

ADVICE FOR FDS UNDERTAKING MBOs

The following briefing on the key points to consider when undertaking and exiting management buyouts is based on advice from Mark Barrow and Henry Wells of Close Brothers Corporate Finance.

The team

Does the current team have complementary skills and personalities? In addition to the business plan, this will be one of the key investment considerations for the venture capital investors:

- Will the current team need to be supplemented with any other person?
- Role of a chairman/industry figure. Many VCs like to put a non-executive chairman or industry figure mentor onto the board.
- What, if anything, will be lost by becoming detached from the current group/owner?
- Has the team been assembled for the right reasons? Are they just frustrated with their current situation or are there other strategic reasons?

The business plan

The business plan will be one of the team's core planks to its MBO and will drive a number of the investment and banking decisions. There is endless literature on how best to write a business plan, and while there are a number of key areas that must be covered (a financial summary with historic and forecast financials, the operations of the business, the opportunity for the business, the market and your competition), Barrow and Wells advise that the most important feature of this document is that it is readable (an investment story

which avoids jargon and too much detail) and credible (reality is always different from the plan, especially when forecasting more than two years into the future).

Depending on who the reader of the business plan is, finance directors should consider their requirements. A traditional VC investor will be looking for:

- Continual growth
- Strong cash generation
- 2-4 years of expansion
- The exit opportunity – who the business can be sold to and whether it can be correctly positioned at the time of sale.

Timing

There is no correct or incorrect time to carry out an MBO. But to the extent that the MBO team has some input on timing, factors to consider include:

- Carrying out an MBO is time consuming and time intensive at times – especially for the FD – so consider when the team's less busy periods are likely to be.
- At what stage are the current year financials likely to be in the bag? It is much easier to sell the business (as the MBO team is selling the business to the potential VC) once those critical months have been secured.

Financial backing

There are now more than 150 VC firms that are members of the British Venture Capital Association that will invest in MBO activity. The range and amount of money that different VCs will invest varies enormously, and finding the right backer is critical. Advisers can assist, but points for consideration include:

- How much equity investment the MBO will require.
- The VCs track record with previous investments.
- The length of time the VC wishes to hold an investment.
- The manner in which the VC deals with its investee companies (ask to speak to other MBO teams they have backed).
- The VC's ongoing costs and requirements.

Depending on the type of investment, at least half of the acquisition price will be provided by bank debt. Advisers and the VC will be able to advise on the debt providers and the optimal way to structure the deal. The MBO team will also be required to invest in the venture. This may take the form of shares being rolled over, a loan from the VC or security over the managers' personal assets.

Structuring the deal

A specialist corporate adviser will spend considerable time with the MBO team structuring the deal – working on the MBO financial model, and advising on the capital structure to ensure it will reward the performance of the team where growth and the VC's expectations on exit can be exceeded. Considerations in structure will include:

- Cost of equity, quasi-equity and loan notes.
- Amount of debt and agreement of banking covenants.
- Type and requirements of the debt package – senior debt (and working capital facility), mezzanine, use of warrants/bonds.
- Terms of the management equity and ratchet structure.
- Minimising future tax.

The approach

If the idea of a sale or MBO has not been considered by the owner, they will need to be approached. This can be done by the MBO

team, the new VC partner or adviser. Issues that may be raised include:

- Value – individual owners may not judge this solely on a financial return.
- Disposal to other parties – auction process.
- Commitment of MBO team if they are not allowed to try to carry out the MBO.

Due diligence

Both VCs and banks will require extensive due diligence (financial, commercial and legal). This needs to be managed carefully so as not to waste time and money.

Post completion

Having agreed and completed a successful MBO, the job of making it work with your new partner, who will probably sit on the board, begins. There will be new corporate responsibilities and ambitions, but Close Brothers says there will always be an eye on the exit.

Tom Berry

A wide range of Briefings can be found at www.financialdirector.co.uk/briefing

Useful links

- Close Brothers Corporate Finance is at www.cbcbf.com
- Th BVCA is at www.bvca.co.uk
- Mark Barrow and Henry Wells can be emailed at mark.barrow@cbcbf.com and henry.wells@cbcbf.com