Management Buyouts

What you need to know

Contents

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The basics

What is an MBO?

A Management Buyout (MBO), is the purchase of a business by its current management, in co-operation with external financiers to provide funding, followed by an eventual sale of the business to realise value.

In essence management are purchasing the future cash flows of the business, which they will use to pay the interest and repay the capital on the borrowed funds.

How is value created for management?

Value is created for the management team in two main ways:

- **Firstly by paying off the debt used to finance the deal.**
- **Secondly through growing the business and increasing its absolute value.**

How does a management team realise their investment?

A management team's value is realised when the business is sold ("exited"). Typically management teams realise their value through an exit after three to five years.

For most management teams **an MBO is a once in a lifetime opportunity.** They involve risk and are typically complex but can reap significant and life changing amounts of return.

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The basics

How to spot a potential MBO:

1. Sale of a subsidiary or division?
2. Public company turning private?
3. Conflicting shareholder interest?
4. A desire to realise value of investment?
5. Owner looking to retire?

MBO Opportunity

The basics

What makes for an attractive MBO opportunity?

More attractive	Less attractive
Stable industry sector	Highly cyclical
Strong reputation within its markets	Fashion orientated
Good spread of customers and suppliers	Rapid expansion
Defensible market position	Significant R&D and/or capital investment required
Secure contracts	High/volatile working capital
Good visibility of profits and cash flow	

When considering a potential MBO it is important to consider the business' market position and the market itself. It is inevitable that in any market there are unattractive aspects to the industry as well as highlights.

The decision needs to be made as to whether the positives exceed the negatives – the best advice in certain circumstances will be not to progress with the MBO in question.

Requirements for a successful MBO

1 *A sound and well-balanced management team*

The quality of the management team is the most fundamental consideration in any management buyout. Investors are looking for a balanced team of managers covering all key areas of the business. The management team needs to be fully committed to the business plan and be prepared to invest their own money – usually equating one times annual salary. It is not uncommon for members of the management team to borrow money from financial institutions to help fund this. It is usually expected that the core members of the management team will invest, with the 'leader' investing more than other key members.

2 *A commercially viable business*

The business must be capable of operating commercially as a stand alone entity. The business will need to generate sufficient profit and cash to repay debt and sustain the business as it grows; provide adequate returns to shareholders, and support the on-going capital expenditure requirements.

3 *A willing vendor and a realistic price*

MBOs rely on a willing vendor. There are several advantages of a buyout to a vendor (compared to a trade sale or alternative deal structure), including confidentiality, speed, flexibility, continuity and deliverability.

It is crucial that the management team does not overpay for the business.

4 *An appropriate funding structure*

Buyouts are usually financed through a combination of debt and equity, and it is crucial to achieve the right balance. Whilst debt is cheaper it typically places a higher level of fixed payments on the business, increasing the risk of business failure.

The management team

Key considerations

- What is the ideal size of a team?
- Is the team complete?
- Is there a second tier to the management team?
- Does the management team have a shared vision for the future of the business?

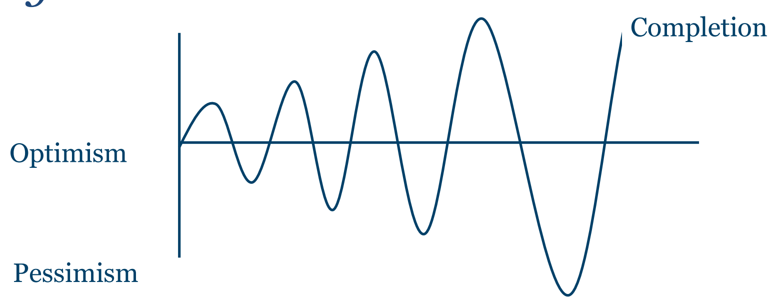
Legal position

The fiduciary duties of the directors and employees are to act:

- In the best interest of the company
- In honest and good faith

The management team should consider the effect of a failed MBO. It may damage the relationship with the shareholders.

