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YOUR MONEY

When It’s Time to Buy Out Partners, but Money Is Tight

Wealth Matters

By PAUL SULLIVAN MARCH 11, 2016

BRAD SACKS brought in two family friends who were older and wiser when he started his sauce company, More Than Gourmet, in 1993. They didn’t invest any money, Mr. Sacks said, but for their help, he gave the men half of the company.

Two decades later, the company, in Akron, Ohio, was booming, with lines of demi-glace and cooking stocks that were being used at the Capital Grille and the Hilton Hotel chain and sold at supermarkets like Wegmans. But Mr. Sacks said the two original partners were reaping the benefits of his work even though they were no longer advising the business.

“The company had huge growth, but they weren’t interested in me buying the company back,” Mr. Sacks said. He called the negotiations “ugly.”

When the two sides finally agreed on a price, Mr. Sacks had to find a way to pay them without crippling the company, which has annual revenue of $25 million.

His situation is typical of people who become wealthy through starting private companies but whose wealth is tied up in those companies. While the value of the company may continue to grow, the founders can only borrow so much against it before they are stymied.

They can generally cover their expenses. But getting money to buy out existing partners or to invest in other businesses is another story. It gets more challenging if they don't want to give up control of the company.

Mr. Sacks knew one thing: He didn't want to sell his business to buy out his partners. Soon after he started More Than Gourmet, the owner of the sauce-making plant he used sold to a larger competitor. The sauce maker thought he had freed up some of the money from the business and shed the burden of running the company. Six months later, the buyer ousted him.

The best strategy for buying out partners is, not surprisingly, to have an arrangement set up in advance, advisers say.

Rick Marcatos, senior vice president at UBS Wealth Management, said that there should be legal documents that discuss just how any buyout would occur. "To not hamper the company, you can do some payment structure — 'I've been given 12, 18 months to pay you back,' " he said.

But, of course, that requires planning at a time when entrepreneurs are scrambling to bring their idea to life. When a buyout isn't so clearly delineated, the options are more complex.

Banks will lend, but they are constrained as to how much. Part of the money Mr. Sacks needed was arranged as a loan from Key Bank, which is the company's bank. But the bank couldn't lend all that he needed without putting the company's debt ratio above the limits set by the Dodd-Frank financial reform law.

Mezzanine financing is another option. This type of financing looks like debt but the mezzanine lender has the right to convert it to equity. That conversion happens when the company is doing better than expected, since it increases the return for the lender.

"If the company is projected to be at $2 million to $3 million in a couple of years and it's at $5 million to $6 million, the mezzanine lender is going to convert to equity and there's nothing you can do about it," Mr. Marcatos said. "They dictate the terms because you need the money."

Mr. Sacks kept searching for other options. He could have ended up paying as much as 30 percent on the money from the mezzanine lender if the company performed as he expected it to.

The other problem with using mezzanine debt to buy someone out is deciding on the value of the firm, said Ryan Budlong, managing director at Harris Williams & Company. He said he often advised clients to get two appraisals and then split the difference.

Short of turning to a private equity firm, there are family offices and other private lenders willing to acquire companies and give the founders the opportunity to sell some portion of their company yet remain involved.

William J. Kidd, the founding partner of Kidd & Company, a family office in Greenwich, Conn., said he looks to buy companies with net income of $3 million to $20 million a year that have more potential.

"The businesses we're interested in have been taken by the founder from the floor to the table," he said. "They haven't been taken to the ceiling for a number of reasons. It takes a different skill set to take a company from the table to the ceiling."

Kidd & Company generally pays the founder 70 percent of the price in cash and then structures the remaining 30 percent as a five-year note, which could pay the founder above that amount if the company does well.

"The key when you do this is to make sure the person we're dealing with has a role in the business that is meaningful to them and fun," he said.

In the end, Mr. Sacks found a niche firm, New York Private Finance, part of Emigrant Bank, that was willing to structure something creative: It would make a personal loan to Mr. Sacks using his ownership in the company as collateral. When he then put that money into the company to buy out his partners, it would appear on the balance sheet as an infusion of equity.

"The only real negative was the fact that it was a personal loan so you couldn't get away from it if everything fell apart," he said. "But I was all in."

Leigh Hoagland, chief executive and chief credit officer at New York Private Finance, said the firm sought out entrepreneurs and lent to them personally, not to an operating company. While the borrowers will be responsible for the loan, they will not have to contend with the lender taking a board seat or exerting control over the company.

Mr. Hoagland would not disclose the interest on the loan but said that there was a cap on how much the lender would be paid back, even if the company did better than expected. And the overall cost is less than mezzanine financing. “For people for whom this product works, it’s an extremely important part of their wealth creation,” Mr. Hoagland said.

The loans are generally $4 million to $20 million for periods of three to seven years. Mr. Hoagland said the firm preferred to lend to people who had multiple businesses to act as security.

That was the case with Joe Cambi, a private investor in Springfield, Mass., who built up a food service company there and sold it to Sysco in 2001 for $100 million.

After the deal was done, he found he couldn’t retire. “I like the building process,” he said.

That led him to invest in several businesses, including a minor-league hockey team and a mortgage banking company. In 2008, the mortgage business was struggling and he took on an outside investor, whose money stabilized it.

Last year, the investor, a billionaire, wanted to cash out his stake and wasn’t inclined to wait. “Banks aren’t going to lend to someone like me to take out a partner,” Mr. Cambi said. “We needed to go to a private equity firm, but we didn’t want to give up a lot of equity.”

Like Mr. Sacks, Mr. Cambi got a loan from New York Private Finance to bridge the gap, in his case for $5 million of the $25 million the company needed to buy out the investor. Personally guaranteeing the money, he said, was worth it to regain control of the company.

“He had 70 percent and we had 30 percent,” Mr. Cambi said. “Now, we have a lot of debt. It’s heavy to bear, but it was better than having him in the nest.”

Mr. Sacks shared that feeling. “I was running this business and there was this shadow over my head,” he said. “The company was limited based on that situation. By changing it, it changed the overall outlook.”

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