Acquisition by Management

Management Buy-Outs and Buy-Ins

Expert knowledge means success

Contents

Note: This publication has not been updated since it was last published. Some of the hyperlinks may have changed and may need updating. In addition, some of the information in this publication may be out of date.

Introduction

A Management Buy-out or Management Buy-in (or MBO or MBI as more usually known) is a transaction that results in the purchase of a business by its existing management team or by an outside team. On the whole, they are fairly new in Europe having emerged here in the 1980s. In the USA these transactions have a much longer pedigree and are referred to as Leveraged Buy-outs (or LBOs).

This type of transaction is a popular means of ensuring the continuity of a company. But it can also be highly complex - involving issues such as psychology, finance and taxation.

MBOs or MBIs are popular because:

- They offer either the existing or an outside management team or a combination of the two to run the business in their own way and the opportunity to buy a financial stake in it - often for a comparatively small sum;
- For the existing owners, it provides a way of releasing the capital tied up in the business, as well as an opportunity to reward the existing management team for past services and a way of preserving the independence of the company;
- For the investors, a buy-out is an opportunity to invest in a business with a strong track record and a dedicated management team;
- An MBO or MBI often revitalises the business by releasing the controls and policies of the previous owners. As morale rises, it improves the performance of all employees.

Often, when business owners get to a point where it's time to sell their business, there are few options - a trade sale to a competitor, a supplier or even a customer, springs immediately to mind. But any purchaser will usually be interested in the business not only for its reputation etc and its trading record but also for the quality of the management. When the management see an opportunity to buy the business themselves, problems can arise - imagine how senior managers will feel if their efforts to buy the business are thwarted by a determined outside purchaser. That's why management buy-outs are recognised as a viable alternative to a sale to a third party.

Many institutional investors have cottoned on to the attraction of MBOs or MBIs - the success rate for this type of transaction is high and institutional funding is readily available. But whilst institutions will provide the necessary funds for a management acquisition of a business, they are reluctant to do so unless the management team is prepared to put their own cash into the transaction.

Questions and Answers

Why do managers want to buy the business they've worked in?

- To gain control over their future;
- For personal achievement and satisfaction;
- To control the strategy of the business and implement their own ideas;
- To gain wealth through share ownership.

What are the factors for success?

- A well-established industry position;
- A steady demand for the organisation's products or services;
- The ability to stand alone from the present owner(s);
- A steady predictable and reliable cash flow.

Why are businesses sold to their management?

There are many reasons why businesses are sold to management such as to:

- Dispose of a non-core activity;
- Relieve a present owner's financial pressures;
- Rearrange the assets a vendor may hold in a portfolio of businesses.

Vendor Advantages

A sale to management often has significant advantages to the vendor over the alternative of a sale to a competitor or other investor. These advantages include:

- Speed and confidentiality: Management buy-outs can often be completed quickly and without the market either being aware that an ownership change is underway, or having access to the business' sensitive information;

- Retention of special relationships: Most businesses have built up special relationships with their customers and suppliers and these are preserved after the sale;
- Securing a full price for the sale: Management is intimately aware of the business' strengths and weaknesses and an MBO secures a good price for the sale;
- Benefiting from a likely positive public relations outcome: Both the vendor and the sold business can benefit from positive public relations outcomes from an MBO;
- There is usually some dilution of vendor warranties.

Three factors generally are considered essential to conducting a successful leveraged buyout:

1. The ability to borrow large sums (leverage) against the company's assets.
2. The ability to retain or attract a strong management team.
3. The potential for each participant's (including management's) investment to increase substantially in value.

What price should be paid?

At an early stage in the MBO process, the net asset value of the target company or the business (as appropriate) will have to be paid.

But how much?

The management team must consider the proposed price and the likely source of funding.

While the maximum price will depend on cash flow projections and assessment of future maintainable profits, the actual price will usually depend on whether a competitive bidder emerges. The warranties and indemnities required of the vendors will be much less in an MBO than in other acquisitions. The incumbent management are in the best position to acquire the business – they know it well since they work in it and will rely on their own knowledge of the business rather than reams of technically worded vendor warranties and indemnities

While the management team must act honestly, provoking competition for the business is to be avoided since the team would want to pay the minimum price.

Also remember that the business in MBO ownership may change from its current ownership - advantages such as bulk discount rates and the cost of pension provision may vary. These factors can affect future profitability and thus the purchase price payable.

The accountant engaged to advise the MBO management team will often be in the best position to help you to calculate the price to be paid for the target business.

