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Guide to Executing a Management Buyout

What is a MBO?

Critical Ingredients to Success

The MBO Process

Managing the Deal

A management buyout is the purchase of an existing business, usually with a combination of debt and equity. The equity can be from investor groups or private equity funds or other institutional investors.

A management team faced with the opportunity to participate or initiate a MBO has an unique opportunity. Entrepreneurially inspired managers with a firm belief in their ability to build a business can capitalize on a rare opportunity to build significant personal wealth.

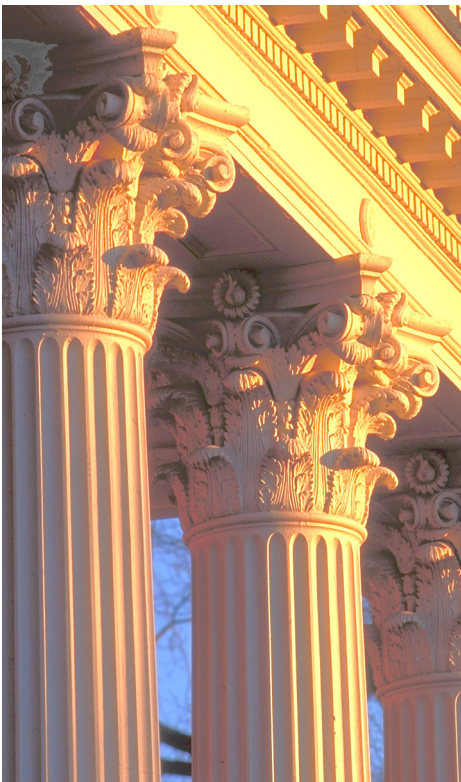
Management Buyouts (MBO) are a special segment of business purchase and sale transactions that arise under circumstances where the seller has objectives that preclude a wide exposure to the market. This is often due to a desire for a high level of confidentiality or a limited strategic buyer market.

Typical MBO Candidate Businesses

Corporate Seller – Non-core business unit or division desires to exit the business but wants to maintain confidentiality until the transaction is complete or is concerned that exposure to competitors would be too risky.

Private Owner that wants retire and is considering a sale of the business to the in place management team.

Distressed situations where speed of transaction and management's familiarity with the business make them the best buyer.



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a Cleveland based investment bank serving
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Executing a MBO Successfully

Most management teams who contemplate a MBO find that they lack either the capital access to conclude a deal or are faced with conflicting objectives with their current employer in proposing a deal. Third party advisors are usually critical to supporting the management team to successfully complete the deal.

Three L's make a MBO Deal

The most obvious and often the key to executing a MBO is the existence of a management team and in particular a CEO to champion and lead the deal. The potential CEO and the team will be expected to show commitment and to clearly articulate how the business will succeed. The general expectation from any capital source will be that the team will invest personally in the deal. Although the team will typically not be the main source of equity capital they are expected to put a meaningful amount of "skin" in the game.

The team must have a well defined, coherent plan for the business. This plan should demonstrate an understanding of the strategic elements of the business, sufficient operational detail to establish the viability of the future cashflow of the business and the adequacy of returns to any potential investors.

....a MBO requires a strong management team and leader, a coherent plan for building value, and a cash out strategy.

Leverage

MBO's almost invariably rely on a significant amount of debt capital to fund the purchase. Therefore, MBO's are appropriate for businesses with an established track record of cash generation. In some cases the distressed MBO will have a damaged short term record but a very clear plan to reverse the trend. The MBO's is not appropriate for the purchase of early stage businesses that are cash flow negative or the need to make large capital infusions to gain scale or cost positions.

Any MBO that requires investors to supply equity capital must have a reasonable path to future liquidity for that capital. The most prevalent source of equity capital in today's markets are private equity investors. These investors need to achieve liquidity in a 3 to 7 year period. They will look to the team and their advisors to define the exit strategy or how they will obtain cash for their investment. This is usually through a subsequent sale of the company to another buyer but can be through a recapitalization. The quality of the exit opportunity will affect the attractiveness of the deal and the ability to attract investor capital.

The MBO Process

In general a MBO will follow a five step process from initiation to completion. These steps will generally proceed in sequence although there is a great deal of overlap and parallel activity that as the deal matures from inception to closing.

Feasibility

An investment banking firm is usually engaged to assess the feasibility of executing a MBO. The advisors will analyze the business on a strategic level and on the basis of past financial performance. The strategic overlay will encompass a review of the markets served, growth rates, the industry and customer structure, competitive advantage of the business, and intensity of competition. In many cases the financial performance must be decoupled from the existing corporate framework, infrastructure and cost allocation assumptions. Proforma income, balance sheets and cash flows will be developed. These analyses and a review of current market conditions will lead to a valuation range and an assessment of the likelihood of a successful MBO sale. Implicit in the feasibility assessment is an unbiased measure of the potential buyout management team.

