

**Chapter**

**7**



**MANAGEMENT  
BUYOUTS**

**A** *Management Buyout (MBO)* is a specific type of Mergers and Acquisition (*M&A*) transaction. An MBO occurs when a team of managers purchase a company, subsidiary, division or business unit from its existing owner. They typically borrow a large portion of the purchase price. A *Management Buyin (MBI)* occurs when an external team of managers purchase a company, subsidiary, division or business unit from its existing owner. An *Institutional Buyout (IBO)* is a buyout instigated and led by a private equity fund (institution). Management is either retained following the acquisition or new managers are brought in on closing.

All buyouts typically borrow a large portion of the purchase price. Thus, they are referred to as *Leveraged Buyouts (LBOs)* in the US. The underlying principle behind all the variants of buyout is the use of the business's cash flows to pay for the debt incurred to finance the purchase. Over time, the business pays for itself.

The US provides the largest buyout market globally, although the European market for deals is rapidly catching up. Within Europe, the UK is the largest market for buyouts by a large order of magnitude (see Figure 7.1), but continental transactions are increasing.

As noted above, the purchaser is using the future cash flows of the business to pay down the debt assumed on the buyout which was used to fund the purchase price. The following example (Box 7.1) describes the core financial elements of an hypothetical MBO.

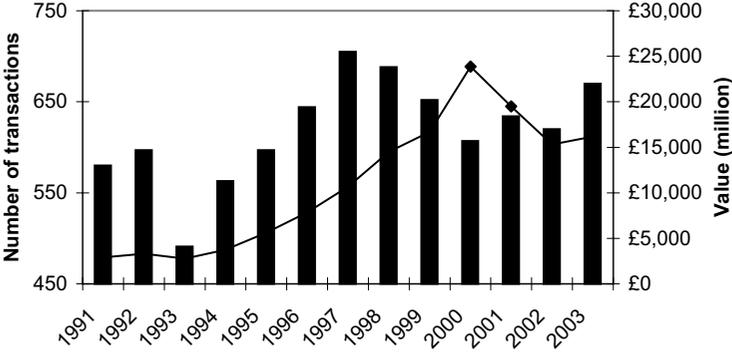


Figure 7.1 UK buyouts (1991–2003).

Source: CIMBOR.

Box 7.1 Example.

Assume that a company has gross assets of £80 million, total liabilities of £60 million and, therefore, net assets (shareholders equity) of £20 million. Assume that an MBO takes place for a purchase price equal to the net assets of the firm, or £20 million. The purchase will be funded by borrowing against the assets of the company.

Immediately following completion of the buyout, the balance sheet would show £80 million of gross assets as before and £80 million of liabilities, including the £20 million of borrowings assumed to make the purchase. Thus, net assets are £0. The MBO team now owns a business with equity that is worth zero (at least on the balance sheet).

During the ensuing years, the company's business will continue to generate profits and cash flows. Suppose that by the end of year 3, £20 million of net profits and cash had been generated. The balance sheet now has £80 million in gross assets, £60 million of liabilities and, having repaid the £20 million borrowed to buy the company, £20 million in net assets.

At the end of year 3, the owners have equity with a book value of £20 million. They have used the cash-generative capability of the

company to repay the debt of £20 million assumed on closing of the transaction, thereby creating value of £20 million for themselves over a 3-year period.

One of the main prerequisites for a successful buyout is the purchase of predictable cash flows at a reasonable price – something that is not always possible.

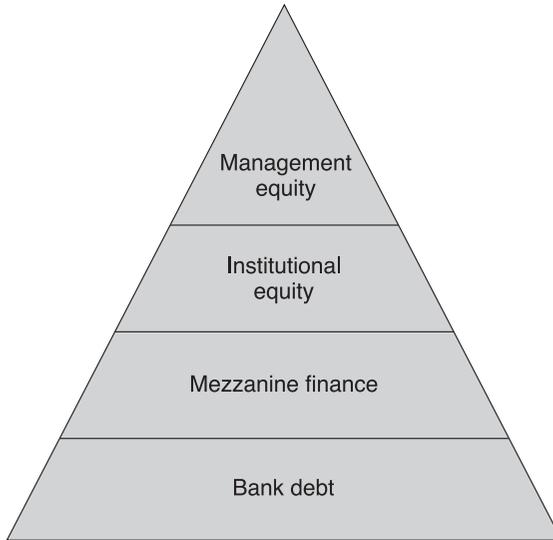
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## FINANCIAL STRUCTURE

The organisers of a buyout first determine how much bank finance can be used in the transaction. They then add the (relatively small) amount of equity provided by the management team to the bank debt. At this stage the institutional equity providers calculate their expected return, based on the risk of the transaction and the amount of equity they are required to invest to meet the purchase price. If the combination of bank debt, management equity and private equity is not sufficient to purchase the business, the organisers will turn to mezzanine financiers to fill the gap.

