



topical tips

Management Buy-Outs and Buy-Ins

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For some, the route towards owning their own business will be through starting up from scratch. For others, there is the option of taking over an existing business either by way of a Management Buy-Out (MBO) or Management Buy-In (MBI).

An MBO or MBI offers managers a unique chance to own their own business, however these are not simple transactions. Often the process can be very complicated and extremely demanding.

What is an MBO?

An MBO is when a business is sold to members of the existing management team. It will often occur either as the result of a large company seeking to dispose of parts of the business, or as the result of the existing owner-manager looking to retire.

What is an MBI?

An MBI is when an outside management team buys a stake in or the whole of an existing business. This usually occurs when the

business is financially under performing, where the owner realises that the future growth of the business requires a more knowledgeable and experienced management team.

The need to appoint an advisor

The MBO process involves a great deal of negotiation with vendors and financial backers. At the same time the managers are still required to run the business. Likewise, the process for an MBI is equally time-consuming and complex. The management team will

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usually have existing commitments that will need to be considered.

As a result additional resources are essential to drive either process through to a successful conclusion. An advisor, like Devonshire Corporate Finance, should have the appropriate experience and expertise to provide innovative solutions to all the material issues, which arise during a complex transaction.

They should have a commercial attitude combined with a knowledge of businesses in almost all sectors. In particular you should look to call on their help to:

- provide preliminary advice on the feasibility of the buy-out/buy-in;
- advise on the preparation of a business plan and financial modelling;
- provide an independent valuation of the business;
- advise on the raising of finance from appropriate sources;
- carry out due diligence work;
- conduct negotiations with the vendor;
- provide tax advice to optimise clients' personal and corporate tax positions;
- project manage the work of other professionals through to completion.

Feasibility of the plan

It is important that the proposed transaction benefits both the management team and the business going forward.

Discussions with the management team and your advisor should critically appraise and assess the target business. Not just a review of the management's plans and projections in terms of their likelihood of success, but a proper reality check on deliverables.

Valuation of the business

With their expert knowledge of the business, the MBO team is likely to have a good idea of how much they think it is worth. However it is very important to take professional advice in order to exploit favoured status and devise vendor consideration options which can reduce cash flow for the management team, but enhance the net proceeds received by the vendor.

The level of risk in acquiring the business will also affect its value. Risk is increased in situations where the business has a history of trading losses or relies on a small number of key customers, suppliers or contracts. The requirement of the team to borrow heavily to finance the transaction will also increase the risk.

Raising finance

A major consideration for both an MBO and an MBI team is how they will finance the transaction. Raising finance requires careful consideration, approaches to appropriate potential sources of finance and skilled negotiation.

Stage 1 – The appraisal process

The first stage of the process is to make a thorough appraisal of what the funding requirements are, what resources the team can invest, as well as consideration of vendor financing possibilities.

Stage 2 – The business plan

All potential funders will want to see a business plan. The team may or may not have already drafted a business plan. Whether you have or not, your advisor's role is to ensure

that the business plan is complete and will stand up to scrutiny from a potential finance provider.

Stage 3 – Identification of potential funders

Searching for appropriate funders is a time-consuming process and your advisor's role will be to take on this work so that you can concentrate on your other commitments.

Stage 4 – Funding the transaction

The method of funding a transaction is an area where the advisor will use their experience to arrange the appropriate debt equity funding mix (gearing).

Broadly the gearing (leverage) is the ratio of debt to equity in a company's financial structure. High levels of gearing are associated with greater financial risk for two reasons;

- a highly geared company is a potential credit risk and might be unable to repay debts or interest;
- annual earnings for shareholders are generally more volatile as gearing increases.

Stage 5 – Negotiations

Once potential funders have been identified it will then be necessary to agree terms of the funding. Obviously the team will want to obtain the funding on the best possible terms. However, bear in mind that the potential finance providers will need to meet their return on capital objectives.

An active lead is essential to ensure a successful negotiation outcome. In a position of impartiality, your advisor should be able to liaise directly with both sides to help iron out any problems which could hold up proceedings.

10 practical tips for a successful MBO/MBI

1. Summarise the main objectives of the transaction in a profile
2. Appoint an experienced advisor
3. Obtain preliminary, independent advice on the feasibility of the project
4. Be realistic in your valuation of the business
5. Consider how much finance is required and for how long
6. Make sure that your business plan can stand up to potential funders' scrutiny
7. Undertake due diligence to quantify areas of commercial and financial risk
8. In negotiation, be aware of the vendor's objectives. Be reasonable and realistic in your demands
9. Be patient. The transaction is likely to encounter problems at some stage, these can nearly always be overcome
10. Do not spend too much time on the deal at the expense of your existing commitments

Stage 6 – Completion

Once terms have been agreed, you will need to ensure that the contracts drawn up reflect the agreed terms and provide the necessary legal protection. Your advisor will need to make sure that this is the case, as well as make sure that the deal is structured in the most tax-efficient manner. Often this can help to bridge the gap between the two parties.

Initial Offer

In making the initial offer, the team should also take into account the competition. Initial offers are usually made on the low side with the expectation that the vendor will ask for

more. Room should be left to improve the offer if necessary.

Once satisfied with the proposed valuation and that the necessary finance can be procured, the initial offer should be submitted.

Due diligence

An MBI team will want due diligence to be performed on the business to provide them with an independent assessment of that business's financial risks and help them quantify areas of commercial risk.

Legal due diligence will provide assurances that ownership of the key assets rests with the vendor. It will also give information on any

onerous contractual obligations or lawsuits past, present or pending.

Negotiation of the final terms

With their detailed knowledge of the business, an MBO team should be in a relatively strong negotiating position. Problems and weaknesses identified in due diligence should also give an MBI team a position from which to negotiate. During negotiations, requests for a lower price or insistence on tougher terms should be kept reasonable.

Completion

It is especially important that the communication channel is kept open through to closing the deal. The team should always bear in mind that there are two sides involved in completing the deal, they should try and see things from the vendor's perspective too.

A number of different advisors will be involved in the transaction. An independent advisor will ensure that communication runs freely between all parties and take on responsibility for managing the process through to completion.

For further information about Devonshire Corporate Finance and how we can help you achieve your ambitions, please contact:

Marc Fecher
Devonshire Corporate Finance Limited
Devonshire House
60 Goswell Road
London EC1M 7AD

mf@dcfl.co.uk



DEVONSHIRE
CORPORATE FINANCE

Devonshire Corporate Finance Limited

Devonshire House, 60 Goswell Road, London EC1M 7AD

Telephone 020 7566 3583 Fax 020 7689 6783 email cf@dcfl.co.uk www.dcfl.co.uk

Registered in England No. 1516845 Registered Office: Devonshire House, 60 Goswell Road, London EC1M 7AD

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