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Management Buy-outs – A Reality Check

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There are a number of basic prerequisites to a successful management buy-out (MBO) and undertaking a feasibility check to assess how any prospective deal measures up to these criteria is an essential first step. For the adviser – who is likely to be working on a contingent fee basis – a review of these prerequisites will usually determine whether the idea will be attractive to financiers and is worth backing. A review forces the management team – for whom this will be a life-changing transaction – to take a long, hard look at the reality of what they are about to embark upon. Even for the propositions that score highly at this stage, the deal can be incredibly difficult. The management team must have the stomach for it and be prepared to make some hard decisions en route before they reap the rewards of ownership. A hard look at these prerequisites at an early stage can therefore save a great deal of time and anguish later.

Is there a real opportunity?

Often, the MBO team of a privately owned company may perceive that there is a buy-out opportunity if the owner wants to retire or simply move on to other things. If the company is part of a larger

group, it may become apparent to a management team that their company no longer fits. Whatever the management's instincts may be at this stage, there is a need to explore whether there is a real opportunity. This can often be difficult for the team, for whom there are conflicts of interest, and they may not want to ask the question for fear of appearing disloyal. In addition, they clearly cannot supply external advisers with any confidential information without clearance from their parent company.

It is important at this stage for the management team, together with their advisers, to try and understand the dynamics of the situation. If the company is privately owned, what are the vendors' circumstances, do they require the money, are other family members involved etc? If it is a corporate, what is currently driving the corporate strategy, how best is the whole subject approached of whether divestment is a possibility? It is vital to establish at the outset whether this is an actual opportunity. Too often, vendors are happy to test the market place and obtain a free valuation but actually have no real intention of selling.

Many owners, both private and corporate, also have reservations about dealing exclusively with the management team. If the management team are to find themselves in an auction, what is their competitive advantage? The fact that they manage the business and have an intimate knowledge of it may not give them a sufficient advantage over, for example, a corporate acquirer who also knows the market well. A number of trade buyers may be prepared to purchase the business and integrate it within their own management structure. The MBO team need to assess how important they are to the business and whether they can defend their position against a trade acquirer.

Being able to argue a strong competitive advantage can decide how the vendor proceeds with a sale. In a recent example, a large corporate announced its intention to sell a subsidiary on the open market. The MBO team and their advisers recognised that there would be substantial interest from an overseas agent who was familiar with the business and could potentially outbid the management team. The key to that MBO, above all others, was to dissuade the vendors from taking it to the market place. Right at the outset a coherent set of arguments was put together to persuade the vendor that to take the business to the market would be detrimental and they agreed to deal exclusively with the MBO team.

Identifying issues from the outset, and developing the strategies to deal with them, can make the difference between success and failure.

Venture capitalists are spoilt for choice; if they come up against a problem with one buy-out, they are just as likely to move on to another one. For most management teams, however, there is usually only one chance. The issues may look straightforward but often it is difficult for the management team to perceive the broader picture and identify key priorities. The input of an experienced adviser can definitely help put strategies into perspective and contribute to the successful outcome of the deal.

Management team

Historically, there has been a view that if you back the right team, whatever the business or the market, you will make money. Although today's investors are far keener to review sector issues and the company they are buying into, essentially the core of any MBO is still about having the right team for the business.

The management team needs to do some navel gazing about themselves. How well do they know the sector? Have they been involved in the sector for 10–15 years or are they relatively new arrivals? When the going gets tough, the survivors are those who really understand the dynamics of their sector. Do they have a good track record in the sector and preferably in the company they want to buy?

The motivation of the buy-out team will vary and, of course, being in charge of their own destiny is often a key component. The bottom line is, of course, that they must want to make money within a reasonable timescale. Their objectives need to align with those of the venture capitalist: to create value and exit within 3–5 years. Lifestyle aspirations such as running the business until retirement, handing on a business to their children or simply protecting their jobs are not favoured by investment houses.

