



MANAGEMENT BUY-OUTS - FINANCING THE SALE

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Management Buy-Outs

A management buy-out (MBO) is usually an exciting, once-in-a-lifetime opportunity for managers to own their own business. It's the American Dream. The MBO opportunity occurs when the owners of a business are looking to retire or where the owners have little to no involvement in the day to day running of the business. Selling to the management team can present a more viable option to the owners than putting the company up for sale.

In general there are four conditions which must be met to produce a viable MBO:

- The management team is solid, committed and experienced.
- The business is/will become commercially viable.
- Owner/Seller must be willing to sell at a reasonable price.
- Company must support an appropriate funding structure.

A management buy-out is a form of a leveraged buyout (LBO) to transfer the ownership of a company. MBO transactions rely on debt instruments to finance a significant portion of the purchase price; therefore the transactions most often occur in profitable, stable companies that generate sustainable cash flows. While MBOs are more easily financed in traditional businesses such as industrial, manufacturing and distribution companies, software and technology companies can be solid candidates for management-led investor groups.

Advantages and Disadvantages to the MBO

There are far more advantages to the management buy-out than an outright sale of the business, assuming of course, that management is capable, willing and committed to the process. Both advantages and disadvantages affect all parties to the transaction in that the flip side of an advantage may be a disadvantage to the Owner/Seller or the management team.

Advantages

1. Owner/Seller can cash out at a fair value or negotiated price.
2. Managers gain an opportunity for equity in the company.
3. Depth of knowledge and experience remains within the company.
4. Loyalty of the management team.
5. More confidential than an outright sale.
6. Transaction can be concluded quickly and efficiently.
7. Flexibility of financing structures.
8. Simpler negotiations.
9. Management has a high incentive to perform and reduce debt.
10. Good public relations for vendors and customers.
11. No risk of integration and transition issues.
12. Known growth opportunities and experience.
13. Potential for re-invigoration of growth and profits.
14. Owner/Seller has a controlled exit.
15. Owner/Seller has an opportunity to reward its managers.

Disadvantages

1. Potential for disagreement on purchase price.
2. Management's pursuit of an MBO can be perceived as disloyal and suspicious.
3. May require an extensive period of time to execute.
4. Generally requires more capital than a start up company.

Steps in the MBO Process

1. Approach the owner about a sale.
2. Obtain independent advice on the feasibility of the buy-out.
3. Perform a preliminary valuation of the company
4. Review balance sheet and cash flows for financing capacity
5. Hire an attorney, accountant and a corporate finance advisor.
6. Write a Business Plan for financing sources and investors.
7. Negotiate the transaction.
8. Identify the most appropriate sources of financing.
9. Negotiate the financing.
10. Close the deal!

Approaching the Owner about a sale is perhaps the most delicate of the steps in the process. If it is not clear how the owner feels, you will need to tread very carefully. Some owners will view your request to discuss a buy-out with suspicion and consider your actions to be disloyal. In no way should the discussion lead to acrimony between owners and managers. It can sour relations and lead to resignation if not carefully thought out. The transaction needs to be conducted in an atmosphere of mutual trust and

with the economic self interests of both parties in mind. On the upside, managers of the business are in a strong position to put themselves forward as the potential buyer. The advantages for the management team are confidentiality, continuity and speed.

The Valuation

The valuation of any company is a matter of opinion. Everyday, publicly traded securities are priced on a matter of opinion of both buyers and sellers – and the opinion is usually only a matter of a few cents per share. In the case of the main street MBO, there is the Seller's opinion, management's opinion and the opinion of the financing sources. These opinions of value will most likely be widely divergent at first. To determine whether an MBO is feasible, you will start with the Seller's asking price to see if it is financeable. Management should conduct their valuation from a buy-out perspective, taking into account the likely financing structure necessary to complete the transaction. In many ways the value of the company will be determined by its ability to carry debt. Management should consider hiring an M&A specialist to assist them in the valuation process.

Common valuation methods include market comparisons and Discounted Cash Flow analysis. There is a valuation of the business as it exists today and a valuation of the business as it will exist in the future. Of particular concern to investors is the valuation the company would be given five years from now. This is why the financial forecasts must be defensible in all regards.

Lenders and investors will analyze the financial viability of the manager-owned company. This will include analyzing the prospects of the company to service the debt and to provide a market rate of return. Frequently, management will forecast productivity improvements and cost reductions. These "add backs" are very important to the valuation process for the "as acquired" company.

