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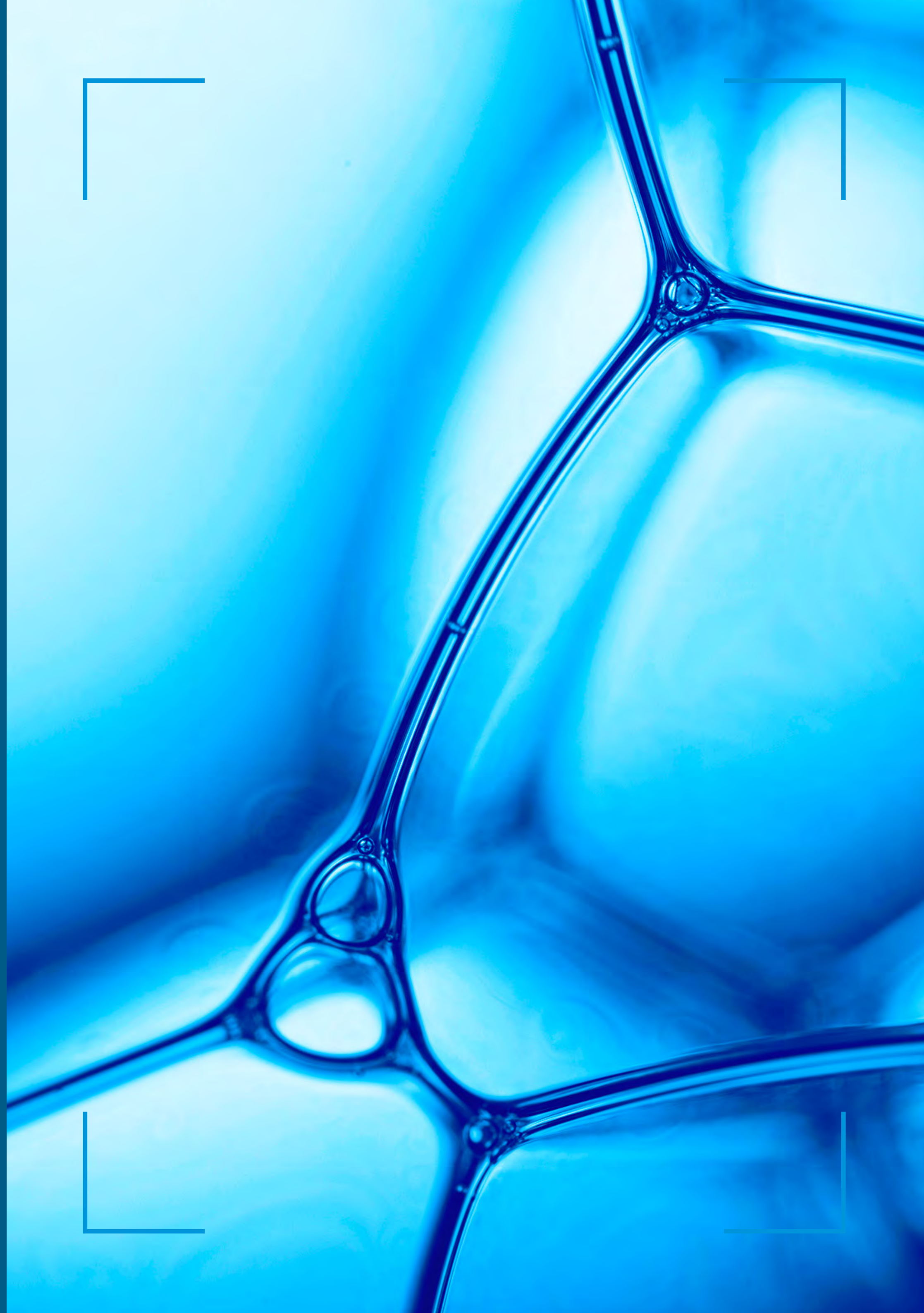
Management Buyouts