The management team guided by investment banking advisors will develop and document a business plan. This plan will present the critical elements of the business as is typically presented in a private offering memorandum. In addition to a 3-4 page executive summary, the plan will describe the industry, products and services, customers and markets, internal operations (manufacturing, sales, marketing, facilities, etc as appropriate to the business) and the organization. The plan will review past financial performance and outline plans for future growth. The future projections will be summarized in income and balance sheet projections. The plan must encompass the capital needs of the business and especially any capital required for critical add-on acquisitions.

Financing

Armed with a business plan the investment banking team will identify and select a limited number of potential investors that are well suited to invest in the deal based on the capital required, the investors prior track records with similar industry investments, and the investors appetite and enthusiasm for MBO deals.

The field of selected investors is kept small to allow focused effort to quickly identify and gain consensus on the investment opportunity. It is critical to establish a working relationship and compatibility between the investor group and the management team. Key parameters to proceeding with the deal must be developed. These parameters include the investors position relative to the “deal price”, management equity incentives and expectations for management investment, and the plans and costs of due diligence expenses and broken deal costs. Typically preliminary debt financing is solicited with commitment letters arranged subject to final due diligence. A legal advisor to the team is usually engaged at about this point in the process.

....it is usual to expect a several iterations between negotiation of the financing package and negotiation of the deal with the seller.

Final Negotiations

The interplay of the investors perception of value, in relation to the deal price that was been established earlier in the process is a critical to the deal. The investment banking firm plays a critical role in supporting the team must be able to negotiate and resolve any these early stage issues to avoid derailing the deal downstream.

At this stage a formal Letter of Intent is usually signed committing the participants to the deal framework and a timetable to move towards closing. The buyout team should at this stage seek to obtain a contractual level of protection for out of pocket costs in the due diligence process should the deal not proceed.

Due Diligence and Documents

The due diligence process proceeds in parallel with the preparation of the final legal documents for executing the deal. MBO due diligence is typically considerably more straight forward as the management team has first hand knowledge of the seller. Executing a MBO typically takes around 6 months. However, in situations where the buyout involves a distressed business the timing may be required to move faster

Starting the Engine...

Perhaps the most difficult aspect of a MBO is in its initiation. The process of buying and selling a business is always fraught with a certain amount of high emotions and less than rational behavior on the part of both buyers and sellers. The MBO by its very nature can seem to shift the balance of negotiating power towards the MBO team. This develops in two ways. First, the MBO team are insiders and should be well versed in positives or negatives to the potential valuation of the business and certainly should know the business better than any outside buyer. Second, the MBO by definition restricts the buyer field to just one party, the MBO team. These apparent shifts in negotiating power towards the Buyer can make sellers highly sensitive to concerns that they are not getting the best value for the deal. Additionally, personal emotions can engender antagonism between the seller and what can develop to be perceived as “their formally loyal employees”. In both a corporate setting and in a private company sale these issues can become “career limiting” should a deal fail or even get off on the wrong foot.

.....without Blowing a Gasket

The Role of the Investment Banker

In many cases an investment banker is retained to assess and establish fair value as a means of initiating a deal. The investment banker advising on a MBO normally will have primary responsibility to assure the deal moves forward to completion and contribute on the tasks as outlined to the right

The investment banking advisor will be able to bear the brunt of the workload in managing, organizing and stewarding the deal through the 6 plus months it will take to execute. This will mitigate to some degree the distraction to the management team and allow them to continue to operate the business.

Develop and advise on the business plan including the need for any future capital to support the business.

Assess the capital structure of the deal and determine the best three to four sources for equity capital.

Identify appropriate debt sources for the size and structure of the transaction.

Negotiate a letter of intent with the sellers for an exclusive period, including any provisions for deal cost recovery.

Negotiate equity incentives for the management team from the preferred investor group.

Support the investor group in negotiating the final deal with the owners.

Introduce appropriate and experienced legal and accounting firms to support the management team.

Summary

Successful MBO's take substantial effort and ready access to the capital markets. These requirements plus the need to provide a buffer and facilitating intermediary between the seller and the MBO team argue strongly for the process to include investment banking expertise. The advisory firm can be retained either by the seller or by the MBO team depending on the circumstances. A MBO is inherently a negotiated transaction at a “fair market price”. For the seller the MBO process can avoid many of the risks of a widely marketed sale and for the MBO team and their investors the deal is a “proprietary” opportunity to build future value and wealth.