The Business Plan

The principal feature of an MBO is the structuring of the financing package to enable management to achieve a high return on their investment. The business plan is a necessary component to attract outside capital. At a minimum, the business plan, supported with projections must detail how the debt will be repaid and how investors will exit. The crucial point in business planning is that forecast growth and profitability will be sufficient to attract capital.

The forecast integrates historical financial performance of the company with future projections of the manager-owned company. It includes a detailed income statement, balance sheet and cash flow statement on an as acquired basis. The forecast assumptions are extremely important to both the valuation and business plan. Management should perform these forecasts with the help of an accounting firm to gain credibility in the numbers.

Naturally, banks and outside financing sources pursue loan and investment opportunities that are likely to generate high rates of return relative to the risks involved, thus they are likely to target businesses with solid fundamentals. Some of these fundamentals are -

- Reasonable purchase price
- Strong, forecasted cash flows
- Adequate debt capacity
- Strong management team
- Attractive industry fundamentals
- Good market position
- Exit strategy within 4-7 years

The business plan should be a blueprint for the accurate forecasting of cash flows and value creation. New investment partners are not going to make their investment if the plan is incomplete. Every MBO requires a thorough plan and execution strategy.

For companies requiring outside financing from equity sources such as mezzanine and private equity, the exit strategy becomes crucial. For these sources of funding their return is realized when the company has paid down its acquisition debt and is ready to be sold or refinanced again. Private equity/mezzanine investments may be realized in a recapitalization (re-leverage) or sale of the business.

Financing the MBO

In financing the MBO, there are two critical elements. The financing must meet the needs of the Seller for cash and it must also provide for adequate working capital post-acquisition. A buyout which is short on cash after the sale is a recipe for disaster. A little history – the capital structures of buyouts in the late 1980's and early 1990's taught the banks a harsh lesson in leverage. Many companies failed to operate with tremendous debt burdens and the term "Highly Leveraged Transaction (HLT) came into being. Many deals were funded with only 20% or less of the purchase price in equity. In today's transactions, the equity portion is closer to 40% and sometimes 50% of the deal.

The funding for an MBO will encompass the following requirements:

- Purchase price
- Transaction costs
- Working capital and capital expenditures

In many ways, the transaction will be shaped by the funding sources, including whether or not the proposed transaction is even considered a possibility. A purchase price which is too high relative to the company's intrinsic value is most often rejected for funding. Other attributes such as profitability, a committed management team, business planning, sellers' willingness and collateral issues are important to the financing sources. A well crafted transaction using multiple sources of financing is generally best for both the seller and management.

There is also the matter of the size of the transaction. Small transactions under \$2 million might require only bank financing and a little help from the U.S. Small Business Administration. A somewhat larger transaction can generally be handled by a bank alone. When the deal begins to exceed \$5 million or more, external funding sources such as mezzanine finance companies and private equity groups (PEGs) may be needed.

Here is a chart of the various types of financing which may be combined to make a transaction happen.

Capital Sources and Terms

Source	Type	Rate of Return	Security
Bank Debt	Line of Credit	P + 1%	A/R and Inventory
	Equipment Term Loan	P + 2-3%	Fixed Assets
	Senior Term Loan	P + 3%	All Assets
Seller's Notes/Earn Outs	Term - Subordinated	Prime Fixed	Third Lien
Subordinated Debt	Term - Variable	12-14% + Warrants	Second Lien
Private Equity	Preferred Stock	30-35%	None Board Seat
Common Equity	Common Stock	30+%	None Board Seat

Bank Debt

Bank debt is one the least expensive forms of financing and managers will do well to maximize the amounts borrowed. Typically, the banks will look first to the company's collateral to make loans. The receivables and inventory serve as collateral for a revolving line of credit and may be under a borrowing formula, such as 80/50% of the net collateral. The revolving credit must not be used entirely for the transaction, but a substantial portion should be reserved for post-transaction working capital. Banks typically lend a percentage of the fixed assets (usually equipment) based on the liquidation value of the assets. A senior term loan, sometimes called a "stretch term loan" or "air ball" may be loaned to the company over and above the collateral values. This type of loan is most often used to close any gap in the overall financing structure and usually must be repaid in a short term of 12 to 18 months.

