Garbutt & Elliott
Corporate Finance

# Management buy-outs

“...you are probably looking for your next challenge.”

“...provide an opportunity for management and employees for the future.”

# What are you looking for?

## As a manager in a business you are probably looking for your next challenge. Are you interested in owning your own company? Do you have some great ideas about improving the business you work in but feel constrained?

Being a manager puts you in a good position within your current business to be in line for ownership when your current employer retires, and this could be sooner than you expect.

Alternatively, you may own a company and be thinking about long term plans for your businesses future. Are you wondering who will continue the business when you’re ready to retire, or do you have a non-core part of the business which you would consider selling? If this is the case it may be worthwhile considering your current management as the new owners. It could potentially be a far less traumatic sale than to external parties and provide an opportunity for your management and employees for the future.

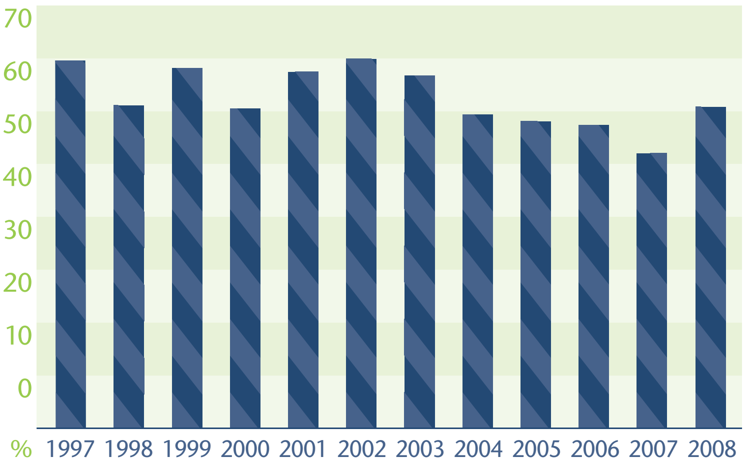
If you are in either scenario it is a realistic option for management to buy the company they currently work in. This transaction is commonly known as a management buy-out (“MBO”).

# What is an MBO?

**An MBO, by definition, is the purchase of a company by its management. Management would generally acquire a controlling or significant equity stake for a small personal investment. The remaining purchase price is financed by external parties providing debt and additional equity.**

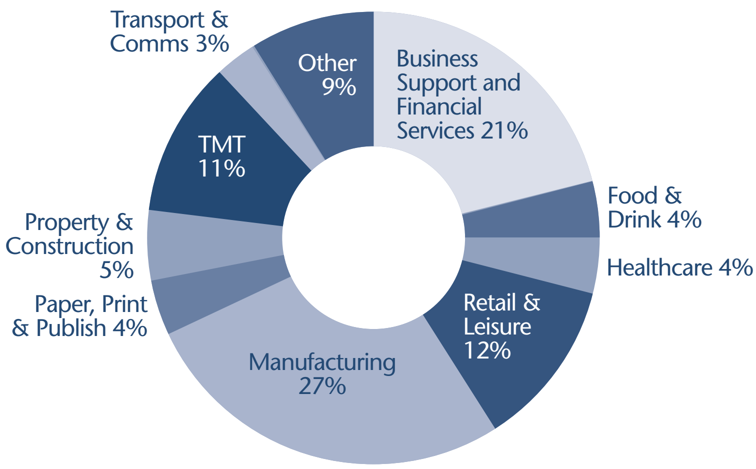
MBOs first came to the UK market during the 1970s. Since then they have increased in popularity to become the most common form of acquisition today. The graph to the right demonstrates that MBOs generate, on average, 50% of all merger and acquisition transactions.

It is a common misconception that only certain sectors fit the MBO model. In reality all types of business lend themselves to MBOs. The chart to the right illustrates the broad spectrum of industries that MBO transactions have occurred in the last 5 years to 2008.




MBO share of Takeover Market

*Source: CMBOR*



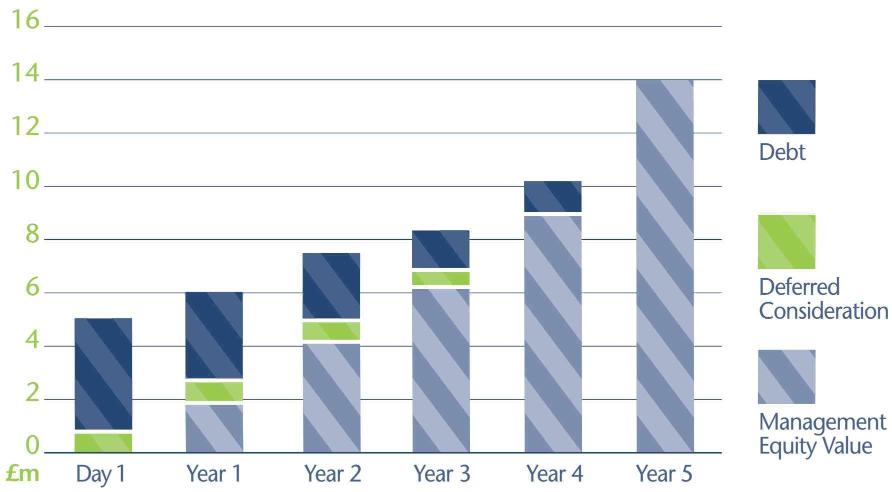

5 year average MBO Sector distribution

*Source: CMBOR*

# What are the benefits of an MBO?

If you are currently working in a management role but with no (or limited) shareholding in the business, by taking the next step and investing a relatively small amount of money in an MBO transaction, you could stand to significantly increase your personal wealth in a short period of time. A bank or funder will support you financially for a number of years but once the finance is repaid you will have gained an equity value in your own business for a small investment.