A practical guide



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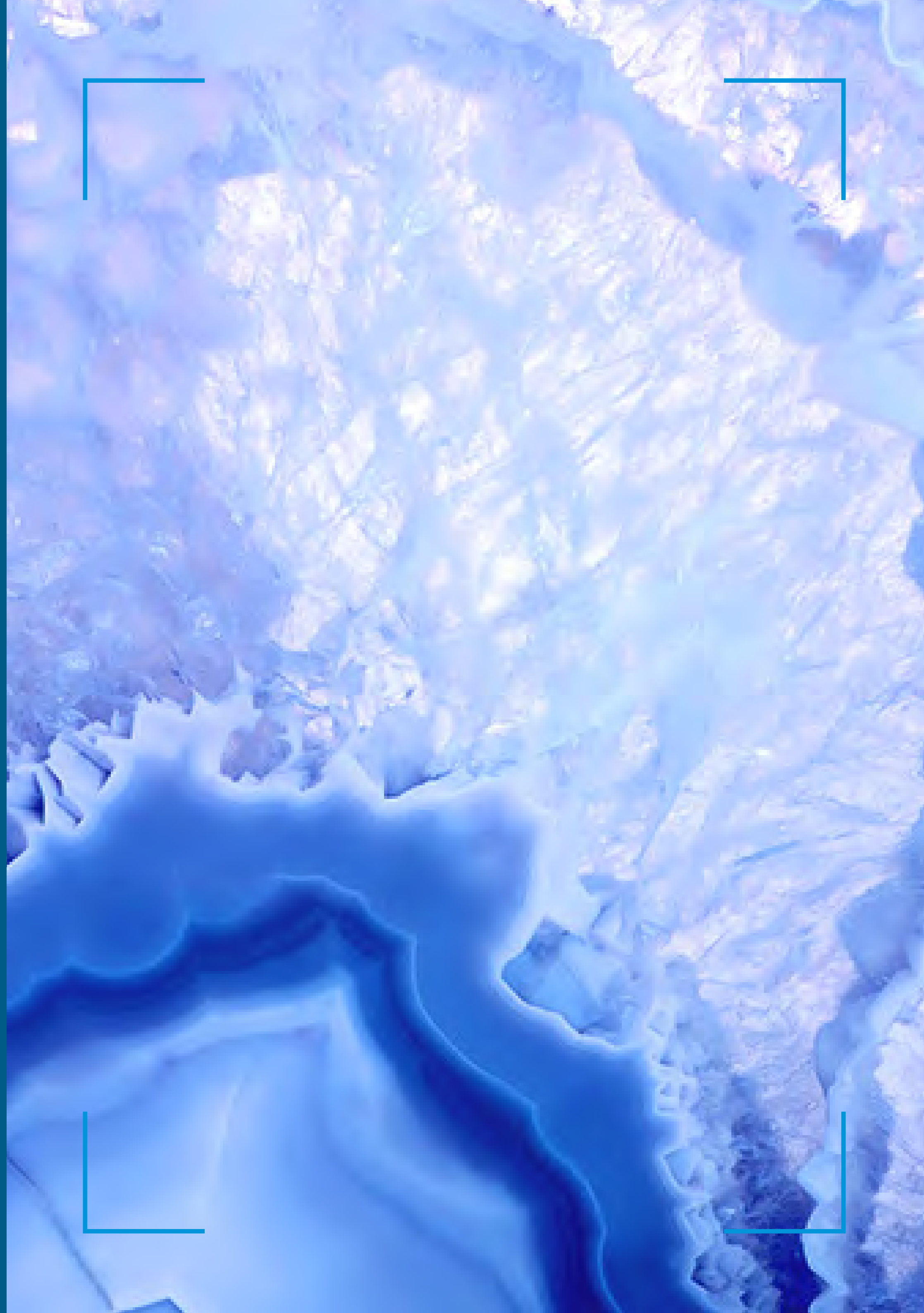

The basics

What is an MBO?

The background, when it is possible and why it might be attractive.

