

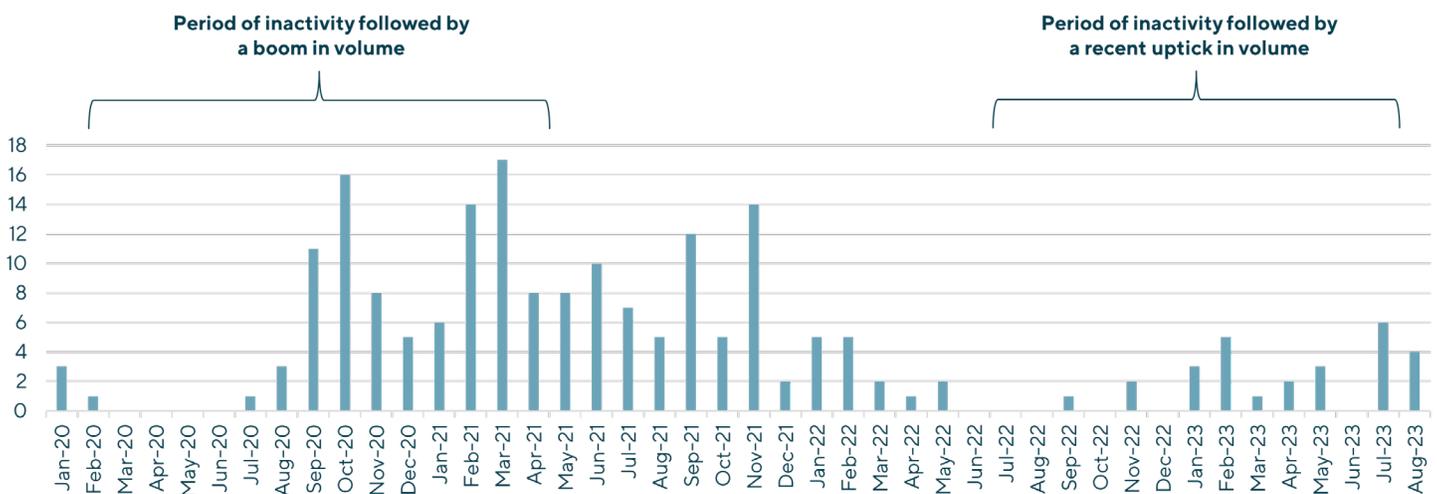
# Dividend Recapitalization Activity Shows Signs of Renewed Life

The dividend recapitalization market slowed down in 2nd half of 2022 as companies digested rising interest rates. However, in recent months, there has been an uptick in volume as borrowers reconsider utilizing dividend recap transactions for a variety of reasons and recalculate the impact a leveraged dividend has on their shareholders.

In our latest perspective, Lincoln International explores the current market environment, provides an overview of dividend recaps and why they are an attractive option and discusses how solvency opinions can mitigate risk in these transactions.

## Dividend Recap Market Environment

Number of Dividend Recapitalizations <sup>1</sup>



(continued on next page)

## What Does the Current Environment for Dividend Recaps Look Like Compared to the Last Time the Market Opened? <sup>2</sup>

	Sep 2020 – March 2021	July / August 2023
 <b>Market Activity (# of deals)</b>	77	10
 <b>Corporate Credit Rating</b>	B and B- (75%)	B and B+ (75%)
 <b>Spreads (1)</b>	1 <sup>st</sup> Lien: S + 400 (350 - 450) 2 <sup>nd</sup> Lien: S + 750 (700 - 800)	1 <sup>st</sup> Lien: S + 400 (350 - 450) No 2 <sup>nd</sup> Lien Issuances
 <b>All - In Yields (1)</b>	SOFR: 0% (0.75% Floor) All In 1 <sup>st</sup> Lien: 4.25% - 5.25% All In 2 <sup>nd</sup> Lien: 7.5% - 8.5%	SOFR: 5.25% All in 1 <sup>st</sup> Lien: 8.75% - 9.75% No 2 <sup>nd</sup> Lien Issuances
 <b>Illustrative FCCR (2)</b>	~2.00	~1.25