Figure 7.2 is sometimes referred to as the funding triangle. It represents the total funding required for the MBO, including working capital requirements.

When funding a buyout, one starts at the bottom layer: bank debt. Generally, the entrepreneur trying to fund a buyout attempts to get as much bank debt as possible because it is cheaper than other forms of finance. The relative costs of finance are covered in Chapter 9.



*Figure 7.2* Typical funding structure.

Frequently, banks will lend only on a secured basis – i.e., they must have direct claim over the assets of the business. Because they are lending on a secured basis, the interest rate charged by a bank (or syndicate of banks) is relatively low. During the decade from 1995 to 2005, the average amount of bank debt in transactions ranged from a low of around 40% at the tail end of the early 1990s' recession to a high of slightly more than 50% of total value.

We next move from the base of the triangle to the top which represents the small amount that management will invest in the shares of the company. Their investment is pure risk capital and rarely comprises more than 10% of the funding pyramid. In-between the bank finance and management equity is the institutional equity 'tranche'.

The amount of equity invested by institutional investors – private equity funds and venture capitalists – will vary by transaction and the perceived risk. Most private equity investors aim to earn a return of 25% to 40% on their portfolio of investments. During the decade 1995 to 2005, institutional equity accounted for between 30% and 40% of total transaction value.

The mezzanine tranche is not present in all buyouts. It is unsecured debt, which usually charges a high interest rate as well as requiring some form of equity, usually in the form of warrants or options. Mezzanine finance is normally supplied by specialist financing groups. Mezzanine finance typically ranges from 0% to as much as 20% of transactions in which it is sought.

## **BANK FINANCE (SECURED LENDING)**

The level of bank financing depends on four areas: the security available, the interest cover, the gearing ratio and the cash cover.

The first stage is the examination of the fixed and current assets of the business where the bank will assess their quality and security for lending purposes. For instance, a firm whose customers are major multi-nationals will have a higher quality debtors' book than a firm concentrating on sales to local owner-operators. Thus, banks will be prepared to lend against a higher proportion of the former than the latter.

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With respect to coverage ratios, the banks look at profit before interest tax and depreciation and divided by the expected amount of interest expense. As described by Brealey and Myers (2000), 'The regular interest payment is a hurdle that companies must keep jumping if they are to avoid default. The [interest coverage] ratio measures how much clear air there is between hurdler and hurdle.' A ratio of 2.5 times or so is generally the minimum acceptable level. The gearing ratio (debt to equity ratio) is also examined. Maximum gearing is 140%, as a result of Bank of England rules.

Finally, the banks will want to know that they can be repaid from the forecast cash flow of the business. In early 2000, the maximum period for loans to UK buyouts was approximately 8 years, while a couple of years previously the maximum period was 5 years. The variation is a result of changes in the perception of risk, future economic conditions and competition among banks to make loans.

The interest rate charged will vary with market conditions and the quality of security offered, but a range of London Inter-Bank Offer Rate (*LIBOR*) + 200 basis points to *LIBOR* + 400 basis points gives you the idea (remember from Chapter 2, *LIBOR* is the rate at which banks lend funds to each other). During economic boom times, when lenders are confident and competition to win business is high, the interest rate will be at the low end of this range and occasionally below. During less prosperous times, the interest rate charged will trend upwards.

In 1998, the size of the European leveraged lending market was \$36 billion. It leapt to \$96 billion the following year, before levelling off in 2000. By 2004, the value of the market had hit nearly \$250 million. Bankers involved in the business say that the trend toward corporate focus and restructuring was the main driver of LBOs and leveraged loans.

At the time of writing, some of the most active participants in the European leveraged loan market were: JP Morgan, Citibank, Royal Bank of Scotland, Deutsche Bank, Barclays and Bank of America. In addition, 'traditional' investment banks such as Goldman Sachs and Lehman Brothers had joined the market in a major way.