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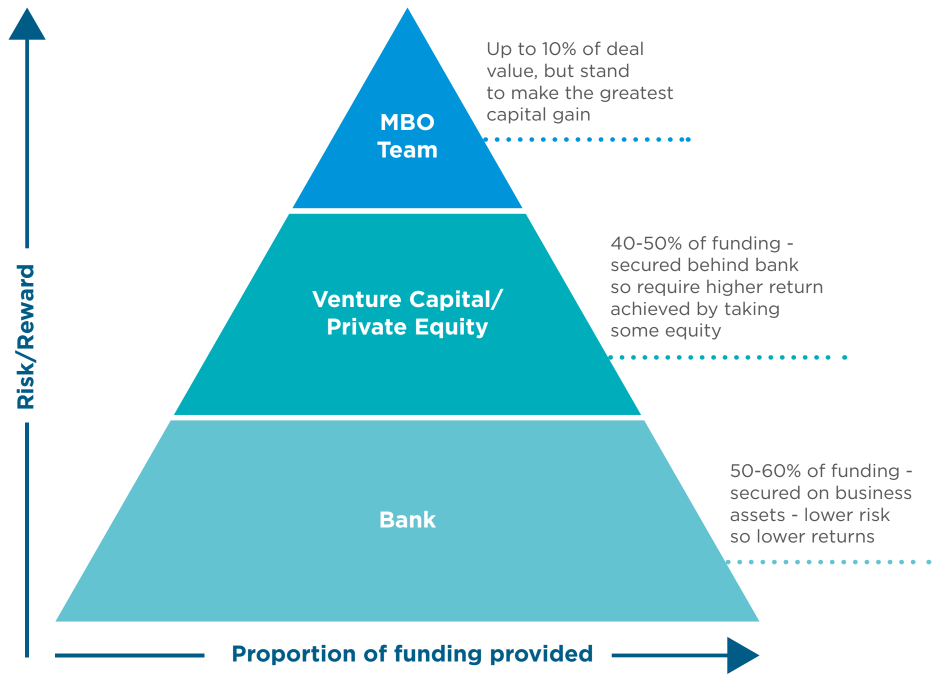
What is an MBO?

A management buyout (MBO) is a deal that allows the management team of a company to acquire the business that they work in, from its owner, with the help of financial backers.

Usually, the bulk of the finance to acquire the business is provided by banks and private equity groups. The banks provide loans and overdraft finance, which is relatively cheap finance, while private equity groups provide equity finance and will want a larger return to compensate them for the additional risk that they are taking. Sometimes the vendor, who is selling the business, will provide some of the finance.

A typical deal structure is shown on the right.

The finance structure shown allows management to acquire a large proportion of the equity of their business for a relatively small investment. The gearing introduced in the structure (paid for from the profits of the business) allows management the opportunity to make very significant gains on their acquisition, provided that the business continues to perform at the levels agreed as part of the deal financing.



Background to MBOs

Research shows that in 1979 there were only 18 significant sized MBOs with a total deal value of just £14m. In 2015 this had increased to 415 completed deals with a transaction value of over £47bn. The number of completed MBOs is expected to continue to increase and it has become a mainstream way for businesses to change hands. Deals are happening in large companies such as Weetabix, Mountain Warehouse and the AA but also in small to medium sized local businesses.

Buyouts are therefore not unusual and the advisory, banking and legal markets are well set up to deliver these deals successfully.

> "...the number of completed MBOs has continued to increase and it has become a mainstream way for businesses to change hands."

Many managers discount their chances of being able to participate in MBO deals – there are a number of common misconceptions out there;

- You have to be independently wealthy to be part of an MBO team – finance structures are put in place as part of the deal to cover the bulk of the purchase price.
- MBO teams can compete with trade buyers – a trade sale can be unattractive to vendors (they may not want to sell to competitors / want to maintain confidentiality / want a quick deal / or may just want to reward management).
- MBO deals occur across all business sectors – there are no industry boundaries.
- Deals have to be of large value – the model works for small to medium sized businesses too.
- It has to be a high growth business – MBOs also work well in stable, profitable but slowly growing companies.

What is in it for managers?

As suggested above, management can make significant gains on their investment in the business – even if the business does not grow significantly. Simply running the business and repaying bank debt increases the value of shares in the business. The example to the right shows how this works:

In Year 0 the target company is acquired by the MBO team for £15M. This is financed by £10M of bank term debt and £4.25M of private equity loan stock. The balance, £0.75M, is subscribed for equity in the business with the MBO team paying £0.45M for 60% of the business and private equity funders paying £0.3M for 40%. The private equity house has put up a total of £4.55M of risk capital (equity plus unsecured loan) for its 30% stake. This means that it has paid much more than management for its equity offset by the fact that its loan stock will be repaid before the equity shareholders.

On day one the value of the business is equal to the value of cash paid for the shares, £0.75M. Deal costs will be paid out of this cash, usually only if the transaction is successful.

After five years, it is assumed that the business has paid off £6M of the bank debt and is now worth £20M having grown steadily over the period. The Equity Value is now £20M less outstanding debt of £8.25M – thus £11.75M. Shareholding percentages have not changed and management's stake is therefore now worth £7.05M. This is management's reward for having had the courage to do the deal and for delivering good business performance in the period post buyout.

