.

The cost of completing a recapitalization can be steep. The price tag—including fees paid to M&A attorneys—starts at 1 percent of the deal amount and varies according to the complexity of the transaction. FlagZone's recapitalization cost $550,000.

As far as Koloseike is concerned, it was money well spent. In the past year, he has plowed $2 million into hiring staff and buying equipment. With the help of TRF, which now holds a seat on FlagZone's board, he plans to enter the specialty advertising market this year. He also put some cash in a college fund for his three daughters. "This is 'sleep well at night money,'" he says. "Now I can focus on running the company." —*Dalia Fahmy*

## Recap renaissance

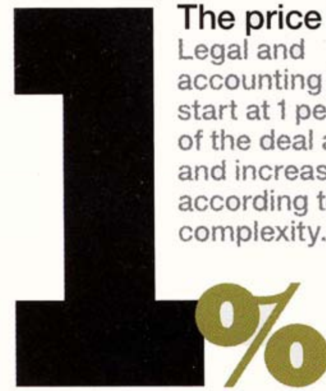
Thanks to heated competition in the private equity market, now may be the ideal time to recapitalize.

**How it works:**
Private equity firms buy stakes in companies, allowing business owners to buy out a partner, reinvest in the company, or pocket the cash.

**3→12**

**Time frame:**
Deals typically close in three to 12 months, during which time businesses create proposals and vet bids.

**The bottom line:**
Most private equity firms expect annual returns of 20 to 35 percent and plan to exit in three to seven years, usually through a sale.




**The price tag:**
Legal and accounting fees start at 1 percent of the deal amount and increase according to complexity.

**Resources** For more information on recapitalizing, check out the website of the National Venture Capital Association (nvca.org), which has links to various resources related to private equity financing, as well as the latest industry news.