

Momentum Corporate Finance LLP

*Management
Buyouts*

*What you need to
know*

Experience
Enthusiasm
Success



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What is an MBO?

An MBO, “Management Buy-out”, 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. Value is created for the management team in two main ways:

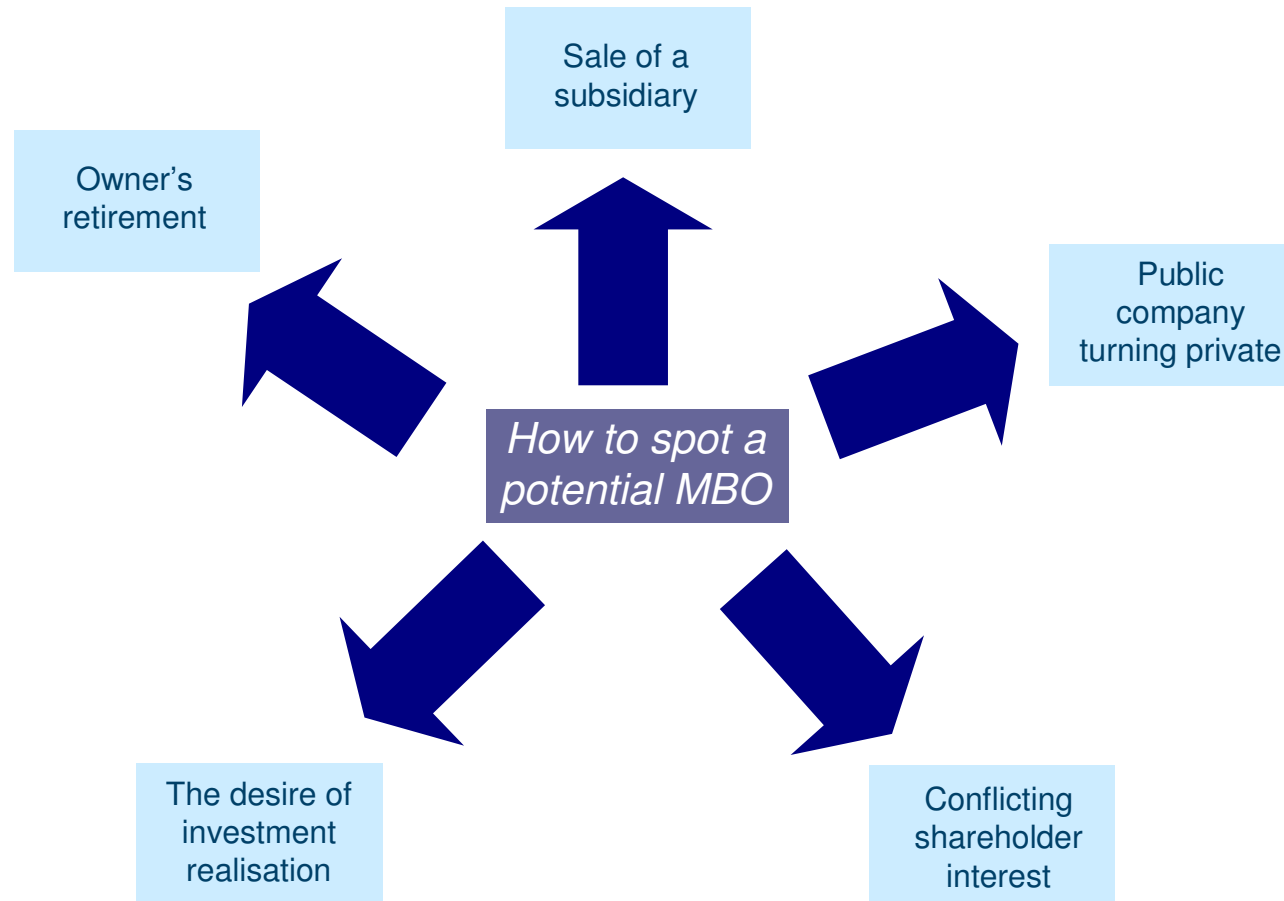
- Firstly by paying off the debt used to finance the deal.
- Secondly through growing the business and increasing its absolute value.

This value is then realised when the business is sold, or “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.

The basics

How to spot a potential MBO



What makes for an attractive MBO opportunity?

More attractive

- Stable industry sector
- Reputable in its markets
- Good spread of customers and suppliers
- Defensible market position
- Secure contracts
- Good visibility of profits and cash flow

Less attractive

- Highly cyclical
- Fashion orientated
- Rapid expansion
- Significant R&D and/or capital investment required
- High/volatile working capital

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 buy-out. 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. The vendor must be willing and prepared to deal at a realistic price

MBOs rely on a willing vendor. There are several strong reasons why a vendor would favour a buy-out: confidentiality; speed, flexibility, continuity and deliverability. It is critical not to overpay for the business.