Emotional cycle



During an MBO it is highly likely that the management team will experience emotional highs and lows, which generally become more extreme as the process draws to a close. We believe that the optimism for the deal at completion will exceed any previous fears during the process.

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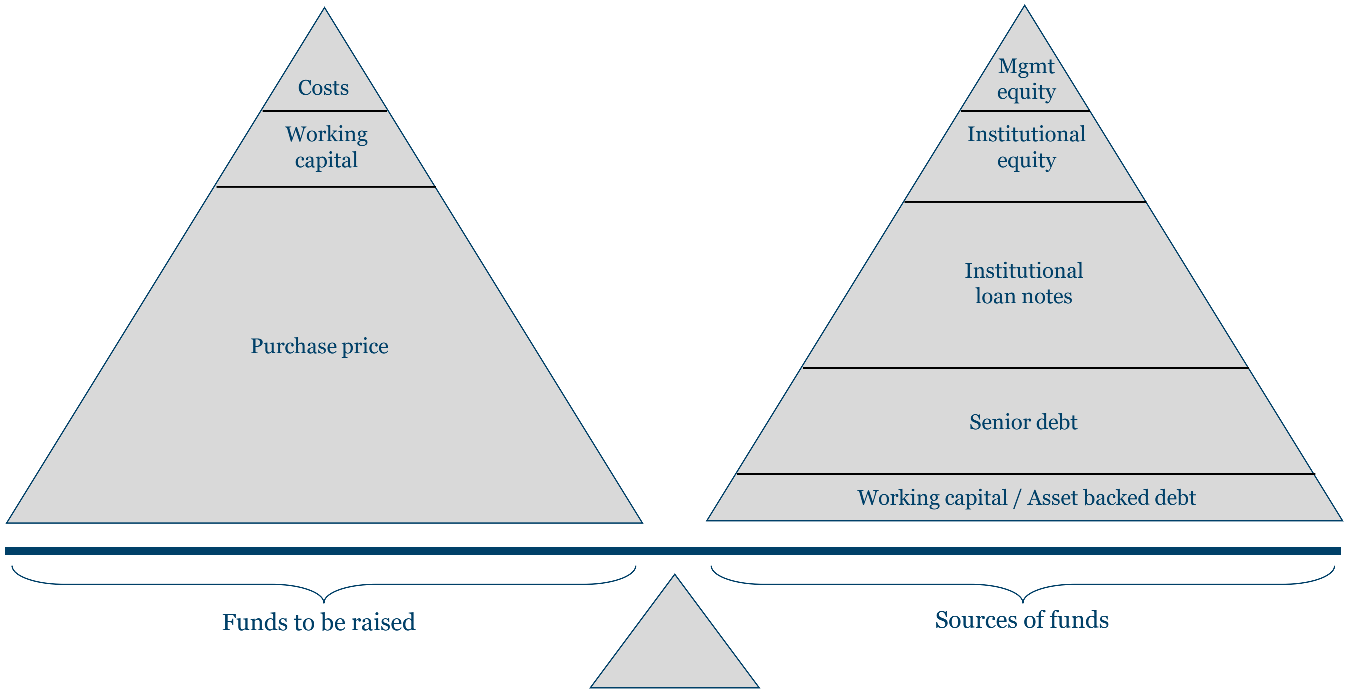
Raising the money

How is an MBO financed?



- The amount to be funded will be the purchase price plus deal costs and any working capital requirements needed to deliver the business plan.
- These funds are raised from a mixture of debt and equity and of the key skills in an MBO is being able to achieve a sustainable and optimal balance between these.

Raising the money: equity

Choosing an equity provider:

What are private equity providers looking for?

- Experienced and committed management
- Good product/service
- Protected market share
- High/predictable margins
- Opportunity to double money within 3 years
- Running yield and arrangement fees
- Foreseeable exit opportunities
- Control of the Board, not operational control

Key criteria for the MBO team

- Personal chemistry
- Ability to deliver
- Deal structure
- Exit expectations
- Management returns
- Buy and build funding
- Ability to add value (sector expertise or useful businesses in their existing portfolio)

Finding an equity partner that understands the business and the team is paramount

Raising the money: debt

Choosing a debt provider:

What are banks looking for?