£ Million	At completion	Repayments	Year 5 sale
Purchase price of business	15.00		
Sale price of business		6.00	20.00
Financing			
Bank Debt	10.00		4.00
PE Loan Stock	4.25		4.25
Ordinary Shares	0.75		11.75
Enterprise Value	15.00		20.00
Ordinary share cap split			
PE provider (40%)	0.30		4.70
MBO team (60%)	0.45		7.05
Total Equity Value	**0.75**		**11.75**

How to spot an MBO opportunity

An MBO opportunity exists when the business owner wants or needs to sell its business:

- Restructuring of a corporate group (sale of non-core business)
- Distress sales (vendor may need to raise finance)
- Unwanted acquisitions by corporates (they may buy a group with non-core businesses)
- Administrator selling a business as a going concern
- Institutional investor seeking an exit
- Retirement of owner
- Exit of one or more shareholders

Why is an MBO attractive to vendors?

Vendors do not always wish to sell to trade buyers:

- They may want a quick sale (management know the business and can act quickly)
- They may not want to sell to a competitor
- They may want to reward management and secure the workforce
- They may prefer for the business to stay in friendly hands
- The MBO team know the business so will require fewer legal warranties than a trade buyer

In other words, provided the MBO team can make a fair offer for the business there are good reasons for it to be accepted.

MBO teams are well placed to compete with trade buyers and often the vendor will not seek a trade sale provided the MBO offer is reasonable.

Getting started

What needs to happen?

What is required of the team, the business, and how much do you need to invest?

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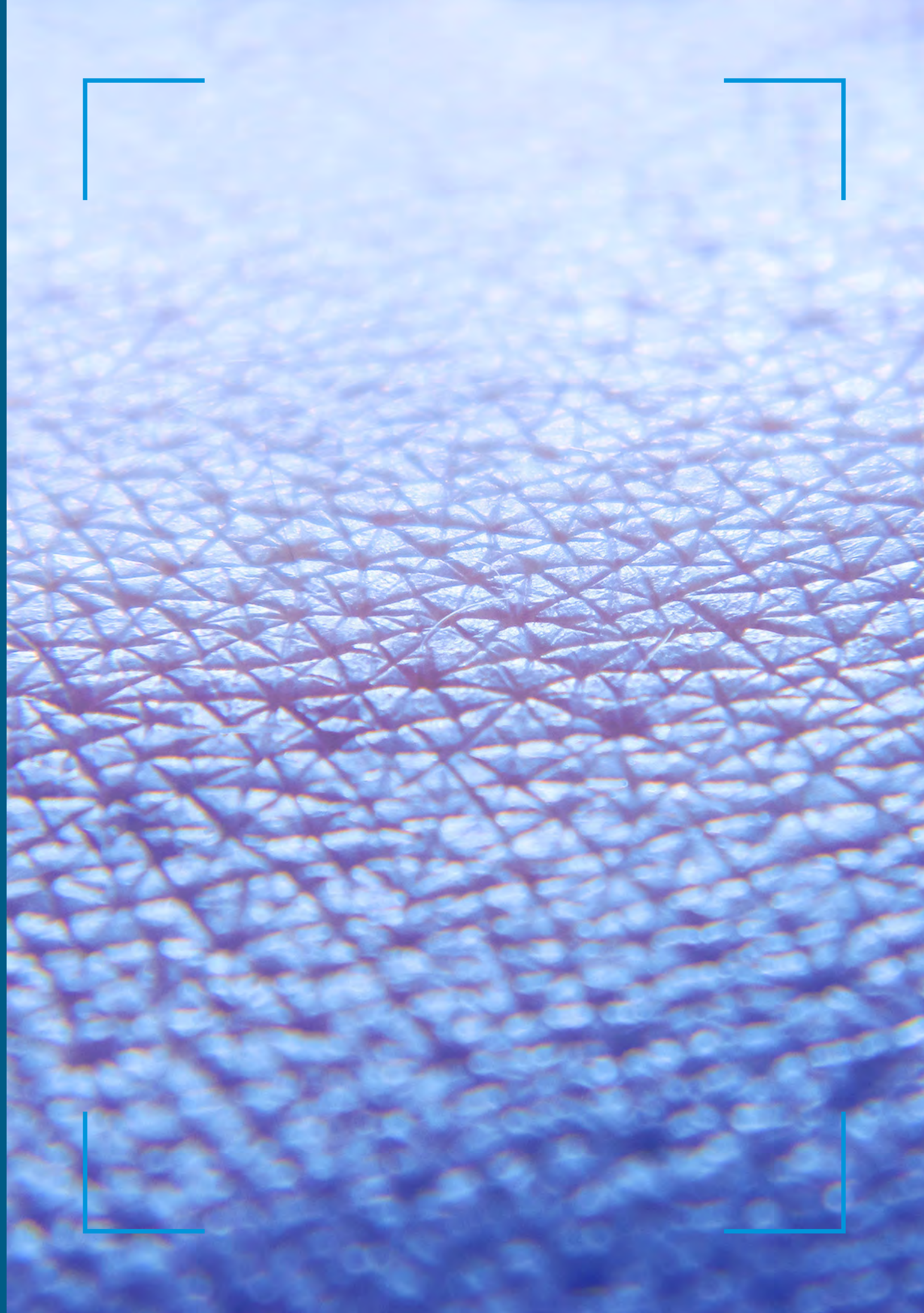