Seller's Notes/Earn Outs

The Seller has a large role to play in the buyout and may be called upon to provide several layers of financing, including term notes (usually five years), earn outs and possibly retain a common equity interest in business. The Seller's financing is almost always subordinated or junior to the senior bank financing. Earn Outs are contingent payments made to the Seller in the event certain performance targets are met. An example would be that future profits are in excess of a certain amount, triggering additional payments to the Seller. More frequently, the Seller/Owner will choose to retain a small common equity interest in the business (say 20%) to be acquired at a later date, usually five years from the buyout. This lessens the overall price and financing needs and demonstrates that management has the confidence of the Seller.

Subordinated Debt

In larger transactions, management may need outside financing in the form of subordinated debt or mezzanine financing. Mezzanine financing is so-called because it exists in the middle of the capital structure and is used to fill the gap between equity and debt. Mezzanine lenders charge a higher rate of interest than banks and require an interest in the business, sometimes called an "equity kicker". These loans are an integral part of the financing structure and are closely tailored to the individual situation. They may be "interest only" for a period of time and have payments tied to cash flow. It is in the mezzanine lenders best interest to have a successful buyout. The mezzanine lender will require warrants to purchase a percentage of the stock of the company at a later date. At the end of the loan term, the company will be required to redeem the warrants for cash. For additional information see Mezzanine Financing – Versatile Debt and Equity on our web site – www.tuckercapitaladvisors.com.

Private Equity

When the MBO is large and cash flows are in excess of \$2 million, the transaction begins to be attractive to Private Equity Groups (PEGs). PEGs generally invest alongside management to ensure alignment of management and shareholder interests. In situations where there is little common equity from management or significant Seller's Notes, the PEG may require as much as 70-90% of the new ownership of the company. Private equity funds are not venture capital funds, but they do look for returns in the 30-35% range. Of key concern for the PEG will be the exit strategy in which the investment will be realized. PEGs rely on the growth in valuation at the end of the investment to realize returns; therefore the growth needs to be substantial to attract this type of investment.

Management's Common Equity

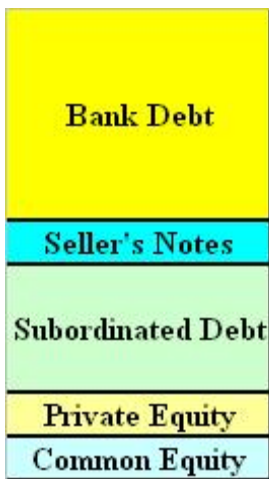
Management will be called upon to contribute capital to the transaction. The amount of the contribution or Common Equity is often called "having some skin in the game". Management is expected to contribute money, liens on their personal assets and personal

guarantees to the bank and the Seller/Owner. In larger transactions, requiring outside financing (Mezzanine or PEGs), the amount of the contribution is not as important as the personal commitment of the managers to the investment. Outside investors will be looking for your experience and expertise more than your cash. Another opportunity for management to gain additional equity is called “sweat equity”. Management will be incentivised over time in the management of the company by the other equity participants for hitting performance goals, primarily profitability.

Putting It All Together

MBO financing can look like a layer cake of various debt and equity sources, each with their unique requirements for returns and exits. Bankers look to interest income and the timely repayment of term financing. Mezzanine lenders want the same plus a healthy growth in the enterprise value of the company. Equity participants are most patient of all, requiring no repayment, but have a keen interest in the rise in value of their stock investment.

With all of these moving parts, management should consider hiring an M&A specialist to assist them in raising capital. Some key points to remember in financing the MBO are simply common sense.



- More assets = more debt financing. Less assets = more equity financing
- Seller participation is often the key to the transaction.
- Pay off the subordinated debt as rapidly as possible.
- Concentrate on growth and profits – possibly even a breakthrough growth plan.
- Stay reasonably conservative in forecasting future growth and consider that not all plans will be achieved.

Professional Advisors

You will need lawyers and accountants, and possibly a corporate finance advisor (M&A specialist) to complete a transaction. Experience matters. Your advisors must have the expertise to provide innovative solutions to the issues which will arise during a complex transaction. Use your advisors to assist you in approaching the owner, valuation, business plans, negotiation and arranging the financing. In the early stages, many advisors will defer their compensation to give you a better chance of succeeding, but do not expect them to spend large amounts of free time on your project.

Conclusion

In conclusion, the financing structure must provide lenders and investors with an acceptable rate of return and give the acquired company enough financial flexibility to pursue its growth objectives and service debt. It is important that the capital structure fully considers the interest of all parties concerned, including the employees, selling shareholders, and management. Perhaps most importantly, the financing structure is in the best interest of the business itself. Good Luck!



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