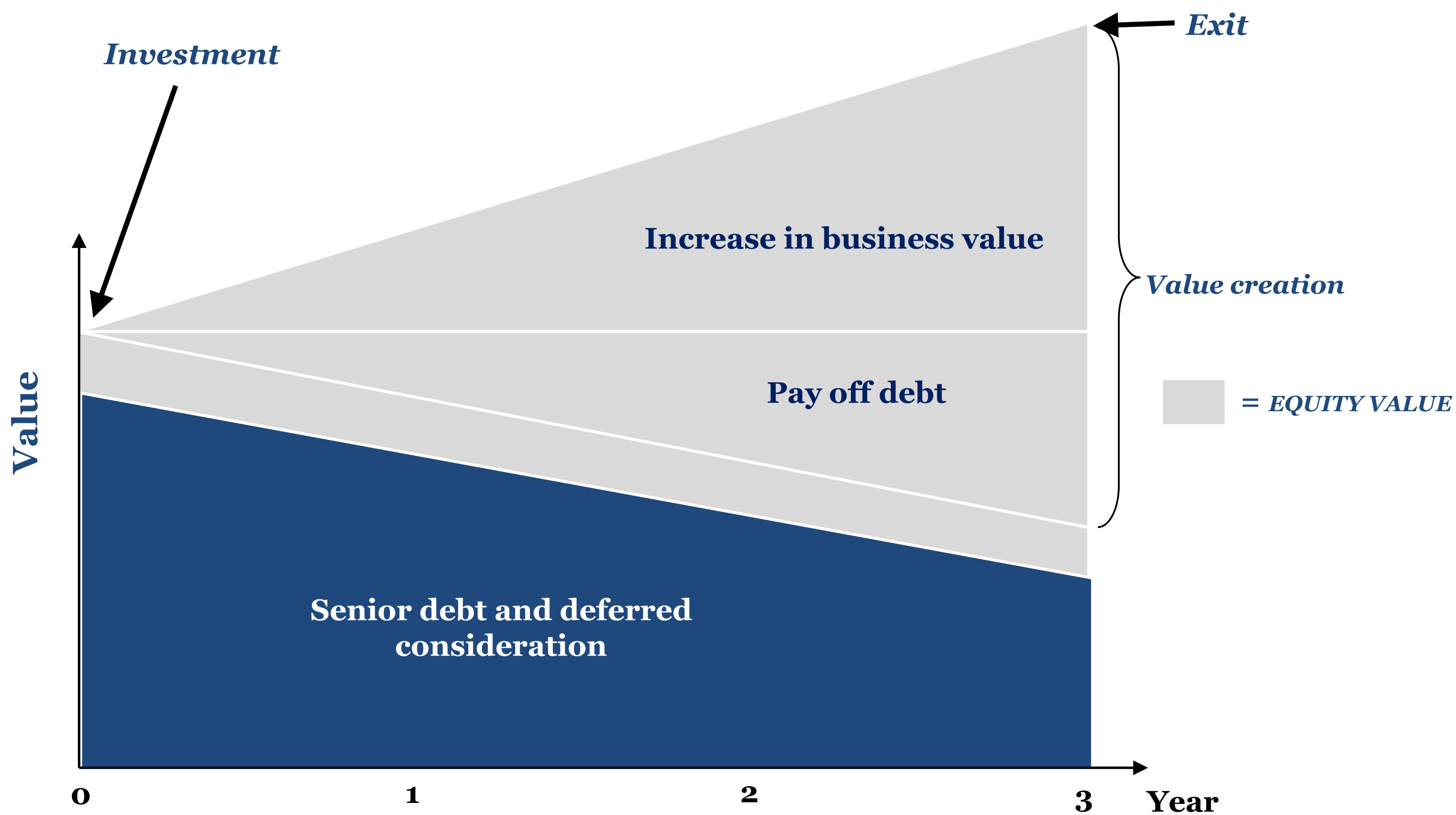
- Interest Cover
- EBITDA multiple
- Strong positive cash flows
- Repayment of monies, typically within four to six years
- First charge over assets as security
- Financial and other covenants
- Note that asset backed lending can also be an important source of funds

