



# MBO: So what's stopping you?

In the first of a series of three articles, Brian Cummings of venture capital house, Enterprise Equity, unravels the mysteries of an MBO and what businesses need to know if they're going to 'do the deal'...

**W**ith an estimated average of 12 MBO's per week in some parts of the UK<sup>1\*</sup>, Ulster business owners are still missing out on a golden opportunity to exit their businesses and realise the fruits of their labour.

According to the British Venture Capital Association (BVCA), there was a total of three management-related buyouts completed in Northern Ireland over the three-year period from 2002 to 2004. While the BVCA will not have picked up on all such activity, Northern Ireland is still bottom of the pile compared with Wales (nine deals) Scotland (23 deals) and the English regions (averaging 48 deals per region, excluding the south-east) over the same period. The south-east managed 287 deals over that time.<sup>2\*</sup>

There are various options for company owners who want to exit their businesses including a trade sale or a sale to a private acquirer. Put simply, an MBO is a transaction in which management get a material stake in the business (often in partnership with an external investor) and a change in ownership takes place.

While other avenues might be open, the MBO route becomes a viable alternative particularly in the following situations:

- A family-owned business with family succession issues.
- An owner who doesn't want the business openly marketed (i.e. to its competitors) as part of a trade sale.
- A foreign-owned subsidiary which is non-core to its parent's operations.

## EXISTING

While the MBO route can be initiated by the existing owner, it is usually the realisation by the MD that the business is, or might be, for sale. As soon as

the possibility is raised, the following questions need to be addressed:

- Are you capable of running the business outside its existing ownership structure?
- Will the owner be agreeable to selling to a buyout team and possibly external investors?
- Is the likely price viable?
- Who needs to be part of the buyout team; will the outgoing shareholder leave a skills gap?
- Assuming that finance is required, who can provide it?

The buyout can present the management team with a once in a life-time opportunity to prove itself and also, over a three to five-year period, to generate an otherwise unachievable level of personal wealth.

This wealth can be generated through the same principles that lie behind the 100 per cent mortgage; i.e. the value of the equity in a property grows as it increases in value and as the mortgage is paid down. The equity value in a buyout company behaves in exactly the same way. An example of how such a deal could be structured will be *cont'd >>*





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provided in the next article in this series.

But there are a number of assumptions in the 100 per cent mortgage analogy that need to be addressed:

- *The market price of the house increases:* Therefore the business must increase its profits in order to increase the value of the business.
- *The mortgage is successfully paid down:* Therefore the business must be cash generating in order to service some debt and make capital repayments.

- *Value is extracted when the property is sold:* The same applies; the business must be sold in order to realise the increase in value.

The above assumptions will automatically disqualify some companies as potential MBO targets. Moreover, the success criteria below reflect that good buyout performance is generally based more on solid, predictable operational and financial

performance than volatility and rapid growth.

- **The management:** Obviously having a management team with a full set of skills is key, but listed below are some of the other factors required to take the business to a new level of performance:
  - Trust and reliability between the MBO team members.
  - Experience and competence in P&L management and growing profits and cash.
  - Endless drive and passion to meet the budgets and forecasts that see the business grow.
- **The company:** Ideally the company should be almost boring in its ability to generate cash from operating profits. However, the following qualities are also important:
  - A robust competitive advantage.
  - Solid defensible positions such as barriers to new entrants and ideally, a product or service that possesses a proprietary element.
- **The Strategy:** As the management team look to a future exit, they will need to anticipate what sort of shape the business

will take in three to five years time that will maximise its appeal to potential acquirers. The business can be grown organically, or by acquisition (assuming that funding is available). There may be other means of creating value by exploiting inefficiencies in the business or tackling new markets. However, the management team will need to be able to provide strong evidence to potential investors that such opportunities can be converted and that they will not sacrifice long-term value for short-term gain.

## FAILS

What happens if the buyout attempt fails? Apart from frustration and some potentially large professional fees to pay, it could be very messy. It's worth closely considering if the owner is truly committed to selling the business. There is a host of reasons why the owner may back out at the eleventh hour, so the logic for the owner to sell must be compelling.

If potential investors are involved in the deal, such as venture capital firms, access will need to be given to key elements of the company including its staff, customers and suppliers. Will the owner be willing to provide this access? Further down the line, could the deal be blocked by other stakeholders such as customers? It's not unknown for a change in ownership clause to invalidate purchase contracts issued by key customers.

Having done the deal, the key difference in managing a buyout company is operating without a safety net. Financial and career success is only achieved through driving the business to meet its forecasts and plans and hopefully, to a beneficial exit for all parties concerned.

For many such buyout teams, the MBO acronym could stand for something else - Make or Break Opportunity.

*The next article in the series covers the buyout process and how a deal can be structured.*

*\*Sources: <sup>1</sup>Centre for Management BuyOut Research, Nottingham University; <sup>2</sup>BVCA Economic Impact of Private Equity 2005*

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