The BHP guide to **management buy-outs**

BHP Corporate Finance

About BHP

BHP is a UK Top 40 advisory firm, with specialist teams to support all of your financial needs.

Our multi-award winning Corporate Finance team offers strategic advice and practical support across a wide spectrum of areas including:

- Strategic options and exit planning
- Company sales
- Company acquisitions
- Management buy-outs and buy-ins
- Private equity
- Debt fundraisings.

We provide our clients with exceptional advice and our partners remain actively involved in transactions throughout a process. We understand that choosing your advisor is a very personal decision and that you entrust specific individuals to advise you on what will likely be a life changing transaction. We therefore don't have separate sales and execution teams. The team you meet at the outset will be the team that works with you hand in hand towards a successful completion.

In today's global environment we also recognise that businesses need to be able to transact on an international basis. As part of Kreston International our ability to advise on cross border transactions is underpinned by our presence in over 100 countries. However, no matter where our clients transact, all our assignments are led by your local BHP Corporate Finance team ensuring that delivery of the deal always remains with the individuals you have appointed.

The BHP guide to management buy-outs

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What is a management buy-out?

A management buy-out ("MBO") is the purchase of a business by its existing management team, usually with the help of financial backers.

The funding for these deals is not dependent on the existing management team being able to finance the whole purchase price from their own resources. Instead, the majority of funding for these deals will come from financial institutions providing a combination of debt and equity finance alongside some level of investment from the management team.

Debt finance is usually provided by specialist teams within the major banks, independent Asset Based Lenders ("ABLs") or private debt funds. If external equity funding is required it is likely that it will be provided by venture capital funds, private equity houses or High Net Worth ("HNW") individuals. Additional funding may also be provided by the vendor in the form of loan notes or deferred consideration.

Generally speaking, debt finance costs less than equity and the lower the requirement for equity funding the higher the management team's shareholding in the business is likely to be.

The requirement for an external equity investor will depend on a number of factors including:

- The price paid for the business
- The availability of debt funding
- Future investment requirements
- The willingness of current owners to defer some of the consideration.

While it might seem tempting to raise as much debt as possible to maximise the management team's shareholding, care should be taken not to put the business under too much financial strain. A key part of a corporate finance ("CF") advisor's role is therefore to develop and negotiate the optimal balance of debt and equity funding.

Essential ingredients

MBOs are a well-established route for businesses to change hands and experience highlights that there are three elements that are fundamental to a successful transaction: a high quality management team, a strong business and an appropriate return on capital for funders.

A high-quality management team

The strength of the management team is the single most important factor in a successful buy-out. Lenders and investors need to be convinced that the management team has the requisite skill set to manage the business independently. If there are gaps in the team then funders will want to understand how and when these will be addressed. The vast majority of all buy-outs need to have a strong, full-time finance director in place either pre-deal or very soon after completion.

The management team will nearly always be required to demonstrate a meaningful level of financial commitment to any buy-out. The exact amount will depend on the funding sources being used and the management team's personal financial circumstances. As a rough rule of thumb, one year's gross income will be required either in cash or potentially by way of a personal guarantee. If the members of the management team are investing different amounts, this does not necessarily mean they will need to have different shareholding percentages.

In most cases, the leader of the buy-out team will be the current chief executive/managing director. It will be their job to ensure that the management team is not overly distracted during the buy-out. Typically the finance director will also be very heavily involved in the buy-out process.

The opportunity for an MBO may arise in a number of ways:

- The owner of a private company may wish to retire or take a less active role in the day to day activities of the business
- The shareholders may decide they wish to sell the business and thus as part of this process choose to explore a sale to the management team, as an alternative to selling the business to a trade purchaser
- The shareholders may not be involved in the business and it is therefore decided by all parties that change is required
- A group may decide to sell a business because it has become non-core
- An administrator or receiver may sell a business as a going concern.

Background

A strong business

The majority of MBOs involve some form of debt funding and so a positive cash flow is needed to service interest and capital payments. Funding a MBO becomes more challenging if the cash generated is absorbed by additional working capital or high levels of capital expenditure.

Characteristics which will make a buy-out more attractive to funders include:

- A track record of profitable growth or a credible plan for improvement
- Good visibility of future earnings
- A strong competitive position with robust barriers to entry
- Markets with clear growth opportunities
- No over reliance on any particular customer or supplier
- A strong asset base or reliable cash generation.

It is sometimes thought that, from a funder's perspective, 'people', 'services', and 'technology' companies make less attractive buy-out opportunities. This is not the case if the business can demonstrate a number of the features noted above.

An appropriate return on capital

How and when both debt and equity funders receive their required return on invested capital needs be considered from the very beginning of exploring the MBO opportunity.

Debt funders will usually require both interest and capital to be paid back out of cash generated by the business over a specified period, in many cases no longer than five years. Debt providers will not want to rely on a future sale of the company for the repayment of their loans.

In contrast, equity funders will require an "exit" to realise the majority of the returns they require from investing in the buy-out. Typically equity investors want to realise their investment within three to five years, although this can vary. The most common forms of "exit" are:

- A sale of the company to a trade buyer
- The existing management team buying out the shareholding of the equity investor, through the raising of new debt or equity funding
- A sale to the "second tier" management team, subject to their skills and experience.