Key criteria for the MBO team

- Amount of debt
- Flexibility
- Experience
- Personal chemistry
- Price
- Covenants

Although debt is typically much cheaper than equity, it is essential that the business can afford the repayments as cashflow can be tight immediately following a buyout

Illustrative deal



Private equity providers achieve their return through a combination of:

- Debt leverage
- Growth in earnings
- PE arbitrage, hopefully!

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Illustrative deal

Sources	£m		Uses	£m
Debt				
Senior	10.0		Purchase Price	20.0
Working Capital	1.0		Working Capital	1.0
Equity			Fees/Expenses	1.0
Institutional loan notes	10.0			
Institutional Ords	0.7	"Equity pot"		
Mngt Ords ("Sweet")	0.3			
	22.0			22.0

- Typically the first stage would be to assess the debt capacity of the business based on forecast cash flows and any asset backed funding available.
- A funding gap is then left to be filled by management equity, institutional equity and potentially 'stretch' debt

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Process

Although timescales vary, a typical buyout process will take between 3 and 6 months:

1 **Feasibility assessment**

To address whether the business meets the criteria for a successful MBO. Management need to consider their own objectives at the feasibility stage.

2 **Vendor negotiations**

Agree purchase terms (or best current estimate).

3 **Financial modelling and structuring**

To optimise the structure of the transaction and take advantage of both corporate and personal tax planning opportunities.

4 **Prepare a business plan**

To attract interest from finance providers by setting out management's strategy and details of the business.

5 **Fund raising**

To secure the funds required and assisting in selecting the most appropriate finance providers. Identify and present to suitable funders. Select and negotiate terms with appropriate funders.

6 **Finalise vendor negotiations**

Finalise purchase terms.

7 **Due diligence**

Conduct financial, legal and commercial due diligence.

8 **Legal documentation**

Drafting and agreement of contracts.

9 **Project management to completion**

It is usually best to conclude the transaction within the minimum timeframe and with minimal disruption to the day to day operations of management and the business.

Other considerations

Pensions

- Final salary or money purchase schemes – final salary schemes can cause significant issues
- Early actuarial advice needed if a final salary scheme is in place
- Effect on employee morale

Corporate tax

- Buying shares or assets
- Transfer values involved may be substantial
- Change of ownership issues
- Deductibility
- Interest on Newco loans
- Deal costs
- VAT and PAYE/NI

Personal financial planning

- Remuneration package with Newco
- Keyman insurance
- Personal funding

Share option scheme

- Incentivisation of 2nd tier management

The role of the financial adviser

The financial adviser (lead adviser) typically takes the coordinating and advisory role for the transaction. Whilst this will include specific advice on the financial structuring of the transaction, the role is typically much broader and will include advice on the wider commercial aspects of the deal and also coordination of the other professionals working on the deal.

- Assessing the viability of the MBO
- Advising on the business plan
- Negotiating with the vendor
- Attracting appropriate providers of finance – both debt and equity
- Negotiating and structuring the funding
- Monitoring and minimising deal costs
- Project management of the deal through to completion, including liaison with all of the professionals involved in the process

The role can be summed up as making sure that:

- The right deal is secured for the management team; and
- It happens on time

Bristol
St. Brandon's House
29 Great George Street
Bristol BS1 5QT

+44 (0)117 9200 130

London
Amadeus House
Floral Street
London WC2E 9DP

+44 (0)20 3755 3284

New York
1350 Avenue of the Americas
2nd Floor
New York NY10019

+1 646 710 4936