Where does the money come from?

The ability of a company to support significant borrowings depends on whether it can meet the cost of the principal and interest payment obligations that go with a leveraged acquisition. When management of a company decide that an MBO is viable, they will have to convince a venture capitalist that the proposal is sound and offers adequate return given the risks involved.

Venture capital investors have a wide range of preferences, such as:

- The amount of capital you require;
- The company's investment stage;
- The industry sector;
- The location.

All of the above will affect the venture capital sources that the management might target. The British Venture capital association (www.bvca.co.uk) say that as a basic guideline, there are two main sources of venture capital with broadly different investment preferences - venture capital firms and business angels:

- The majority of venture capital firms target firms requiring investment of over £100,000, mainly in expansion stage companies and MBOs/MBIs. The overall average deal size in 1998 was £3.4 million, although 56% of companies backed in 1998 received sums of venture capital of less than £1 million. There are some specialist and regional firms that invest outside these parameters;
- Business angels tend to invest between £10,000 and £100,000 in start-up and other early stage financings - the most common deal size in 1997/8 was between £10,000 and £50,000.

Raising capital for the MBO or MBI

As the British Venture Capital association says: "*raising any type of capital needs research and strategic targeting*". Before approaching any source of venture capital, the management will need to have:

- A good business plan with an executive summary;
- Detailed financial projections with the assumptions used clearly stated;
- Assessed that venture capital is suitable for the acquisition;
- Know how much venture capital is required and what it will be used for;
- Identified a good team of advisors - experienced accountants and business advisors and lawyers.

Sources of finance for an MBO or MBI can include:

- Ordinary shares subscribed for by the management;
- Preferred ordinary shares subscribed for by the venture capitalists (these will be the same as ordinary shares but will have minority protection rights and preferred dividend rights);
- Preference shares (these give right to fixed (usually commutative) dividend but generally have very limited voting rights and rank behind the ordinary creditors of the company but in priority to the ordinary shareholders);
- Term loan secured by fixed and floating charges on all the assets of the target company;
- Asset finance (including leasing) of larger assets in the target company;
- Sales-related finance (factoring and invoice discounting) of the target company's receivables;
- Bank overdraft.

Larger MBOs can include various other forms of financial instruments (e.g. a loan with options to subscribe for shares).

MBO or MBI financing is usually a package that combines several types of loans, as well as equity. The components may even come from different sources. The package itself may be put together by a bank, a commercial finance company, a venture capital firm, or a mergers and acquisitions intermediary with access to capital markets.

Typical components of the package might be:

- 15 to 25 percent equity;
- 10 to 50 percent subordinated debt;
- 40 to 70 percent senior debt.

Equity

Equity (or shares) will usually be in the form of ordinary or preferred ordinary shares. Typically, venture capitalists will seek some preference in their shareholding - for example, they might hold "A" ordinary shares (with preferential rights to dividend and conversion) compared with "B" ordinary shares held by the management.

Senior debt

Senior debt would normally be:

- Loans on assets such as debtors (trade receivables) and stock (inventory) - for current asset-based financing;
- Loans or mortgages against property and equipment for fixed asset financing.

The senior debt holder is a secured lender who stands in first position to collect against the particular asset, if the buyer defaults.

Subordinated (or Mezzanine) debt

This type of funding is like a second mortgage - if the borrower defaults, the lender would only get paid after the senior debt providers have been paid off.

Subordinate lenders usually want a higher interest rate and an equity interest in the business to reflect the additional risk they take on.

Professional MBO Services

Lawyers and accountants are essential ingredients in any MBO transaction.

Accountants

Particular areas where experienced accountants' input would be required include:

- Review of the accounting and reporting systems and controls;
- Assistance with the business plan (the plan must be drafted by the management team, but the figures must be validated by a respected firm of accountants);
- Ascertaining the amount and nature of the purchase consideration;
- Working with management to structure, bid, negotiate, finance and close buyouts on the best possible terms for the managers;
- Assisting in determining the value of a company and the feasibility of the proposed transaction;
- Indicating, in broad terms, the likely financial structure and ownership of the company after completion of the transaction;
- Assisting management in the compilation of their business plan and financial projections;

- Advising and coaching management to make presentations of their business plan to bankers and venture capitalists to raise the necessary funding for the transaction to proceed;
- Negotiating with the existing owners of the business;
- Working with management in the due diligence process and advise on warranties and indemnities to be obtained from the vendors;
- Raising and structuring finance;
- Working alongside specialist lawyers to complete the legal aspects of the transaction.