4. An appropriate funding structure

Buy-outs 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?

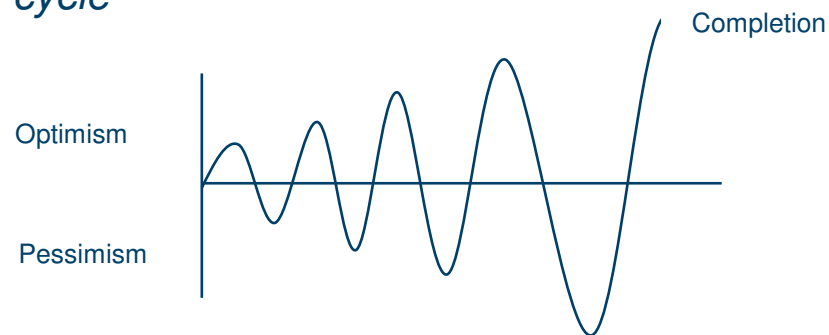
Legal position

The fiduciary duties of the director 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.

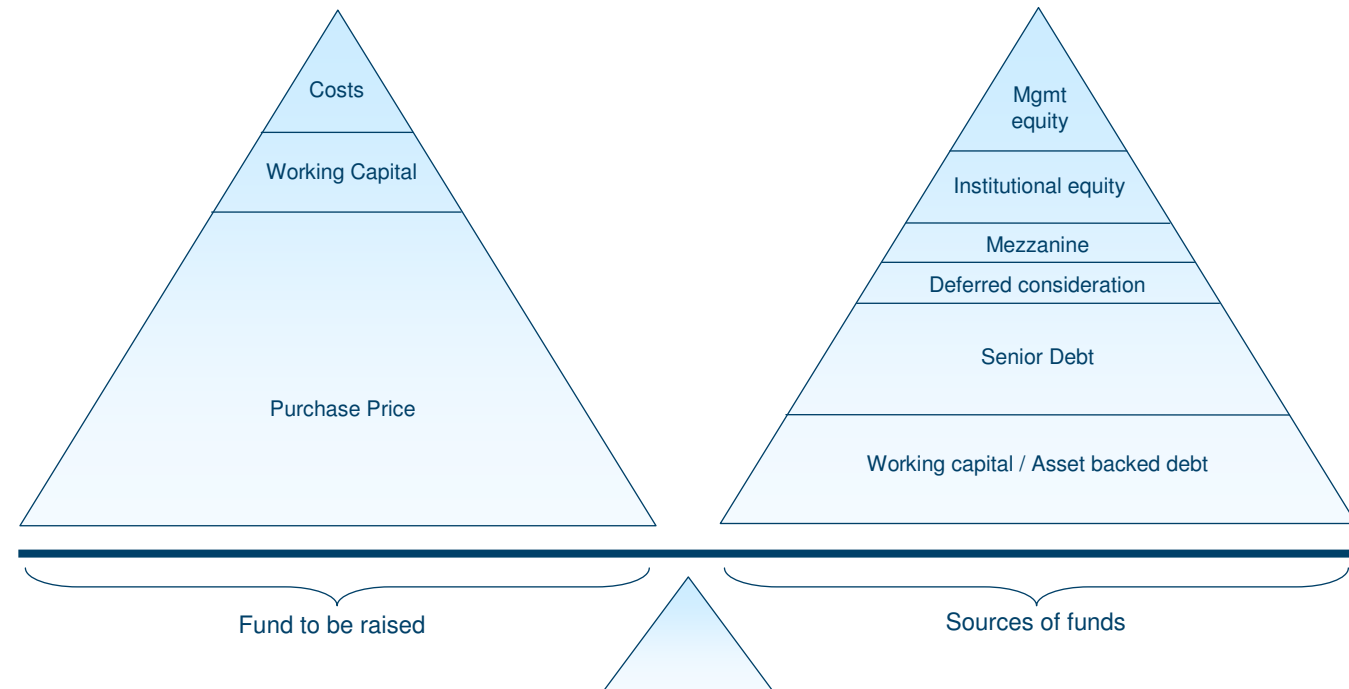
Emotional cycle



During an MBO it is highly likely that the process 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.

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 facility required to deliver the business plan.
- These funds are raised from a mixture of debt and equity and the skill in an MBO is to achieve a sustainable and optimal balance.

