



WHITE PAPER

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Dividend recaps are all the rage with PE funds in 2024... Could they be a smart move for entrepreneurs too?

By Chris Risey, Lantern Capital Advisors

In the private equity world dividend recaps are having a moment. A dividend recap is when a company takes on new debt to pay dividends to its shareholders. It's estimated that cumulative dividend recaps by private equity in the first 4 months of 2024 were \$30 billion whereas in all of 2023 it barely topped \$5 billion ([Source](#)). This should be surprising since [bank interest rates](#) are at their highest levels in recent history. Reasons PE firms are taking these dividend recaps (despite the higher cost of borrowing) include (1) a slowdown in M&A activity making it harder to find new companies to buy; (2) a slower market for selling businesses that PEs currently own; and (3) increasing demand by PE investors for a return of their capital. A dividend recap allows a PE to

return a portion of an investors' capital even if they plan to hold the business for another year or two. The timing of when PE funds return capital to its investors is a big deal since PE funds solicit for new investors by marketing their funds' rate of return history. Thus, returning a portion of investors' capital a few years early can help boost their internal rate of return. (i.e. time value of money)

Are Dividend Recaps a smart move for Business Owners?

So, it's easy to see why private equity funds might do a dividend recap. But, would a dividend recap be a smart move for entrepreneurs too - even those with no intention of

selling? On the surface, most owners may say ‘no’ but digging deeper there can be some compelling reasons to consider a dividend recap but those reasons differ from why PE funds are currently doing them.

Reduce Risk Through Diversification

Taking chips off the table by increasing a company’s debt to then pay a distribution (dividend) to its owner may not seem much like diversification. Most owners may quickly think “why would I borrow against my company (which is really myself) to pay me a dividend?”. Stated differently, “how am I lowering my financial risk with borrowed money the business is still obligated to pay back?” A key consideration, however, is that dividend recaps typically do not require a personal guarantee from the owner or shareholders. Thus, if the Company defaults on the loan, the owner is not obligated to reinvest in the business. This creates financial liquidity that is truly separate from the business.

To illustrate my point, assume an owner takes a dividend and sometime later the business experiences a sudden downturn, like another Covid-19 outbreak, [an industry-wide disruption that halts income for months](#) or [supply chain disruption](#) to name a morbid few. In such a case the owner is likely *better off* having taken a dividend prior to the downturn because the dividend provides financial liquidity the owner could reinvest in the business. If the business looks like it will recover, the owner can chose to inject capital to sustain operations. But if the disruption likely impacts the long-term viability of the business, the owner may decide not to reinvest. The key is the owner makes the decision to reinvest or not. Whereas, had the business suffered a downturn and the owner didn’t have the capital (from a dividend), it’s also likely the bank will be reluctant to lend more capital citing a ‘material adverse change’ to the business.

Provide Patience to Build a Bigger Company

To be fair, most entrepreneurs are not motivated to make plans based on all the bad things that could happen in their business. If they did, they probably wouldn’t be entrepreneurs. But are more subtle and likely risk is the regret of selling the business too early. In fact, [one study](#) found that 76% of business owners “profoundly regretting” selling their business when asked one year after the sale. There can be many possible reasons for this negative experience (abrupt change in daily routine, lack of a challenge, disconnect from business spent years growing, etc.) but a common underlying misconception that may be leading to such decisions is the assumption owners only have two choices... ‘sell it all’ or ‘let it ride.’ There is no middle ground and no real consideration for just “taking some chips off the table.” As the business becomes more valuable, pressure to sell to another business or increasingly eager PE funds only grows stronger. Thus, it becomes harder to resist capturing a financially life-changing event by selling the company. Taking a dividend now gives owners the ability to ensure a more secure financial future while also continuing to enjoy the journey of growing the company. A helpful exercise to make this happen is to work with a personal financial advisor to estimate the amount of capital needed to support a comfortable retirement and the needs of immediate family for years to come – cleverly called “[The Magic Exit Number](#)”™ by one advisor. Taking a dividend of this amount liberates an owner to keep growing the business without the pressure of selling too early to ensure a more secure financial future.

Enhance Investment, Tax and Estate Planning

Another benefit of a dividend recap is it creates the opportunity to do estate planning and invest in long-term assets that grow and preserve wealth. In contrast, taking frequent distributions from current business profits can create a habit of taking distributions to support a lifestyle, often called “living out of the business” where no real savings occurs. In that scenario, thoughtful personal financial planning doesn’t typically happen until the company is sold. Taking a dividend also allows owners to gain experience

investing in financial assets focused on preservation. Lessons learned during that time may be helpful later when the Company is sold later or greater capital is accumulated through additional distributions taken over time.