Lawyers

Particular areas where lawyers' advice would be required are as follows:

- Ascertaining title to property, property searches and transfers;
- The drafting and preparation of contracts;
- Establishing the sufficiency of, and creation of, security;
- The protection and assignment or licensing of intellectual property.

The experienced professionals you engage will help you as prospective management owners to conduct a buy-out analysis. This will help to find out whether it is right to incur the time and expense to proceed with a buyout initiative:

- Where businesses are actively offered for sale and bidders are being solicited, it is necessary to assess the company's value both from the perspective of the management and from other competing buyers;
- To ensure that the proposed transaction is financially viable, it is necessary to evaluate the company's ability to support financing in order to determine the buyout options available to the employees.

Overlap Areas

It is essential that the lawyers and accountants work as a team supporting the management. There are areas where the lawyers' and the accountants' roles overlap and these areas ought to be clarified at an early stage. Areas of possible overlap include:

- Acting as a sounding board on the business plan (overlap should probably be allowed on this);
- Tax warranties, indemnities and clearances;
- Employee share schemes and pension arrangements;
- The finance documents.

Professional Fees

Points to note on professional fees include:

- Professional fees will usually be paid by the acquisition company – usually referred to as "NewCo". This is the company which will be formed to act as the vehicle for the MBO bid;
- The management team may be able to negotiate that part (or rarely, all) professional fees are payable on a contingent basis - contingent on completion of the transaction. Some fees may have to be paid by the management team if the MBO does not proceed;
- On successful completion, the fees will be funded by the equity investors through their investment in NewCo.

The Management Team

Of the several preliminary matters which participants in an MBO should consider, the most important ones are:

- The tendency to make the team too big must be avoided. Four or five is about the right number;
- The ability (or at least the potential ability) of each proposed member of the management team to survive in the private sector;
- The long term commitment of each proposed member of the management team to the success of the venture;
- The allocation of responsibilities - it is essential that members of the management team communicate effectively among themselves. It is advisable for the management team to authorise a committee to make decisions where time is of the essence. However, it is impossible for all decisions to be taken by committee; and
- The proven track record of success of the management team leader and the professional competency of the members of his team.

Vendors and Purchasers

The Vendors

Vendors are the shareholders of the company being acquired in the MBO - either as a share acquisition or the assets of the target company.

Vendors may have balancing competing

objectives. Their concerns will include:

- The need to demonstrate that they have negotiated the highest price reasonably obtainable for the target or its business;
- Wanting to ensure that service and other standards are maintained during the sale process; and
- Ensuring there is no breach of the European Union public procurement directives or compulsory competitive tendering legislation.

The Purchaser

The Purchaser is normally a new company set up by some or all of the management team of the target company.

The Middle Ground – Employees who are part of the Management Team

Employees owe a fiduciary duty to their employers. They must act honestly and the interests of their employer must remain paramount. As you can see, in any MBO there are potential conflicts for employees between duties to their employer and their own personal interests as part of the proposed management team.

To deal with these potential conflicts, the vendors will usually set guidelines (particularly with regard to the supply of information) which must be followed. The Vendors will seek a level playing field between the management team and other potential buyers.

The Business Plan

The key to understanding the business to be acquired and with it, planning for growth and success, is the 'business plan'. It requires you to get down on paper, key information about the target business - historical and projected, financial and non-financial. It plays an important part in promoting an understanding of the business within the business itself but also has a key role in adding substance to a proposal for obtaining investment funds and working capital for the MBO.

The aim of any business plan must not be to persuade a bank or investor to say 'yes' to a shaky proposition - this does none of the parties any good.

It is a mistake to have the business plan drafted by the professional advisers as it is the MBO team who must have ownership of it and be committed to delivering what it promises.

Your business plan should lend substance to the business proposal by giving credibility to what you intend to achieve. Don't use your business plan simply to show how much you know about the business. Use it to set concrete tasks, responsibilities, and deadlines. Use it as a blueprint for the way in which the business will work. Remember that nobody is going to read a long-winded business plan - nobody is going to be interested in something that's more than 50 pages long. Useful business plans contain concrete proposals to achieve specific, measurable objectives. Good business plans assign tasks to people or departments. They set milestones and deadlines for tracking implementation.

Further Information

We have another publication relevant to MBOs and MBIs: *22-Venture Capital: Tips, Traps and more*.

This guide is for general interest - it is always essential to take advice on specific issues. We believe that the facts are correct as at the date of publication, but there may be certain errors and omissions for which we cannot be responsible.

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