REAPING REWARDS FROM MBOs

AN MBO MAY BE THE ROUTE TO RICHES BUT WATCH OUT FOR THE OBSTACLES ALONG THE WAY, SAY **ANDREW ALLAN** (LEFT) AND **MARTIN JENKINS**.

A period of change always creates opportunities for ambitious managers and the current climate is no exception. The volatility in the public markets and the economic slowdown have forced key strategic decisions to the top of the agenda for many companies.

Cash is king at the moment, so disposal activity is being triggered by the need to reallocate resources to core areas, or to raise money. Both public and private companies may now be ready to sell subsidiaries which were previously only on the verge of being non-core. Many privately-owned companies are also taking a long, hard look at growth opportunities and potential exits for the owners, particularly with new regulations coming into force from April 2002, offering the potential to reduce the amount of capital tax gains to be paid.

While it is not easy to complete transactions in the present climate, there are still some excellent businesses out there, which, for a variety of reasons, are ripe for new ownership.

Existing senior management are in a strong position to take advantage of the chance to become their own bosses. However, a management buyout (MBO) is not for the faint-hearted. You need to understand the pitfalls as well as the ultimate rewards before embarking on the process. It is worth talking to an experienced finance adviser at an early stage. They will offer practical advice on feasibility, strategy and tactics, and give you a realistic picture of what a buyout involves.

To raise funding and successfully complete an MBO, three key elements need to be in place: a strong management team, a viable business proposition and a willing vendor.

MANAGEMENT TEAM. To gain the backing of investors, you need to demonstrate that the management team is competent and committed and has a successful track record, usually with experience of full profit and loss responsibility. Investors will be looking for a balanced team that has the skills to run the business as an independent company after the MBO. If there are any skills gaps, consider how you will fill these, either internally or by recruiting. Identify a leader who can act as the focal point for handling negotiations with the vendors, investors and professional advisers. This individual may not necessarily become chief executive or managing director after the MBO, but it is important to define post-buyout roles at an early stage.

The MBO team is expected to back the new business financially, to reinforce its commitment and to help align its shareholder value objectives with those of investors. Outside investors usually take the view that the amount invested by management should be high enough to show serious commitment, but not so high that management will spend all their time worrying about what happens if the new company fails.

DEAL VIABILITY. Once the MBO team is in place, they need to analyse the strengths and weaknesses of the business they work for and develop a clear strategy for the next three to five years. The typical MBO company is well-established, has a clear market position, positive cashflows and a strong management team. A good asset base helps, but deals are generally driven off cashflows. It also needs to be in a sector with a clear opportunity for creating value. This may arise from growth in the market, consolidation or rationalisation of a sector, restructuring within the business, growth arising from new technology, new products or investment in the business.

To attract the serious attention of venture capitalists, they will need to be convinced that you can significantly grow (by at least 50%, and preferably double) the profits of the business over a five-year period.

Managers tend to get the best returns when their company is highly cash generative, either through operating cashflow or asset disposals, since the company is able to gear up and reduce its use of more expensive equity funding and repay its borrowings relatively quickly. Even under-performing or loss-making businesses can be suitable MBO candidates, since they can be turned around with good management and some investment.

Achieving the right financial structure is very important because following the buyout the company must be able to finance its borrowings, generate profits for its equity investors and fuel growth. Management needs to demonstrate that this will be achieved in a business model supported by an appropriate financial structure. Any drastic restructuring should be carried out before the MBO, or reflected in a much reduced purchase price.

WILLING VENDOR? The third part of the equation is the vendor. This may be a PLC selling a non-core operation, a founder manager preparing to retire, or even a receiver. There are two key questions vendor are likely to ask:

- will we get a fair price by going down the MBO route, rather than selling to a trade buyer; and
- will involvement in the MBO process mean the management team take their eye off the ball and fail to continue to run the business effectively?

The MBO team needs to build a convincing case that answers these questions. There is a lot of competition for deals among both trade and private equity-backed buyers. However, in some ways, venture capitalists are becoming quasi-trade buyers. Many of the big venture capital houses have a buy-and-build strategy and focus on creating a portfolio of investments in sectors where they have deep industry knowledge. Increasingly, they are competing and winning against trade buyers.

APPOINTING ADVISERS. Once you and your corporate finance adviser have agreed that there is a strong possibility of successfully carrying out an MBO, the next step is to look at practical issues such as raising the money and approaching the vendor. This is where the corporate finance adviser's role in managing and co-ordinating the process begins in earnest.

The relationship with your corporate finance adviser is pivotal, so you need to be entirely comfortable with the team you appoint. Look at their track record and reputation, and ask other professionals such as lawyers or bankers for their opinions.

Advisers' fees are usually contingent on success (apart from some of the due diligence costs) and there should be no personal fee exposure to the management team. The total cost of doing an MBO is usually about 5% of the transaction value. This includes management's advisers, legal fees (management, equity and debt providers), due diligence (financial, legal or other) and arrangement fees (debt and equity). The MBO company – usually referred to as newco – pays the fees.

BEGINNING THE PROCESS. The first step is for the corporate finance team to look at the potential of the MBO company to operate successfully under the ownership and control of the management team. Once they have established this, they will help you to prepare a business and investment case for potential providers of funding and an approach to the current owners.