## PRIVATE EQUITY FUNDS

Private equity firms tend to look to make an Internal Rate of Return (*IRR*) of between 25% and 40% over the holding period of between 3 and 7 years. Like bank lenders, competition among equity funders will drive the required returns to the lower end of the range, and occasionally below. In recessionary times, private equity houses will require higher returns.

In all cases, the equity providers will evaluate the risk of the business carefully before advancing funds. The above figures are for average risks and for illustration only.

At the end of 2005, private equity firms in Europe were estimated to have over €140 billion of funds available.

*Table 7.1* Selected UK private equity providers.

3i Group	Cazenove
Advent	CVC Capital Partners
Alchemy Partners	Electra Partners
Apax Partners	ECI Partners
Barclays Private Equity	HSBC Private Equity
Candover	Permira

Assuming an average equity portion of transactions of 40%, over €350 billion of transactions were theoretically possible. In fact, some private equity specialists complain that there is too much competition for deals and that they are unable to achieve the returns that they have been used to historically.

During 2004, European private equity providers reported an average return of 24.88% according to a Strategic Capital Management (*SCM*) survey. Institutions earn their return from three sources:

- the running yield on the sums invested, typically by way of a preference share dividend;
- repayment of capital over time;
- sale of the holding in the company on exit – to a trade buyer, to another private equity fund or when the company goes public.

## MEZZANINE FINANCE

Medium-sized companies have used mezzanine debt for many years in both Europe and the US as an alternative

to high-yield bonds or bank debt. The product ranks between senior bank debt and equity in a company's capital structure, and mezzanine investors take higher risks than bond investors, but expect to earn a higher return – typically between 15% and 20%.

Companies that are too small to use the bond markets – either traditional or high yield – often turn to mezzanine funders. This feature, plus the ability to structure each deal more than a bond issue, makes mezzanine a popular source of LBO financing.

Mezzanine is riskier than bank debt as illustrated by the highly levered purchase of Finelist – a car parts distributor – by a French competitor, Autodis, in early 2000. The buyout, which had a total value of €505 million, was financed with leveraged loans and €275 million of mezzanine debt. In early autumn 2000, Finelist broke several financial covenants and entered receivership. While the holders of senior debt financing were able to recover the amounts lent, those who had participated in the mezzanine level were left with significant losses.

## **HIGH-YIELD BONDS**

High-yield bonds are bonds issued by companies with a credit rating below what is called *investment grade*. Investment grade ratings are anything above BBB/Baa (as rated by Moody's or Standard & Poor's). A high-yield bond, as one might expect, generally carries a high coupon offering the investor a high yield to maturity.

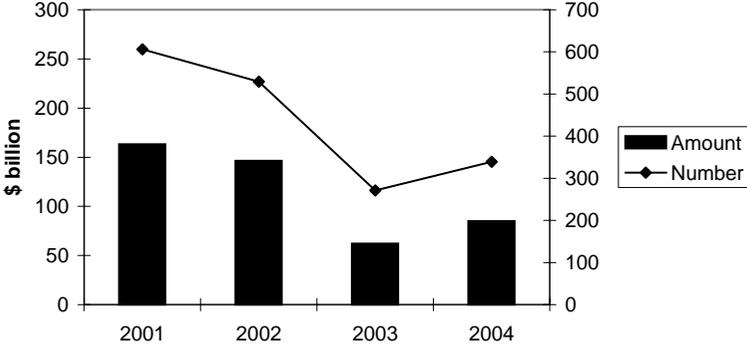


Figure 7.3 Global high-yield debt new issues.

Many bank loans in LBOs are refinanced using the high-yield market, as the rates are competitive and borrowers can gain access to funds for longer periods than banks are willing to commit to making a loan. In most cases, banks refuse to extend long-term fixed rate loans to non-investment grade borrowers. When bank credit is available, it is typically offered only on a floating rate basis at punitive interest rates.

The European high-yield market grew rapidly during the latter half of the 1990s, fuelled by an explosion of issues by telecommunications companies. It continues to be dwarfed by the high-yield market in the US, which accounts for as much as 90% of global new issues of high-yield bonds. Figure 7.3 illustrates the number and volume of high-yield debt new issues in recent years.