WOMEN IN BUSINESS

Financing the Buy-Out of a Business Interest in a Divorce

By David Bonrouhi

One common element of a divorce is the buy-out of a spouse's interest in a business. Many times however this business interest is simply exchanged for other assets, such as real estate. In other words, the primary operator of the business may simply give the other spouse her interest in an amount of commonly owned real estate equal to the value of the interest in the business. This is typically only possible however if there is an equivalent amount of real estate, which is often the case if the business is relatively small.

In terms of financing the buy-out of a divorced spouse's interest, the nature and size of the business is a key factor. Buy-outs of interests in small businesses (i.e., under $5 million in sales) and most professional services businesses can be facilitated by a traditional bank loan, an SBA loan or a seller note. Since the outright sales of such businesses are typically structured with a modest amount (one-third or less) paid upfront and the rest in a seller note or earn-out, the buy-outs of interests in these businesses are similarly structured. The sale and partner buyouts of professional services firms where the partners are operators and represent the value of the business, also typically involve deferred payment schemes to mitigate the risk of a significant loss in value after the transaction.

For larger businesses however partner buy-outs are often facilitated by outside capital investment sourced through private equity firms and mezzanine debt funds. In a situation where a $75 million consumer products manufacturing and distribution company is owned 50/50 by husband and wife, in rare cases would there be $75 million or more worth of real estate to use to facilitate a non-cash swap. A business of this size (at least $10 million in sales) which has growth potential, a strong management team, a sustainable competitive advantage and strong profitability (at least $2 million in EBITDA), would qualify for investment from institutional investors such as private equity firms or mezzanine debt funds.

The first source to go after should always be the cheapest. Therefore the acquiring partner should always first max out on senior secured bank financing. Next, the acquirer should evaluate raising equity versus subordinated ("sub debt" or "mezzanine") debt financing. A business with very strong, stable and predictable cash flow would be a good candidate for sub debt. The acquiring partner however would have to be comfortable with this additional leverage of course. Sub debt is more expensive than bank debt since sub debt (a) does not require any personal guaranty from the owners, (b) is contractually in a second lien position behind the senior bank debt, (c) is term debt (not a revolver) with a five-year maturity, and (d) allows an interest only period of at least 3 years if not 4 or 5.

Private equity firms differ by industry focus, target company size, geographic focus and importantly by whether or not they require control. While most private equity firms require an interest of greater than 50% many firms are comfortable owning less than 50%. Few firms however will acquire 100% unless they are buying a target through an existing portfolio company. The vast majority of private equity firms want to partner with the acquiring spouse and strongly prefer to keep the acquiring spouse as the operator of the business and for the acquiring spouse to continue maintain at least a significant minority position in the company (at least 20%) if not a controlling position.

Neither private equity nor mezzanine investors are looking to immediately takeover day to day management and slash expenses to the bone. Most institutional investors are able to leverage their investment experience in similar companies to add real strategic value to the business going forward in addition to growth capital. A formal board of directors will be established and the investors can often assist in executing strategic growth initiatives by tapping their resources in the industry, including potential vendors, customers and C-level executives.

Each situation needs to be evaluated accordingly and a customized approach to financing the buy-out of a partner, whether it is a spouse or not, can be implemented by an investment banker.

David Bonrouhi is co-founder and Managing Director of Calabasas Capital, a boutique investment banking firm that provides sell-side and buy-side merger and acquisition advisory services and private equity and debt capital raising service to lower middle market privately held companies. Calabasas Capital works in a broad range of manufacturing, distribution and services industries and has specific expertise in working in the areas of food and restaurants, other consumer products and services, business services, manufacturing and distribution.

Contact David at (818) 657-6130 or at david@calabasascapital.com.

Disclaimer: This should not be considered in any way an offer to buy or sell a security. This is for informational purposes only. Buying or selling a security involves substantial risk. Investment may be worth more or less than the original investment. Calabasas Capital is a division of Fallbrook Capital Securities Corp. Securities offered through Fallbrook Capital Securities Corp. Member FINRA/SIPC.