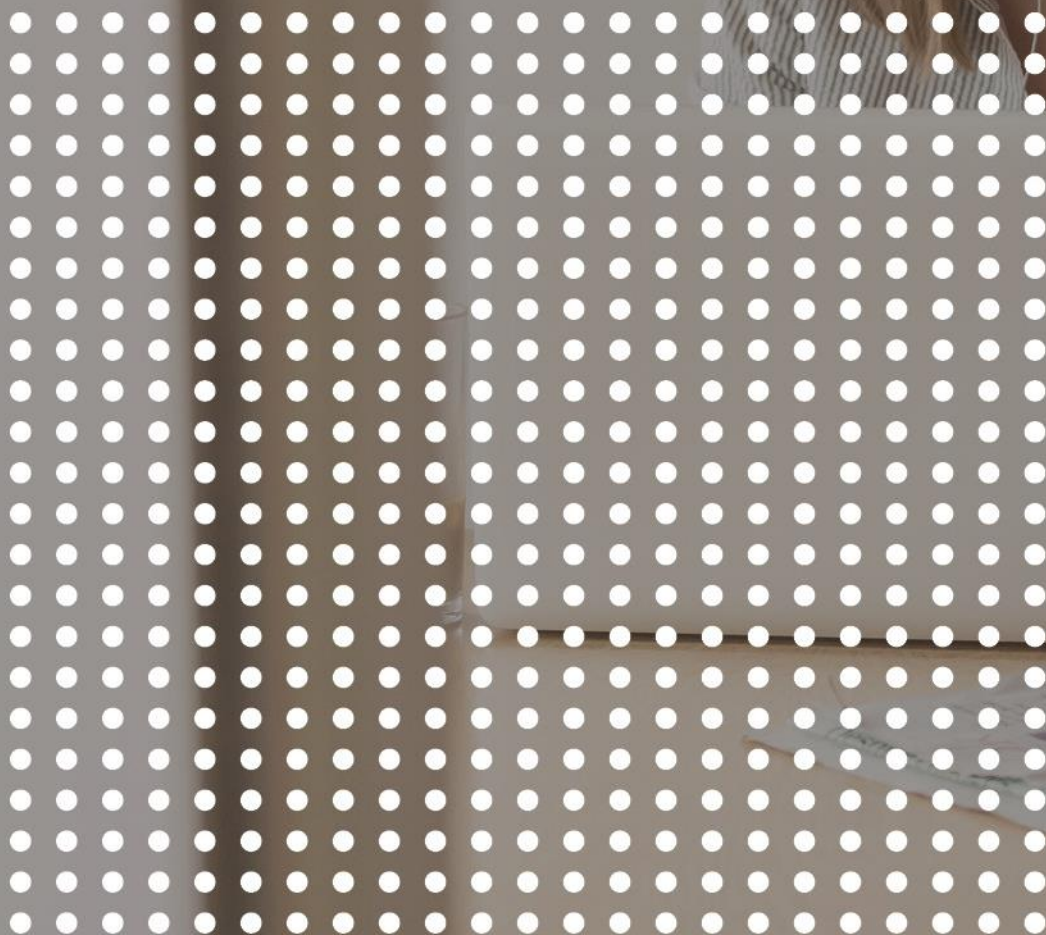


Management buyouts (MBOs)

May 2024



Management buyouts: is this a viable exit route for your business?

A management buyout (MBO) can offer a seller an attractive alternative to a trade sale for many reasons. You might be constrained by a limited buyer universe. Perhaps you have a desire for your company and its heritage to continue 'as is'. Or maybe you're worried about approaching the competition and disclosing commercially sensitive information.

Weighing up the pros and cons of choosing a MBO for your business exit can be complex. Our guide explains what they offer (and what they don't), along with funding options.

What is a MBO?

A management buyout (MBO) is a type of corporate transaction where the management team purchase the business or company (either partially or in full) from its existing owners. It's often structured by forming a new company, aka the "NewCo", to acquire the shares of the existing company and can occur in any size of business and industry.

Is my company a MBO candidate?

Businesses that are typically strong MBO candidates often exhibit:

- an experienced management team
- a track record of profits and cashflow generation that is expected to continue in the future, and
- a seller who is willing to accept a fair and realistic purchase price.