Concurrent with making quality financial investments, owners can work with advisors to evaluate different strategies to maximize tax planning and efficiency both at the time of the dividend as well as over the years following. Depending on the objectives of the owner and investment vehicles utilized, there is no shortage of tax advantaged strategies for estate planning, business succession, or maximizing after tax income from the business. A sample of such strategies includes family trusts, [donor advised funds](#) for charitable giving, [ESOPs](#) and [deferred compensation plans](#) to name just a few. In addition, dividends may be treated as a partial sale of the business to capture to lower capital gains rates or possibly qualify for tax free treatment such as AAA earnings for S-corps. Simply put, a dividend recap creates the opportunity to consider all these options in light of an owner's long-term goals and objectives.

Lock-in key management

A common problem that can make a company sale difficult is when owners have promised to give equity to management but never get around to doing the paperwork. Once a transaction starts to happen, advisors scramble to craft a transaction in such a way that gives credit for what the owner has promised. Sometimes, there is no graceful solution. A dividend recap is a logical time for business owners considering such moves to reward employees for their work and contribution to date while further solidifying management's commitment to the future of the business. Getting buy-in from key management prior to a sale of a business also helps de-risk a management defection just at the time of sale. That is, if management doesn't have any ownership and they don't like the new buyers or feel cheated out of ownership promised earlier, they can decide to leave and derail a sale. Also, a grant of additional shares in the company to the management team can provide a future

benefit if owners wish to complete a management buyout in the future. A dividend recap can create an equity stake for management. Prospective investors and lenders will be attracted to a business where management already owns part of the equity. Locking in key management as part of a dividend recap can be done with a large cash or stock bonus or structured as an ownership grant that vests over time.

The Cost of Planning

It's worth noting, a dividend recap will cost money...mainly the interest expense paid on the debt assumed by the company. However, it's helpful to realize that the net cost is reduced by any returns made on the dividend capital invested and the interest is tax deductible to the Company. Also, the interest expense won't hurt the Company's future enterprise value since most businesses are valued based on a multiple of EBITDA or Earnings *Before Interest* Taxes Depreciation and Amortization. Also, any principal still outstanding on the debt at the time of sale would likely need to be paid off from proceeds but this principal essentially represents company value the owners took in advance of a sale to diversify and de-risk.

A Recent Company Example

Five months ago, I had a client execute a dividend recap for over \$50 million for the benefit of its three founders. As part of this transaction, the owners also granted large one-time cash bonuses to select key managers. The owners were motivated to do this dividend recap, in part, because the business was completely shut down for two months during the Covid-19 pandemic. Now each owner has enough personal liquidity to take care of their immediate family regardless of what happens in the future. Even more exciting they still own over 90% of the Company's equity and remain focused on growing the business. Doing a dividend recap allowed them to de-risk now and be patient as they continue to realize their company's long-term potential while also rewarding key management along the way.

About the Author

Chris Risey received his BS in Finance from the University of South Florida in Tampa. He was twice named Academic All-American (USF Men's Basketball) and is a former Rotary International Ambassadorial Scholar at the University of New South Wales in Sydney, Australia.

Chris has spent his career helping growing companies and entrepreneurs plan for and use corporate finance strategies to raise capital and execute transactions in order to support growth, finance acquisitions, buyouts, or refinance debt. As a recovering CPA, Chris has found passion in using the same financing strategies and sources as investment bankers and equity firms in order to successfully secure business financing for his own clients, but without clients having to pay the high broker fees, or give away control of their businesses.

Mr. Risey is very active in many local civic and business organizations. He is an active speaker for Vistage International and Renaissance Executive Forums, Membership Director for his local chapter of the Knights of Columbus, past President and founding member of the Tampa Downtown Daybreak Rotary Club; past President and Member of Financial Executives International of Tampa Bay, and a board member for The Association for Corporate Growth Tampa Chapter. He is a long time member in a Mardi Gras Krewe in New Orleans. Mr. Risey is a Certified Public Accountant and a frequent speaker to industry groups, executive networks, and corporate meetings throughout the United States on business planning, strategy, and financing issues for growing companies.

Concurrent with Lantern Capital Advisors, Chris Risey served as a Vice President for Decathlon Capital Partners from 2019-2023. Prior to Lantern Capital Advisors, [Chris Risey](#) was Managing Director for Tunstall Consulting Inc. in Tampa, Florida, and was with the firm from 1997-2006. Mr. Risey left Tunstall Consulting after being with the firm for nine years to create Lantern Capital Advisors and provide his high growth clients with a more reliable and cost-effective corporate finance solution that would guarantee results and ensure client satisfaction. Mr. Risey has successfully helped Lantern Capital Advisors clients raise capital from a variety of institutions including banks, mezzanine and subordinated debt providers, venture capitalists, and underwriters. Prior to Tunstall Consulting, Mr. Risey was a CPA in the audit and advisory services group for Arthur Andersen in New Orleans, Louisiana.

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