The management team - what is required?

The team needs to be complete, competent and committed.

A complete team will normally consist of the following (although will vary from industry to industry):

- Chief Executive / Managing Director – a leader with experience, ambition and vision, who has held full profit responsibility in the business or elsewhere.
- Finance Director – capable of maintaining the financial discipline and control required to manage the business finances and ensure that the deal finance is repaid.
- Sales Director – experienced customer focused sales person with a good commercial understanding.
- Operations Director – a technically proficient person who understands the technology and processes in the business.
- The team needs to be balanced and individuals need to work well together. On occasion if there is a good but partial team, a manager can be added to complete it. This is sometimes referred to as a Buy in Buy out or ‘BIMBO’.

Competence will be assessed by reviewing the track record of the business, the CVs of the individuals concerned and an assessment of their credibility in delivering the plan for the business.

Commitment is usually ensured by requiring all of the MBO team to personally invest in the deal. This is sometimes unhelpfully referred to as ‘hurt money’.

The importance of the management team can not be over emphasised – financiers are backing the team to deliver.

The business - is it suitable?

Primarily the business needs to be profitable with strong cash flows and reasonable prospects in its market place. The business needs to be able to operate independently.

This is particularly important if the business is being sold from within a group which may provide central support.

The business needs to be able to generate sufficient cash to repay financing loans as they fall due, as well as supporting required investment in the business. In addition it needs to generate a reasonable return for private equity investors over a three to five year period.

Businesses requiring significant investment can be financed if the business case is strong, though usually a higher equity stake will have to be taken by investors. Usually MBOs happen in mature cash generative businesses that are able to take on deal finance without damaging business prospects.

How much money does the MBO team need to invest?

Management commitment is witnessed by personal investment in the deal – financial backers will require this. A rule of thumb often quoted is that each manager should invest an amount equal to their gross annual salary. This can, however, be varied to reflect the actual financial circumstances of the individuals.

It is quite usual for the financing bank to provide loans to the MBO team to cover their personal investment.

Dealing with the vendor

The vendor needs to be approached early in the process to ensure an MBO deal is a possibility.

Before making an approach, it is sensible to work with a financial adviser to undertake an initial feasibility study to identify whether a buyout deal is achievable. This will be fairly high level in nature but will give some comfort that a deal is possible. The appointment of advisers also gives credibility to the initial vendor approach.

All dealings with the vendor need to be carefully handled since the MBO team will remain employees until the deal is completed. The team should ensure they respect their duties to shareholders in respect of confidentiality until such time as they have been given the go ahead to proceed with a bid.

Planning an exit

If the deal will require equity finance, the providers of that finance will need to have the ability to realise their investment in a three to five year time horizon. A plan will need to be put in place to deliver such an exit, hopefully on favourable terms for all shareholders.

The plan should provide for the business to be appropriately “groomed” over the three to five year period so that it is as saleable as it can be at the required time.

Options could include:

- Sale to a trade buyer – ensure likely buyers exist within the business.
- Flotation (AIM or LSE)
- A secondary buyout – whereby management acquire nthe private equity stake in the business, or sell to a team which is capable of succeeding them.
- Refinancing by another private equity provider.