While less common, a form of exit may also be achieved through a flotation of the business on the London Stock Exchange or the Alternative Investment Market.

Just as a credible plan for profit growth is important at the inception of a MBO, a successful exit will require the company to demonstrate how it will achieve continued growth throughout the foreseeable future.

On an exit the purchaser will generally require the management team to continue working for a minimum handover period, which can be as short as three to six months but frequently this is longer.

Three factors are essential if an MBO is to be achieved:

- A high quality management team
- A strong business
- An appropriate return on capital.

The buy-out process

Key stages

No one buy-out process is the same as another. Some will start with the management team (or more likely a single member) being approached by the existing owners, others will be driven by the desire of management to be proactive in achieving a change of ownership. The following are key stages in a typical process, although they will frequently occur in a different order. One thing that is common to all buy-outs is that the earlier a management team appoints an advisor to work alongside them, the more likely it is that a deal will be concluded successfully.

Key stages are commonly:

- Select CF advisors to the management team
- Assessment of whether the opportunity is suitable for a buy-out
- Obtain approval from the vendor to pursue a MBO
- Determine or evaluate the vendor's asking price
- Understand the deal structure and the amount of the asking price payable on day one
- Produce high level annual financial forecasts
- Hold initial discussions with potential funders about their appetite to support a deal
- Decide in conjunction with your advisor if a deal is possible based on the vendor's current expectations and if it is one you are comfortable with
- Formally agree heads of terms with the vendor
- Write a detailed business plan, including monthly financial forecasts and associated assumptions
- Meet with potential funders to discuss the opportunity in detail
- Obtain initial written credit approved offers from potential funders
- Appoint legal advisors to the management team
- Form a new company ("Newco"). This will typically be the legal entity that will buy the shares of the existing company
- Select the preferred debt funder(s) following further negotiation
- Negotiate the best possible deal for the management from equity providers (if applicable)
- Carry out financial and legal due diligence (as required by the chosen funders)
- Carry out any other specific areas of due diligence such as commercial, management, environmental or IT
- Prepare and negotiate legal documents
- Achieve legal completion.

Role of a corporate finance advisor

The CF advisor should support the management team throughout the entire deal process right up until legal completion.

The first job of the CF advisor is to help the management team assess whether an MBO is achievable. This will include assessing whether adequate financial backing will be available. If there is any doubt it is important that the CF advisor checks the appetite of potential funders before you proceed. It is not in anyone's interest to invest lots of time pursuing an MBO unless there is a strong probability of success. Your CF advisor should also advise you on whether or not the price being proposed by the vendor is reasonable.

If the current owner has initiated discussions, then moving to more detailed negotiations should be straightforward. On the other hand, if a MBO has not been mentioned, there could be a risk in requesting an opportunity to pursue one. Prior to making an unsolicited approach to the shareholders about the possibility of a management buy-out, the management team should discuss the tactics and risks of doing this with their CF advisor.

Assuming all parties still believe the MBO opportunity is a good one, the CF advisors and the management team will have an intense period of working together to produce the required business plan and financial forecasts.

A MBO process can sometimes feel like an emotional rollercoaster and can become frustrating and stressful. It is vital that the management team has a strong personal relationship with their CF advisor as well as a good professional relationship.

Business plan

The primary purpose of the business plan is to convince potential funders that the proposed buy-out is an attractive opportunity. It should set out a compelling proposition of the company's strengths, the market opportunities and management's skill set and commitment to deliver the plan.

The business plan will be a joint effort between the management team and their CF advisor. It will be based on the core information provided by the management team (either verbally or in writing). The CF advisor will undertake a critical and constructive review of the plan and its associated financial forecasts. The plan should ideally be no more than 20 to 30 pages long, plus appendices.

A typical business plan will include:

- An executive summary, preferably no longer than one to two pages, covering the key investment highlights
- Background to the proposed deal, including an estimate of the price and details of any potential vendor finance
- A brief history of the business
- A description of the products or services sold
- Details of the markets served, key customers and routes to market
- An analysis of the market and the competitive position of the business
- Headline details of sales pipeline / order book
- An overview of any key suppliers
- A summary of what makes the business unique and / or great at what it does
- A profile of the management team, their positions and responsibilities, their qualifications and experience plus an overview of the staff
- A description of the main assets and any key features of the way the business operates
- Summary results over typically the last three years and monthly profit cash flow and balance sheet forecasts for the next three years.

Financial forecasts

The forecasts should be positive, credible and based on assumptions which are clearly articulated and capable of standing up to robust challenge. Ultimately there is a balance between getting funders excited about the opportunity and ensuring that you can deliver on the forecasts presented both during and after the deal.

Future capital expenditure requirements and detailed balance sheet assumptions will also be very important as all funders will need to understand the cash the business will generate.

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Legal process

The legal documentation involved in a MBO is significant. Each party to the transaction will need to have their own legal advisors, although in "friendly" deals some of these roles may be relatively small in nature. However, the entire management team will be represented by a single law firm.