The graph to the right depicts an MBO deal where the business is worth £5 million at the transaction date. Management are required to invest only £200K, the remainder of the deal is funded by debt of £3.8 million and deferred consideration of £1 million. As the value of the business increases under new ownership and the debt is repaid, the value owned by the management increases substantially. After 5 years the business in the illustration is worth £14 million, all the debt is repaid and 100% of the business is owned by the management. Therefore, after a £200K stake and 5 years' work, the management have made 69 times return on their initial investment. Even if the business didn't grow, managements' value would still yield a 25 times return for the MBO team.




**An MBO also provides you with job security. If your employer sold to an external party the new owners might take the decision to replace management with their own team.**

Commencing an MBO transaction may, however, put strain on your relationship with your current employers and they may feel uncomfortable divulging sensitive company information to you. This process needs to be managed with the assistance of external advisors. You will also need to put 110% effort into the venture to convince funders of your commitment, as well as having a defined strategy for continuing the growth of a profitable business which can meet its debt repayments and has a healthy future.

# Can I really run my own business?

More than likely, you will be suffering from a number of doubts as to your capabilities in running a business of your own. This is common as an MBO is a big step to take. It is important to be confident in your team's abilities and to convince funders that you are the right team to provide financial backing to. You may want to ask yourself the following questions:

- Are you and your team sufficiently experienced?
- Are you committed to seeing the transaction through?
- Do you have a clear vision or strategy to take the business forward?
- Will you be able to step up your role in the business in respect of dealing with staff and other stakeholders?
- Are you able to access some personal capital to invest?

In addition to looking at yourself and your team, you should also decide whether the company is a viable business going forward, does it have good prospects and are your plans going to improve its current trading position further? What are the risks facing the business and do you have a strategy to address or mitigate these?

> "... you could stand to significantly increase your personal wealth in a short period of time."

# Financing the transaction

The major issue concerning management teams at this stage is how they are going to afford to acquire an established business themselves. It is important to note, however, that the MBO team will only be required to input a relatively small portion of the overall consideration. The main reason you are asked to put your own capital in initially is to show your commitment to the deal. This is commonly known as "hurt money".

The remaining consideration often comprises bank debt in one form or another. It is one of the cheapest forms of financing but requires repaying prior to any other financial provider and will have strict terms attached.

**Deferred consideration may also be introduced. This is effectively where the exiting shareholders lend back to the company a proportion of the consideration for a period.**

Venture capital ("VC") funding is another common option (usually alongside bank funding) for financing the purchase price. A VC will assist companies by injecting cash in return for an equity stake. They have a mid-term plan of typically 3-5 years, where they aim to increase the value of their stake (as well as yours) and ultimately exit through a number of possible routes. They will usually appoint a member of their team to your board to assist in decision making and strategic direction. They do not, however, take any direct part in the day to day running of the business.

In order to obtain funding from financial institutions you must have a detailed and well thought-through business plan for success.

To measure this, funders will invariably focus on three key criteria:

- A strong and well-balanced management team.
- A commercially viable existing business.
- A sound and developed strategy for the future.

All of the above areas need to be presented to chosen financiers in the correct manner through both the business plan and effective meetings with funders.

# The Management team

This is one of the most critical aspects. A strong management team in a weak business is arguably a better bet than a great business being taken over by a poor management team.

You will need to demonstrate that your team is more than capable of running and growing the business, i.e. has the right spread of skills and necessary experience. A typical MBO team is made up of the following elements, usually consisting of 3-4 people:

- Managing Director
- Finance Director
- Sales Director
- Production/Operations Director

If you can't cover all these aspects it may be possible to fill the gaps with an external candidate. Your advisor may be able to help find the right person. The above team is also not prescriptive. The key is to involve all significant members of management and this will vary case by case.

# The process:

## 1 Assessing your chances and the ‘sounding out’ process

At an early stage the MBO team should be chosen and soundings taken by the team leader as to whether the team has an appetite to get involved.

Alongside this a high-level approach to the vendor should be made. This needs to be handled sensitively and the response judged as to whether there is in principle a possible deal to be done.

At this stage, if there is a willing vendor, outline discussions may take place on value. At this point, if not earlier, it is imperative to take independent advice from a corporate finance advisor.

> “... you must have a detailed and well thought-through business plan for success.”