The configuration of the management team should also be clear. Who are the sponsors of the buy-out? Who is key to driving through the strategies and delivering value? Do they have in place all the people that they need? As part of a large organisation, for example, it is quite common to have finance or marketing handled centrally. Increasingly, not having a complete team would not prevent a deal going forward but new team members should be brought in at an early stage.

The quality of the team is crucial and hard decisions will often have to be made to ensure that the team is strong enough to achieve every

goal. Is the company's financial controller, who currently reports to a group finance director, good enough to step into the finance director role after the buy-out? The interests of the company must come first, over and above personal relationships. How the team handles this part of the process is often a good indicator of whether the buy-out can be carried out successfully.

Underlying strategy

Strangely, it is often quite common for management teams not to have thought out their strategy properly. This is particularly the case with corporate buy-outs where the strategy for the stand-alone business is likely to be very different to that of the group.

What would we do with this business if we owned it? What is our strategy in the market place? Many people will often rush into the business planning process without first thinking about these issues. However, the strategy is the bedrock of the buy-out and everything else is the detail that sits on top – primarily, investors are backing the management team and their strategy to add value.

The management team must look at how they can create profit and cash flow. Can they shake out the balance sheet and create any value there? Sometimes their actions will have been constrained by the previous owner and they need to be open-minded about their options. Are there opportunities to acquire and should they be considering a consolidation play to increase profits?

It is also important to have a view on the exit route, although this has not always been the case. A number of apparently successful buy-outs during the 1980s failed to put exit criteria in place and, when the United Kingdom hit recession and the investors wanted out, there were no buyers. Thus, today, from the outset, venture capitalists are not only interested in getting into the right business, but are also considering how to get out and realise their investment. It is equally important, therefore, for the management team to have their own exit strategy. How are they going to get out? To whom are they going to sell the business?

Market place

Is the business in an attractive market place as far as the venture capitalist is concerned? Typically, the dynamics of an attractive market place are

defined as one that is relatively stable, has some growth, where prospects generally look good and there are a limited number of players.

Historically, there have been some no-go areas – for example, property development, the construction industry and textiles. It is possible to do deals in these sectors but you need to be a major player for it to be a realistic option. For example, while the textile market in the United Kingdom has suffered due to cheap imports, there are a number of success stories where companies have been able to source successfully overseas and create profitable niche businesses. Businesses such as these could be possible buy-outs. However, failing businesses that have not repositioned themselves in unattractive sectors will probably not be buy-out candidates.

Whatever the sector, the closer a company is to a monopolistic position the more attractive it will be to venture capitalists – who are traditionally risk-averse. A dominant market position and good performance (preferably under the proposed management team) present the right profile for investment. Occasionally, businesses do under-perform but, if there have been any hiccups in profitability, the management team must be able to demonstrate that they were not responsible and that this was attributable to other factors, if they want to be taken seriously.

Cash-generative businesses are particularly favoured for buy-outs. After buy-out, the company will need to make repayments and there will clearly be interest costs. If a business requires high capital investment both to operate and maintain its market position, it will be potentially less attractive.

It will be rare to find a business that has all the desired attributes, but the closer you are to achieving all of them the better. One management team, with a business that had lost over £10 million in the previous year, is now successfully running its own company. They were able to demonstrate that the losses were due to a group strategy of expanding overseas, while they personally preferred to concentrate on their core business in the United Kingdom. They also held a virtually monopolistic position in a number of the markets in which they operated, all of which had sound long-term prospects.

Prospects for management buy-outs

The future for MBOs is currently rosy. The volume of transactions may be down but, for good-quality businesses, there is a vast amount of venture capital currently looking for investment.

There has been much talk about the downturn in the economic climate but recessionary environments can actually benefit some businesses. The monetary depression in the United States is actively fuelling MBO transactions in the United Kingdom as US businesses offload overseas and non-core investments to service debts in their home market. This trend looks set to continue and, as the UK recession deepens and vendor expectations about the value of their businesses are adjusted, there could well be far more activity to come.