Areas you will need to cover in some detail to prepare a presentation for investors include:

- the market for the company's products or services and future developments (including customers and competitors);
- senior and middle management, other company personnel and employee relations;
- facilities, reliance on suppliers and other general operational issues;
- past financial performance and anticipated future profitability;
- cashflow and working capital requirements;
- asset base, including any surplus assets not required after the MBO, and any new capital investment required; and
- services provided by the parent organisation and management charges made for them.

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Even at this very early stage, you need to be thinking about the eventual exit options for the investors, and management. These may include a flotation, trade sale or secondary buyout. Investors will be looking for a clear understanding of the value drivers for exit and would expect the management's strategy to be aligned with these.

Armed with a strong investment case, you and your advisers are now ready to meet potential investors.

THE FUNDING MIX. Generally, a large proportion of the buyout finance is raised by means of borrowing. This reduces the share of the company's equity that will need to be given to third-party shareholders and enables the management team to acquire a significant proportion of the business for a relatively modest investment. There are two main types of debt:

- senior debt is normally repayable over five to six years and takes priority over all other types of funding. It is secured through a debenture covering all the assets of the company and is the least expensive form of funding; and
- mezzanine debt tends to be repayable between year six to eight years (or earlier in the event of an exit) and ranks behind the senior debt. It will carry a higher interest rate than the senior debt (although it may be possible to roll-up the interest for the first few years) and will have a warrant over a small amount (usually less than 10%) of the equity.

The most commonly used forms of equity investment are ordinary shares and sub-ordinated loan stock or preference shares. The preference shares or loan stock have priority over the ordinary shares and will carry the right to a dividend or coupon.

The ordinary shares (both management and venture capital) depend principally on growth in capital value for their returns, realised through a successful exit. These should be the greatest returns and hence these shares are often referred to as the 'sweet equity'.

INVESTMENT PARTNERS. Choosing the right investor is a critical decision because you and your investor will be creating a partnership. You may need to meet several potential investors to find those who are the right fit with the MBO team. It is also important to be clear about what they want out of the deal in financial terms, usually including a non-executive chairman.

The venture capital investor usually requires an internal rate of return of 25% to 30% and a yield on its gearing (loan stock or preference shares). It is also usual to give the venture capitalist direct and/or indirect representation on the board.

MAKING THE APPROACH AND AGREEING THE PRICE. Once the funding is in place – or at least in principle support has been secured – the next step is to approach the vendor. This is obviously a very sensitive stage, particularly if the vendor did not initially suggest the idea of the MBO. The case needs to be well prepared before you make any overtures to the owners of the business. The main objective is to secure acceptance from the vendor that it will agree to the MBO and to address any concerns it may have.

The next step is to negotiate the price to be paid. There is considerable room for flexibility in the way a deal is structured, particularly in what is actually bought and how it is paid for. Pricing the deal is a complex task, and involves answering a number of key questions, such as:

- How much debt can be raised on projected cashflows?
- What are the projected working capital and investment funding requirements?
- What returns will the equity investors require?
- How could cash be realised from the balance sheet – for example, by selling surplus assets?
- Is vendor finance available in the form of a deferred consideration or subordinated?
- What can the MBO team prudently afford to pay for the business?
- What is the business actually worth?

Price is often the most difficult part of the negotiations, but once this has been agreed, the deal is well on its way towards completion. Due diligence is then carried out, and it is unusual for this to reveal any unexpected problems as the MBO team will know the business inside out.

The corporate finance advisers will be supporting the MBO team throughout this process. At this stage they will also be able to introduce experts who can help the MBO team to manage the tax-efficient structuring of the deal and of their own personal investment, and to agree contractual arrangements and remuneration packages.

It is important for the MBO team to secure the support of the company's other managers and employees if the new business is to succeed. You may consider offering a second tier of shares to key managers, or introducing a company-wide share option scheme. You will need to review contracts and terms of employment, and ensure sufficient resources are transferred to the new business to meet employee pension obligations.

THE HOME STRAIT. It may not be all smooth sailing as completion of the deal gets nearer. You could hit problems along the way, in the shape of major trading changes or a poor set of figures. Details of the deal may leak out, perhaps resulting in some senior staff leaving the company, or the loss of an important customer. However, there is usually a way round most obstacles.

It is essential to manage the communication process carefully, and have staff, customer and supplier briefing material in place ready for the deal announcement. The final stretch involves the drafting and re-drafting of legal agreements until all the parties involved are happy and tying up any loose ends. It is then time to put the champagne on ice.

Undertaking an MBO is a very demanding and time-consuming process, particularly when the management team also needs to focus on actually running the business. There is a degree of financial and commercial risk, and the hard work is only just beginning on the day the deal completes.

On the positive side, provided you have the right ingredients, there is every chance that the MBO will be a challenging and financially rewarding step for ambitious senior management. Key success factors include a dedicated and resilient management team, a focused approach and clear strategy, and the backing of a committed team of advisers and funders.

KEY POINTS

MANAGEMENT TEAM
- competent, committed
- successful track record
- balanced team
- identify a leader to act as focal point

DEAL VIABILITY
- analyse strengths and weaknesses
- develop a clear 3-5 year strategy
- have a business model with an appropriate financial structure

WILLING VENDOR
- are they getting a fair price?
- will the management team keep its eye on the ball and continue to run the business?

ADVISERS
- be comfortable with them
- examine their track record and reputation

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