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 MBO team

- 🕒 Personal chemistry
- 🕒 Ability to deliver
- 🕒 Deal structure
- 🕒 Exit expectations
- 🕒 Management returns
- 🕒 Buy and build funding
- 🕒 Ability to add value (sector expertise)

Raising the money: debt

Choosing a debt provider

What are banks looking for?

- Interest Cover of 2 to 3 times
- Leverage of 40% to 50%
- Strong positive cash flows
- Repayment of monies, typically within five to seven years
- First charge over assets as security
- Financial and other covenants
- Asset backed lending can also be an important source of funds

Key criteria for MBO team

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

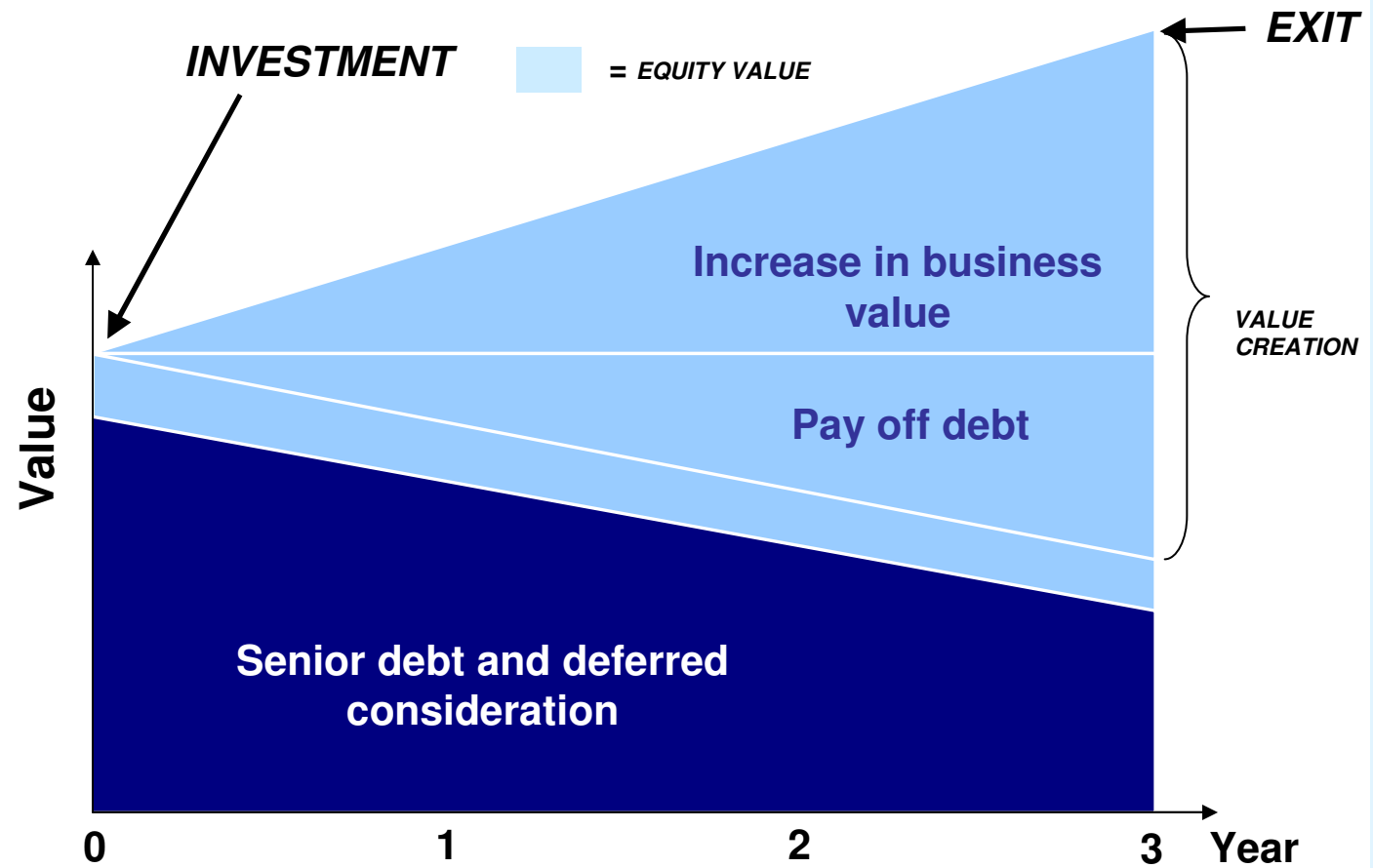
Illustrative deal

Sources	£m
<i>Debt</i>	
Senior	50.0
Working Capital	10.0
<i>Equity</i>	
Institutional Prefs	54.0
Institutional Ords	0.7
Management Ords	0.3
	<u>115.0</u>

Uses	£m
Purchase Price	100.0
Working Capital	10.0
Fees/Expenses	5.0
	<u>115.0</u>

- 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.