There are various agreements that will need to be put in place. Key documents and themes are explained below.

Articles of Association

The rules that Newco needs to abide by in managing the internal affairs of the company and how it conducts its business, as well as how the company should interact with its shareholders.

Shareholders' Agreement

The agreement between all shareholders which states what can and cannot be done, without permission from some or all of the shareholders. This supplements the Articles of Association but has the advantage of not being a publicly available document.

If there is an external equity investor, both the Shareholders' Agreement and the Articles of Association will be subject to detailed negotiations between the relevant parties. If these agreements are too onerous it can inhibit the freedom of the management team to operate the business. For example, there may be a requirement to obtain the approval of the equity investor to recruit or dismiss staff over a certain salary level, or to authorise an item of capital expenditure over a certain limit. The key in such circumstances is to negotiate limits which allow the business to make day to day decisions, without continually having to seek shareholder approval.

Good and bad leavers

Equity investors are not in a position to run the company themselves and will therefore wish to discourage management team members from leaving early before an exit is achieved.

The provisions for members of the management team who leave the business prior to the "exit" are therefore likely to need careful negotiation. Equity investors will want the shares to be sold at the lowest possible price in the event a member of the management team leaves prior to this date. The departing manager on the other hand will want to receive full value for any shares they are forced to sell back to the company.

Typically, equity providers will seek to make a distinction between "good" and "bad" leavers. "Good" leavers will usually receive market value for their shares and "bad" leavers will receive a maximum of what they paid for them.

Service contracts

Service contracts for the management team will be put in place before legal completion. The starting salaries and duration of the service contracts will not normally be materially different to current levels. Equity investors will be keen to ensure that management are focused on growing the value of the business for the benefit of all shareholders, rather than relying on large pay rises or bonuses. Consequently, subsequent salary increases for the management team will not only need approval from the funders, but are likely to be relatively modest.

Acquisition documents

The acquisition documents set out the legally binding terms of the transaction such as price, the timing and conditionality of any deferred consideration and how the acquisition is to be effected (usually by way of acquiring the share capital but in some cases by buying the 'trade and assets')

It is also usual practice for the acquisition documents to contain warranties and restrictive covenants from the vendors in favour of the buyer. The lawyers to Newco will be responsible for negotiating the acquisition documents with the vendor's legal team.

Funding documents

Newco will need to enter into formal funding agreements with each provider of finance. Such documents set out the amount of funding available and the ongoing conditions the lender requires to be met. Typically these will include financial covenants, measures of financial performance that Newco must achieve. A key role of a CF advisor is to assist the management team in negotiating covenants that have a suitable level of headroom.

In circumstances where more than one funder is seeking security over the assets of the business, the funders will usually enter into an agreement between themselves which sets out the priorities and rights of each funder. This is known as an inter-creditor agreement.

Board of directors

Any equity investor will almost certainly require the right to appoint a chairman and/or non-executive director. Some private equity investors tend to put the individual who led the deal for them onto the board. Others will have dedicated portfolio management teams. The non-executive director should typically be someone who all parties feel can help to increase the equity value through their specific skill set. It is worth taking time to ensure that you get this appointment right. Equity investors will have individuals they believe may be suitable but equally they are often open to ideas the management team may have.

Taxation

Expert advice is needed before the MBO is legally completed in order to ensure the deal is structured as tax efficiently as possible.

Management team members should take advice to ensure that no PAYE tax liabilities are triggered and that any future gains are taxed at more favourable capital tax rates.

Newco will require advice to facilitate the tax efficient structuring of the investment, maximise the deductibility of transaction costs and consider the potential to reclaim input VAT.

Professional fees

Newco will usually pay all professional fees at the time of completion, with the exception of the cost of the vendor's advisors.

Newco will also be responsible for:

- Debt and / or equity provider's arrangement fees
- Legal costs of all funders
- All due diligence costs
- Fees in respect of all advisors to the MBO team.

These fees will have been factored into the funding requirement calculations provided by the CF advisor and so will be paid out of the cash raised to fund the deal.

Timescales

It is not unusal for buy-outs to take six to twelve months between inception and completion. Throughout this period, the management team must continue to run the business and consequently a key role of the CF advisor is to minimise the disruption to the business by leading and managing as much of the process as possible.

A typical timetable of events is:

Month one

- Agree on the management team
- Appoint CF advisors
- Obtain agreement to pursue a management buy-out
- Carry out a high level financial review

Months two/three

- Negotiate the heads of terms for the acquisition with the vendor

Month five

- Present plan to prospective funders
- Obtain outline written offers from potential funders
- Negotiate improved terms with funders
- Select preferred funders and lawyers

Month two

- Have initial discussions with the vendor on price and structure
- Initiate discussions with funders to ascertain likely appetite and maximum price and deal structure that should be capable of being supported
- Decide whether the deal is still worth pursuing

Months three/four

- Write the business plan
- Prepare detailed monthly financial forecasts
- Provide potential funders with a copy of the business plan

Months six/seven

- Funders appoint advisors to carry out due diligence (financial and legal plus potentially management, commercial, IT and environmental)
- Prepare and negotiate legal documents
- Legally complete the MBO

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