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THE ANATOMY OF A LEVERAGED BUYOUT

Or

How Potential Entrepreneurs Escape From A Big Corporation

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Profiles of successful entrepreneurs usually tell how a new business or service starts from scratch to fill a niche in the market.

Big corporations sometimes have special programs to develop the intrapraneurship that enables their companies to remain competitive.

A frustrated entrepreneur can seek independence from a vast corporate structure by finding a company division suitable for a leveraged buyout.

Leverage means the same thing in finance as in physics. Leverage magnifies power: a small object such as a lever can control bigger objects.

You use leverage to buy the family home; you make a down payment of part of the cost and borrow the rest from a bank.

In the same way, corporate acquisitors start with a small amount of cash and borrow what they require to complete the purchase. Management used leveraged buyouts to restructure Allegis, the former parent of United Airlines. Small companies can use the technique, also. Any company division valued at more than two and a half million dollars might be a good candidate. For smaller companies, buyers can usually arrange financing through the Small Business Administration and local banks without resorting to venture capital.

How three men bought Alltest, a small division of Penril, can prove instructive.

Penril, a publicly held company on the American Stock Exchange, manufactures and sells computer modems. Penril owned and operated a smaller company called Triplett that manufactured electric meters.

Triplett had excess manufacturing capacity in 1981. With permission of its parent company, Penril, Triplett bought Alltest, a small private company that had been jobbing out the manufacturing of its auto testing equipment. Penril then sold Triplett, but not Alltest, in 1985. That left Alltest stranded and floundering.

Henry Epstein, president of Penril, brought in Thomas Milner of Texas in 1987 to help Penril either turn Alltest around or prepare it for sale. Epstein and Milner had been friends previously when they both worked at Texas Instruments. Milner decided that Alltest was a suitable candidate for a leveraged buyout in which he would like to participate.

In January, 1988, through business networking and mutual friends, Milner, as president of Alltest, recruited the other two officers whom the company needed.

Anthony Zach, former vice-president of sales and marketing at Sun Electric, became vice-president of sales and marketing at Alltest, charged with developing new products, a marketing program, and a field organization.

Ray Murphy, an accountant and the former vice-president of finance at Midland Paper, became vice-president of finance at Alltest.

Before making the career changes the two men had studied Alltest extensively. They agreed with Milner that the company had potential. Even more important, they would exercise their entrepreneurial skills and own the company.

The three men saw exciting possibilities in Alltest. Its research and development engineers had devised new ideas that would enable it to make cheaper and better automotive testing equipment than standard in the auto repair aftermarket industry.

If Alltest could market these products, it could challenge the three companies - Sun Electric of Illinois, Allen Test Products of Michigan, and Bear Automotive of Wisconsin - that controlled the industry.

Alltest, the only other player, held a 5% market share. The new owners hope to increase that to 10% as new products come on-line.

Penril and Alltest arrived at a satisfactory figure for the buyout by valuing Alltest's fixed assets, inventory, and cash receivables.

To raise the money, Milner, Zach, and Murphy invested their own funds, obtained a bank loan by borrowing against the company's inventory, and brought in Farmers Equitable Insurance

Company of Iowa as venture capitalist. They put the financial deal together in ten months. The three entrepreneurs became the new owners of Alltest in October, 1988.

Beginning with only handshakes all around, Epstein, Milner, Zach, and Murphy created a classic, win-win solution:

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*Penril cut its losses by disposing of a division that no longer fit its corporate strategy.

*Alltest will repay the lending banks with interest.

*Alltest will repay Farmers Insurance as the company turns around. Farmers will also share in future profits through its rights to stock warrants, exercisable during different stages of the company's recovery.

*Alltest can now respond more quickly and efficiently to market conditions than if it were still part of a big corporation.

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Milner, Zach, and Murphy, by seizing an opportunity, have fulfilled their goal of ownership and will reap the profits.

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