Making it happen

The MBO process

From agreeing a deal through to
financing and completion.

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The process

The MBO process is summarised below – a number of different cogs need to go around at the right time and the right speed to get the deal done. No two deals are ever the same and flexibility is required on the part of the team and their advisers.

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The role of the financial adviser

A financial adviser should be appointed as soon as the possibility of an MBO arises. The adviser will need to be involved in all aspects of the deal from the first meetings to completion. As already noted it is advisable to undertake a feasibility review with an adviser before getting into discussions with the vendor. This review will sketch out answers to the following questions:

- Are the business and MBO team strong enough to proceed?
- What price might the vendor want for the business?
- Can a finance package be constructed to deliver this price?
- What are the likely possible finance options?
- Who might have appetite for the deal?

Once the deal has been given the go ahead the advisers will advise and help with all aspects of the deal including some or all of the following:

- Approaching and negotiating with the vendor
- Valuing the business
- Helping to prepare a business plan
- Identifying banks and private equity firms likely to be interested in the deal
- Approaching and negotiating with banks and private equity providers
- Helping to select financial backers
- Helping to select legal and tax advisers
- Monitoring and helping to control deal costs
- Project management to completion

It is usual that MBO teams only do this once in their lives. The process is emotionally demanding and time consuming and it is likely the team will spend a considerable amount of time with their advisers. Needless to say it is essential to choose advisers that you feel comfortable with.

Structuring a deal

Deal structuring is a balancing act between the often opposing aims and requirements of all the different parties involved in the deal. There are many different ways to reach a workable deal structure and no single structure is the "right" answer. Usually the deal structure will evolve over the MBO process.

In general, the best structure for the MBO team will be the one that ensures they retain as much of the equity in the business as possible, provided that the deal finance can be serviced by the business. At the same time it is desirable to
negotiate as low a price as possible for the business with a flexible a payment profile. Some vendors may agree to a deferral of part of the purchase price.

Your adviser will assess all the options available and explore with the MBO team the most appropriate deal structures.

> There are many different ways to reach a workable deal structure and no single structure is the "right" answer.

Raising finance

It is likely that multiple finance companies will be approached as part of the MBO process. A detailed business plan will need to be prepared to support this and management will need to deliver a detailed presentation to "sell" themselves and the business.

The total finance that will need to be raised will be the purchase price, plus transaction costs plus any working capital facilities required by the business, less the cash contributed by the MBO team. A number of types of finance providers exist and each have different requirements:

Debt finance

The first step in determining an overall structure is to agree how much debt finance can be supported by the business. This depends on the cash generated by the business and assets that can be financed.

Most debt will be offered with a defined repayment period, usually around five to seven years depending on the business. In assessing offers of debt finance it is important to assess not just the amount and interest rate but also arrangement fees, repayment terms, security requirements and financial covenants. It is essential to ensure the business will have adequate operating cash headroom even with the debt finance.

Equity finance

This is used to bridge the gap between the purchase price of the business and the debt finance raised. It is generally expensive as equity providers require a good return for the risk that they are taking. Finance will be a mixture of equity and loan stock (some of which may be convertible).

Offers of equity finance need to be carefully assessed to understand how much equity is being sold, not just at completion, but on a subsequent sale (after conversions of loan stock). It is not unusual to see equity ratchets being employed. These flex the equity stake of the investor based on the performance of the business and can be complicated.

They can, however, give management a chance to increase their stake or share of exit proceeds. Private equity investors can demand fairly onerous constraints over the operations of the business and again these need to be understood and assessed.

Mezzanine finance

This is a hybrid form of finance that sits between debt and equity (having characteristics of each) and is used to bridge funding gaps if required. It is not usually encountered on smaller transactions.

Vendor finance

Some vendors may help finance the deal through deferred loans; some may even wish to take an equity stake in the business if this helps to get the deal done.

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Tax and other advice

It is important to get good tax advice about the deal. The following areas may be relevant:

- Requirement for tax clearances
- Availability of tax losses
- CGT or group relief issue on companies leaving a group
- Stamp Duty
- VAT – a new registration may be required
- Inheritance and capital gains tax mitigation (longer term)
- Tax indemnities and warranties needed from the vendor
- Share option schemes
- Income tax relief on MBO loans used to acquire the business

Other areas where advice might be needed include:

- Pension schemes (e.g. staff leaving a group scheme)
- Employment contracts
- Property
- Employee incentive schemes
- Key man and other insurance

The legal process

It is usual for a new company to be set up (owned by the MBO team and equity backers) to buy the MBO target. Most of the legal processes will relate to this new company and will include:

- Writing governing documents (articles, memorandum and shareholders agreements)
- Subscription agreement with equity investors
- Loan agreement with banks
- Service agreements with directors
- A sale and purchase agreement covering the acquisition of the MBO target business

In addition to drafting the legal documents, it is usual for the lawyers to carry out some due diligence on behalf of management.