Illustrative deal

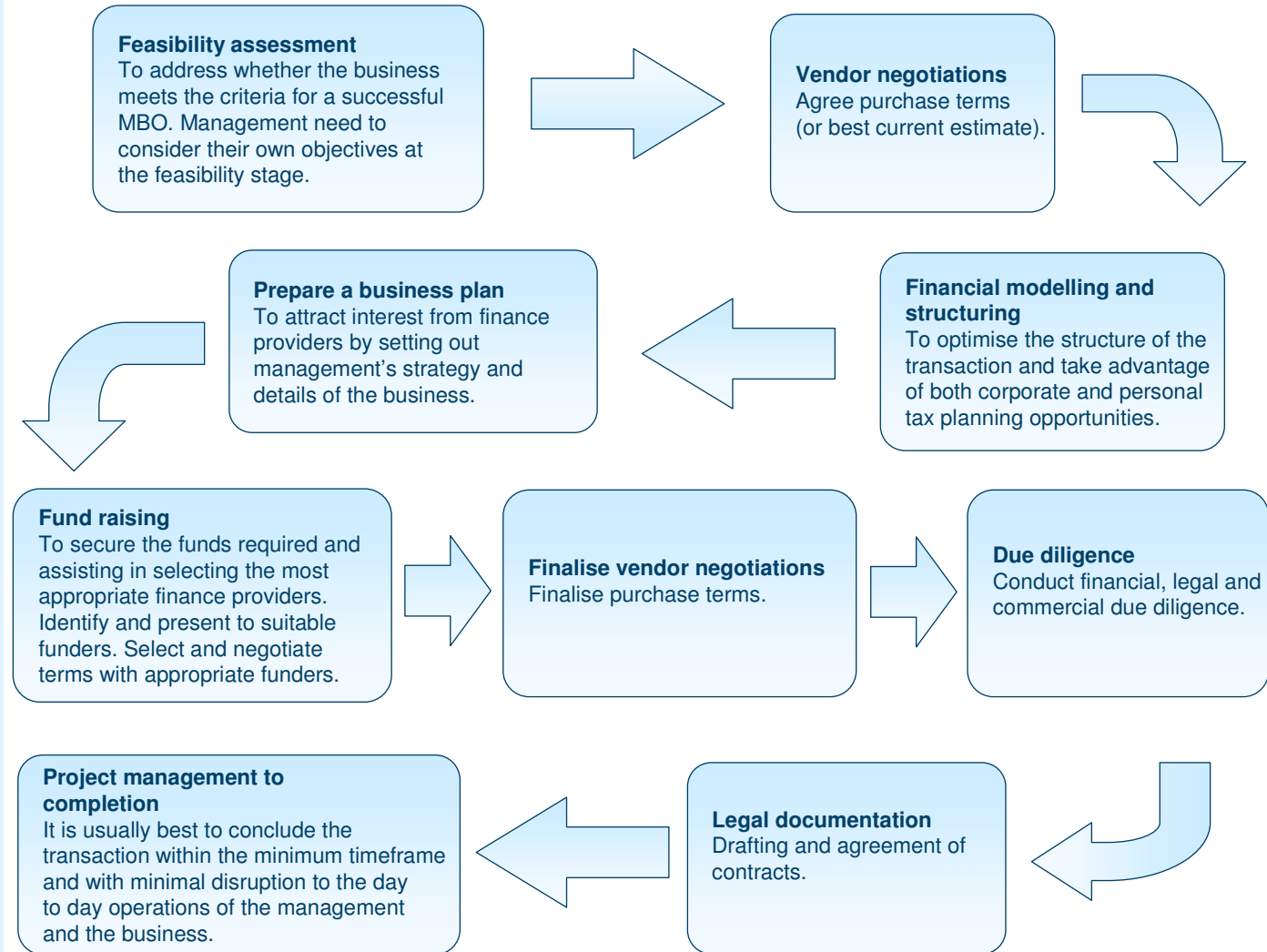


Private equity providers achieve their return through a combination of:

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

Process

Although timescales vary, a typical buy-out process will take between 3 and 6 months:



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 moral.

Share option scheme

- Incentivisation of 2nd tier management.

Personal financial planning

- Remuneration package with Newco.
- Keyman insurance.
- Personal funding.

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.

The role of the financial advisor

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.

Some of the specific aspects of the role include:

- 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**
- **It happens on time**



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