# The process (continued):

“... the best deal for you ...”

## 2 Your Advisor

You should appoint a corporate finance advisor as soon as possible to assist you through the deal. Their fees will often be on a part-contingent basis, and the vendor/company may be prepared to underwrite some of the costs. Costs associated with an MBO transaction will however be built into the overall funding required.

Ensure your advisor has the right credentials. Try to find out what deal experience they have in your sector and whether they are experienced in MBO transactions. This might involve obtaining testimonials.

Your advisor will talk you through every stage of the MBO process and assess whether your plans so far are viable. They will provide an independent, secondary opinion and assist in maximising your chances. They will ensure that what you present to the vendor and funders gives you the best possible chance of success. Your advisor will also ensure the deal is structured in a manner that is commercially viable and advantageous to you in terms of the correct funding structure and minimising risk.

Moreover, an advisor will be able to approach the vendor on your behalf, know the right time to approach them and negotiate with them to obtain the best deal for you and one that the vendor is happy with.

An experienced advisor will have many MBO deals under their belt and this experience is critical to managing the emotional roller-coaster ride to completing a transaction. The advisor will:

- Provide an independent view on valuation.
- Add credibility to funding proposals.
- Prepare you for meetings with funders.
- Negotiate with vendors and finance providers on your behalf.
- Assess the reasonableness of all commercial terms.
- Agree an appropriate financing structure.
- Project-manage the entire process.

## 3 Agree terms with the Vendor

Once you know your MBO team are committed and the vendor has agreed to consider an MBO, it is now time to approach the vendor seriously and negotiate the terms of the deal.

Let your advisor lead the negotiations. You should reiterate your goals and aspirations to your advisor prior to any negotiations, so they are clear on what you definitely want to achieve and areas you wouldn't mind giving a little on. Your advisor will consult you at various stages throughout the negotiations but if they have a clear picture of your goals from the outset they will be able to work more effectively.

Approach negotiations with the aim of reaching a mutually beneficial solution for both parties. Those who go in with a bullish attitude will more than likely just cause major stumbling blocks along the way and break down the existing relationship. Always keep your own goals in mind. Try not to be fastidious on elements that don't concern you too much as, if you give a little in certain areas of importance to the vendor, negotiations will remain harmonious which is critical.

### An imperative tool in negotiations is remaining composed. Emotional outbursts will distract both sides from the task in hand.

It is also important to be strong during negotiations and, if the other party are not playing fair, then have the courage to walk away from or at least reconsider the deal.

Always bear in mind that should negotiations fall through you may need to revert to your existing management roles, which is why some degree of harmony in negotiations is important.

# The process (continued):

## 4 The business plan

Despite knowing the business and its current owners very well you will still be required to prepare a business plan in a professional manner. The business plan will be your selling tool; it will portray your future plans for the business, show your understanding of the current business and its markets and how you plan on making any necessary changes. You should be selling your vision to potential funders in order to secure support for the deal.

As soon as you obtain clearance from the vendors to pursue the MBO you should agree heads of terms and an exclusivity period to arrange finance and then commence work on the business plan. Your advisor will assist in pulling the document together and ensure it covers all necessary areas, but you will need to write the majority of the content and provide detailed financials for your advisors to generate forecast models to substantiate your plans. It takes a lot of effort to create a good business plan but it will prove to be essential in the early stages of the deal, as well as providing you with some structure going forward. It also, importantly, enables your advisor to critique your plans before being put in front of the funders.

## 5 Locate your funding

Once you have a business plan you will be able to engage in dialogue with funding providers. Your advisor will be able to give you advice on an appropriate funding structure for the MBO. Your first move typically will be to speak to your current bankers to see if they will be interested in supporting you.

**This will be the simplest option, as the bank will already know your history and your business.**

It will also be worthwhile approaching some other funders, in case they can provide you with better terms. Your advisor will be able to assist you in determining active and appropriate funders in the local market.

## 6 Perform rigorous due diligence

This phase of proceedings will allow you to delve into the inner workings of the business. Whatever your involvement in the business prior to the MBO, inevitably you will have been excluded from some aspects of the business. This is now your chance to check everything is in working order and that you are paying for what is actually there.

Due diligence for an MBO party may not be as meticulous as for an external buyer, as you already know the business. But remember it is the funders who are taking the lion's share of the risk and they will need to be satisfied with their investment. For this reason, external financial and legal due diligence will be commissioned by them.

# Concluding the transaction

The whole process can take around 6 months (and generally a minimum of 3 months) so be prepared to be fully committed to the transaction for that time frame. This can itself be very challenging, as you will also be doing your normal day job running the business and keeping it on track.

As soon as the deal goes through you should firstly advise your staff and reassure them of what the future holds under your ownership. You should then inform your suppliers and customers of the change in ownership and seek opportunities to get some positive PR. Forward planning will enhance the prospects for this to be successful.

**Your ongoing task is to ensure that your planned changes are implemented and followed through to ensure funding constraints are met and the business sets off on its new course successfully.**

> “...be prepared to be fully committed to the transaction...”

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