## Dividend Recaps Overview

### Why should a board consider a dividend recap?

- Current leverage level is below “market”, including situations where a sponsor over-equitized the initial purchase due to lower leverage availability
- Company is generating strong free cash flow and has the ability to service a higher level of debt while maintaining appropriate fixed-charge coverage
- Avenue to provide liquidity to shareholders in an M&A environment where a full sale is not optimal
- Balance sheet recapitalization simultaneous with general partner-led continuation vehicle transaction
- Allows owners to take “chips off the table” and de-risk fund returns today while preserving upside returns through a future M&A exit
- Potential alternative to a full sale or initial public offering (IPO) in the event the board / management believes appropriate value has not been achieved through the sale / IPO process

(continued on next page)

## What borrower characteristics do lenders look for?

- Steady historical revenue and EBITDA with good visibility – ideally demonstrated by some combination of multi-year contracts, sole-source relationships, recurring “sticky” customers and / or high barriers to entry / competition
- Non-cyclical with favorable industry dynamics – underlying market growth
- Stability in cost structure and asset base – borrower not undergoing major operational changes or embarking on large capex projects
- Minimal adjustments to underwritten EBITDA
- Clear understanding of underlying business enterprise value and equity cushion
- Private equity-backed or other institutional ownership is preferred. Non-sponsored companies will likely have access to lower levels of leverage, all else being equal



*Dividend recap transactions were traditionally underwritten with a focus on loan-to-value (LTV) with debt service metrics being less of a concern. Today, total leverage and fixed charge coverage ratios will carry equal weighting in assessing a company's debt capacity for a debt-driven recap. As a rule of thumb, new-money acquisitions were historically levered to approximately 60% LTV, while dividend recap transactions often peaked at approximately 50% LTV (or 0.50x to 0.75x lower than buyout leverage). In recent weeks, the leveraged buyout market has shifted to approximately 45% to 50% LTV resulting in dividend recap transactions capping out at approximately 40% to 45% LTV. Moreover, the disruption in the markets has resulted in a lack of transparency around enterprise values if there has not been a market-clearing process, causing a heightened focus on the “V” in “LTV.” Consequently, lenders are exercising more caution on how much they will lend in a recap.*

**Christine Tiseo**, Managing Director and co-head of Lincoln's Capital Advisory Group

## Dividend Recaps Overview

### Risks

In the event the borrower becomes distressed or insolvent in the future, creditors may allege the dividend was a fraudulent conveyance.

- *Directors*: Could face significant personal liability
- *Potential “Unwinding”*: Shareholders could be forced to return dividend and / or settle litigation
- *Secured Lenders*: Secured claims may need to settle for significant discounts, despite previously negotiated collateral

(continued on next page)

## Considerations and risk mitigants for boards

- Investigate financial flexibility of borrower and its ability to achieve strategic goals with the increased leverage
- Understand the legal requirements to pay a dividend (i.e. surplus under DGCL §154)
- Obtain a solvency opinion from a qualified investment bank, such as Lincoln International
  - Directors can rely on the opinions of experts in discharging duty of care
  - Line of defense for shareholders and directors in a fraudulent conveyance claim
  - Reduces risk and potential liability in a bankruptcy



*Our clients obtain solvency opinions for many reasons, but the personal liability that members of the board of directors could face is often the leading one.*

**Chris Gregory**, Managing Director in Lincoln's Valuations & Opinions Group who leads fairness and solvency opinions

## The Lincoln Difference

Lincoln's Valuations & Opinions Group, which performs 4,500+ valuations per quarter as part of an investment bank with highly active M&A and Capital Advisory Groups that closed 350+ transactions in 2022, brings real world experience and deep industry expertise to every one of its fairness and solvency opinions engagements. In addition, the portfolio valuation work performed on behalf of over 100 alternate asset managers has earned Lincoln a sterling reputation and credibility within the institutional LP community.

1) Source: S&P LCD Comps; August 2023 data as of August 24, 2023

2) Source: S&P LCD Comps, Lincoln

(1) in chart: Reflects syndicated market pricing

(2) in chart: Illustrative example based on 50% LTV

For other perspectives, visit us at [www.lincolnternational.com/perspectives](http://www.lincolnternational.com/perspectives).

Get to know Lincoln's Global Valuations & Opinions Group at [www.lincolnternational.com/services/valuations-and-opinions](http://www.lincolnternational.com/services/valuations-and-opinions).