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More on Dividends

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Last week we covered dividend recapitalizations on sponsored leverage loans. Turns out the topic required more air time, based on the feedback we received from readers.

One of the top investment bankers in the middle market reflected on the differences lenders perceive among recaps opportunities. “A primary consideration is the vintage of the fund for the company being recapped,” he said.

The theory is that if the portfolio company is in an earlier fund that has little capital left, many lenders will be cautious to provide a large dividend. Sponsors often have limitations on investing across funds, so they can’t put new money into old funds. That means if the borrower struggles, the sponsor may not be able to support it.

On the other hand, our veteran advisor related, some very successful highly leveraged recaps have been accomplished for issuers only one year after the original buyout. In those cases, the new fund vintage allows lenders to feel comfortable letting cash out the door. If the company needs new capital, it’s more freely available as necessary.

Another reader shared her thoughts on how an exit strategy affects dividend policy.

“A lot depends on how the PE firm expects to realize its investment,” she said. “If the plan is to go public, it’s common to allow the founding entrepreneur to take some money off the table first.” Then IPO investors feel their cash is being put to more productive use.

“Another variant on this theme,” she continued, “is providing liquidity for existing shareholders if their participation in the next phase of the company’s development is limited.” This is often the case when founding partners are giving way to the next generation of managers.

Some GP investments simply take longer to harvest than others. The Great Recession wreaked havoc on the timing of sales, particularly with more cyclical businesses. Even in this extremely frothy environment when purchase price multiples have skyrocketed, some companies are not yet ready for prime-time. The recap can be the perfect antidote.

The timing of fundraising also plays a critical role. If the sale of a portfolio company has been delayed for whatever reason, LPs clearly recognize the benefit of a well-timed dividend. As we discussed last week, return of capital to investors is the fiduciary responsibility of the GP, however it’s best accomplished.

Our own recent experience includes a company that had de-levered significantly since the original buyout five years ago. Indeed, the sponsor had already taken a dividend, but had since thrown off so much cash that total debt was now below 3.5x Ebitda.

While the sponsor had none of its original investment left in the business, it had met the other two criteria for successful recaps we laid out last week: it had met its projections since the original buyout, and recap leverage didn’t exceed that of the original buyout.

Our suggestion to the sponsor? Take another dividend!