



MBO: a once-in-a-lifetime opportunity?

In the second of three articles on management buyouts, Brian Cummings takes a management team's aspirations for ownership to proposal stage and reveals that financing the deal need not be as daunting as it seems...

You may be an owner who is looking for an exit or a hard-working manager in such a company. If so, this could be the time to stop and think about the opportunities that an MBO presents.

As a manager, it may be that once-in-a-lifetime opportunity to make a step-change in your professional fortunes, but how should the process be started?

The only thing that matters at this stage is the relationship between the management team and the individual(s) who owns the company. Assuming that the owner is happy to sell and a price can be agreed, it is critical that the management team can demonstrate that it can deliver the price and do so with the greatest degree of certainty so that the deal can come to a satisfactory conclusion.

To add credibility to the approach, thought should have been given to the likely acquisition price and how the deal will be financed. Working proactively with a venture capital firm or bank can establish if, and how, the acquisition can be funded.

CONTROL

But who should make the approach to the owner? The direct approach enables the management team to retain the greatest degree of control over the process. It builds on established relations and provides the owner with the confidence that the deal can be successfully completed.

However, there may be circumstances where a third party



could make a more appropriate approach. This may reduce the chances of a serious falling out between the management team and the owner. Using a venture capital investor or advisor may also add some credibility and lead to the owner being more open about selling to a buyout team.

However, the management team must be very careful about disclosure as this can compromise their existing service agreements with the company.

No matter how the approach is handled, the buyout team and potential backers should be aiming to come away with acknowledgement that they will be treated as potential buyers and that enough financial and corporate information will be released to allow an offer to be tabled. Hopefully, it will also be understood how the sales process will be managed and an indication provided of the owner's price expectations.

EXCLUSIVITY

How the buyout team approaches the process depends on how the sale is conducted by the owner.

Ideally, the owner will be prepared to enter a period of exclusivity with the management team, allowing the deal to be quickly and quietly negotiated. This approach may particularly suit owners that do not want to open the books to competitors and/or who want to minimise the disruption to ongoing operations.

Assuming that a period of exclusivity cannot be negotiated, the owner may appoint a financial advisor to manage an auction. The advisor will often have a sole remit to optimise the value that can be extracted for the business. This can lead to the sale being a long and public affair and, if handled badly, the process collapsing which, in turn, can damage the business.

Management will often not be allowed to talk to any bidders until later in the process when a venture capital bidder will want to refine its offer.

As the buyout gains momentum, the business plan will come to life. What may be less obvious is how useful a tool its preparation can be in helping the management team to crystallise its thinking and address the practicalities of life without the safety net of the existing ownership structure.

Assuming that funding will be needed to acquire the business, the plan will also be used by banks and potential investors in the later stages of the process as:

- a starting point for due diligence;
- the basis for negotiating investment terms;
- a summary for debt providers and possible syndication partners, and
- a help in identifying major issues, shortcomings and risks.

Further down the track after the deal is done, it will be used as a guide to the likely or planned development of the business and as a reference or reminder of what management said that they would do!

SOURCES

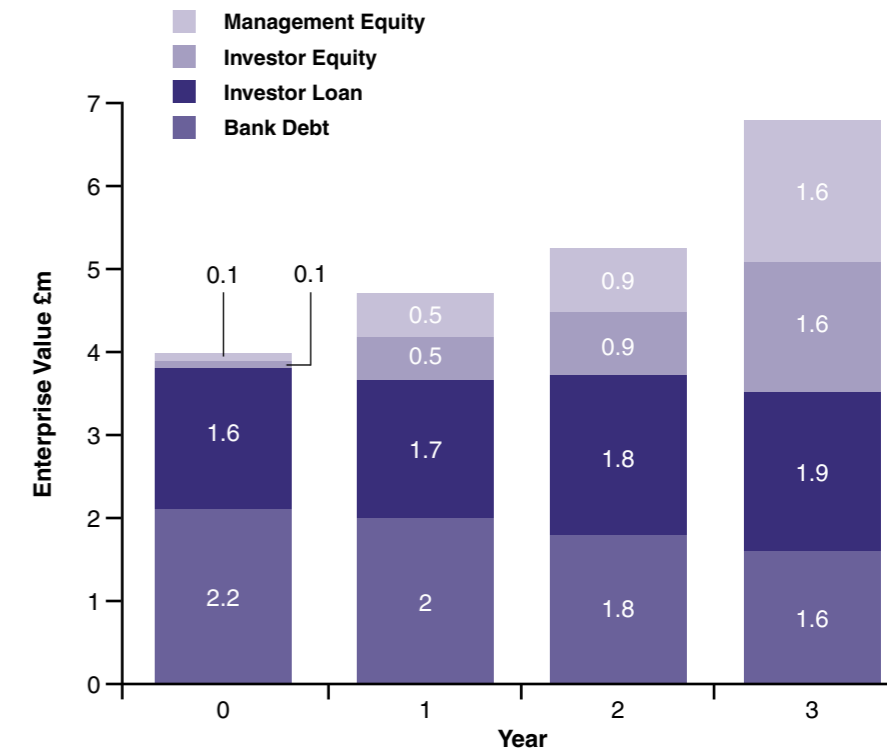
Hopefully, the buyout team will have investigated early in the process whether or not external sources of finance will be needed to make the acquisition. Typically, the buyout team will require some form of external funding to acquire the target company.

Although the buyout team will be expected to make a significant personal investment, it is not unusual for this to be relatively small compared to the amount required from banks and/or other investors, such as venture capital firms or private individuals.

The example in the graph above depicts a situation where the buyout team has not been able to meet the cost of the acquisition from their own personal sources of finance or from bank borrowings. It shows how a venture capital firm has stepped in to fill the 'equity gap' and by doing so, also taken the pressure off the business to meet its debt repayments.

This example illustrates the structuring and creation of value from a simplified example. The company in question is generating operating profits of £0.6 million and has been sold to a buyout team and its venture capital

STRUCTURING AND CREATION OF VALUE IN MBO



backers for £4m (that's for a multiple of 6.7 times operating profits).

The mix of bank debt (£2.2m), venture capital funding (a loan of £1.6m and equity of £100,000) and management equity used to finance this is shown in the left-hand bar (Year 0). The management team has invested £100,000 and shares 50 per cent of the equity ownership in the company.

Three years later, it has grown operating profits to £1m and the business is sold for £6.7m (also a multiple of 6.7). Over this period it has repaid part of the debt from its own free cash flow. The proceeds of the sale are used first to repay the remaining debt and secondly, to repay the venture capital loan plus its interest. That leaves a total of £3.2m which has been created from the increase in the value of the business and from repayment of the debt. With the equity split 50:50, it is divided between the management team and the venture capital investor. The result is that the management team has turned its £100,000 investment into £1.6m over three years.

Based on the 100 per cent mortgage analogy, a stable, strongly cash-generative business can build value by using its surplus cash flow to repay the

debt used to make the acquisition.

In this example, the inclusion of a venture capital investor has not only assisted the management team to fund the deal but also optimise the financial structure so that bank debt repayments do not become an onerous burden should the business not perform as expected - especially post-completion when the management team has been distracted by the transaction. It is not uncommon for a trading wobble at this time to cause a highly geared MBO to rapidly find itself struggling with a nervous banker and repayment difficulties.

Having found a way forward to make the deal happen, the team has then to work its way through the legal agreements established with the owner, banks and investors.

The final article in this series will look at life after the deal and what it takes to make a successful exit.

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