Timescale

As shown to the right, an MBO will take around six months, although it can sometimes be concluded much more rapidly. This can be to the management team's advantage if they can secure a deal with the vendor by completing the purchase prior to a given deadline.

It is essential to understand that the work on the buyout is over and above that needed to run the business effectively so it can be exceptionally demanding.

Cost

The costs of the deal can be considerable; a rule of thumb is 5% of the overall deal value but this can be higher for smaller or complex deals. A financial adviser will ensure that much, if not all, of the costs will be contingent upon successful completion of the MBO and that sufficient funds are raised to meet them. This protects management from having to pick up the tab. Sometimes vendors can even be persuaded to underwrite some costs.

Outline timetable for an MBO

After the deal

When the hard work begins

Planning for the management and development of the business post-completion.

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Things to think about

After the MBO it is essential to hit the ground running. There is usually considerable goodwill from staff, suppliers and customers immediately after the deal is announced and it is important to leverage this.

The deal must be "sold" to important customers and suppliers – it is not difficult to deliver a very positive message about such deals. Staff must also be informed in a thoughtful and positive manner; the introduction of incentive schemes for key staff can help here.

The MBO team may also wish to consider the appointment of one or two experienced non executive directors to the board to help monitor and develop the business.

"After the MBO it is essential to hit the ground running."

The team

A uniquely personal approach to service delivery

Bringing decades of corporate finance experience and insight to our clients. We take time to understand our clients so that we can deliver best advice and good deals.

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PEM Corporate Finance

PEM Corporate Finance is a leading independent corporate finance specialist based in Cambridge.

We work primarily with owner managed businesses in East Anglia, the Home Counties and London, advising on all aspects of corporate finance transactions, from mergers and acquisitions (M&A) and company sales to management buyouts (MBOs).

We have a distinctive approach and a demonstrable track record of helping our clients to succeed. We take time to understand our clients so that we can deliver best advice and good deals and have a track record of success.

We are able to deliver decades of corporate finance experience working on a broad range of M&A deals, company sales and MBOs. The team also has interesting experience outside of the corporate finance sector which we believe helps us deliver an effective service.

Business Weekly in Cambridge describes PEMCF as a “breath of fresh air in deal making” reflecting our uniquely personal and thoughtful approach to service delivery.

Through our links with PEM, a firm of 150 people, we have access to relevant tax and other advisory specialists and are part of Kreston International, one of the largest accounting associations in the world with a resource of over 23,000 professional and support staff in more than 100 countries. This gives us genuine international reach for our clients.

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Our team

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Lake has 25 years' senior level experience in venture capital, as a corporate finance adviser, and as a manager in industry. He spent six years in venture capital with 3i plc where he led transactions and managed a portfolio of investments. As a corporate finance adviser, primarily with EY, he has led transactions including MBOs, disposals and start-ups. He holds the ICAEW corporate finance qualification and is a member of the ICAEW Business Valuation Group. Lake has been FD of a manufacturing business. Lake joined PEM in 2004 to establish PEMCF.

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Philip joined the PEMCF team in 2017, rejoining professional practice after time spent as a Financial Director. He has over 10 years' experience in corporate finance advisory services, on behalf of RSM and BDO, with a focus on mid-market entrepreneurial businesses. He will advise shareholders on the ultimate disposal of their business and assist acquirers with the identification and ultimate purchase of suitable acquisition targets. Philip also delivers exit strategy reviews and help to advise management teams on management buy outs.

Ned Brown

Manager
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Ned joined from Deloitte where he qualified as a chartered accountant. He supports all our service lines, from business sales to raising finance. Ned is great at connecting with people – you can always rely on him for an interesting discussion and a confidence boost. His technical ability is just as effective, and clients highly value his analytical mind and attention to detail. As his team members, we admire the way Ned stays calm under pressure. He works diligently and cheerfully whatever the challenge.

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