What are the advantages of a MBO?

There are various advantages to this type of corporate transaction. We've set out the main points below:

- **Managed exit** – the management team typically has control over the negotiation process and can work to resolve any issues that arise. Sensitive management information remains within the business, which provides a greater degree of confidentiality and control than a typical trade sale.
- **Reduced transaction risk** – familiarity with the business can help reduce the due diligence process and increase the likelihood of completing a transaction. There's no need to market the business to potential third-party acquirers, so MBOs are generally quicker, cheaper, and easier. Also, they tend to be a good option for businesses that are too small to interest a potential trade buyer.
- **Smooth transition** – management have an in-depth knowledge of the business, which aids the transition process. Employees are often less concerned with a change of ownership compared to a third-party acquirer who may focus on cost savings / synergies. Also, existing clients can be reassured the business continues to operate as usual.
- **Safeguard legacy** – a MBO is an opportunity for a change of ownership, but it is also a safeguard for the business to continue with a known management team (e.g. in family businesses or companies that employ a large proportion of the local community).

- **Retention of management talent** – with a vested interest in the success of the business through their ownership stake, MBOs can be a motivating factor for the management team to remain with the company and continue to drive its growth.
- **Partial cash-out** – provides a mechanism where current business owners can realise all or a proportion of their sale proceeds upfront with the remainder received of time (i.e. vendor funded). In addition, a MBO can be structured with appropriate contractual provisions (e.g. step-in rights) to ensure that the seller(s) have the right to step back in and take control if the company is in financial distress, or certain performance criteria are not met.

What are the disadvantages of a MBO?

- **Valuation** – the valuation of the business may be lower than that offered by a strategic acquirer. Often strategic acquirers pay a premium for synergies or the advantages the acquisition can bring to their existing operations.
- **Unproven business owners** – the management team have limited experience as business owners and may struggle with the different skillset requirements.
- **Deferred consideration** – a lack of funding may result in a significant proportion of the consideration being deferred. The larger the deferred element, the less desirable it is from a seller(s) perspective, and there is increased risk.
- **Risk capital** – typically management are expected to contribute some of their own capital towards the transaction. If they have insufficient personal wealth, they may need to raise capital personally from third-party providers which increases their risk profile.

How is a MBO funded?

Funding a MBO can be complex, it usually involves a mix of debt and equity in addition to management providing a meaningful amount of their own capital (aka 'skin in the game'). While a MBO can be funded in a number of ways, the main sources of funds are:

- **Management contribution**
Management typically invests a proportion of their own personal funds in the NewCo. While the overall amount invested by management may not be material in the context of the overall deal, it needs to be a meaningful amount to each member of the management team — to demonstrate they have sufficient “skin in the game”. This is done primarily to align their interests with those of the Sellers, the company, and any external funders.
- **Vendor financing**
Vendor (i.e. selling shareholder(s)) financing structures vary considerably. In all scenarios, the vendor is helping to facilitate the transaction by deferring payment of part of the consideration / purchase price until a later date. This often takes the form of vendor loan notes, where the purchaser pays back the deferred element from profits generated by the business over time. The loan notes often attract a commercial rate of interest.
Alternative structures, such as taking a minority stake in the NewCo, are another form of vendor financing. These are sometimes used in combination with loan notes. Generally, vendor financing is

a popular option for management teams as it reduces the amount of third-party funding required and can increase transaction certainty.

- **Debt financing**

Traditional third-party debt with fixed repayments of principal and interest over an agreed period is a common way to finance a MBO transaction. Senior debt can be the cheapest source of capital, outside of friends and family.

Other forms of debt include asset-based lending, junior / subordinated loans or overdrafts, and can be secured or unsecured. However, unsecured lending from mainstream banks or lenders is not the norm unless strong and very resilient cashflows can be demonstrated.

Debt financing is suitable for businesses or companies that can demonstrate strong predictable cash flows. Lenders usually require some form of security over the assets of the company / business. Management may also need to provide personal guarantees or collateral to secure the funding.

Bear in mind, the senior lender can require repayment first, prior to repayment of any vendor loan notes — though exceptions to this exist. This could take the form of an annual "cash sweep" with any surplus cash above a pre-agreed level distributed to both the senior lender and vendor loan notes in a pre-agreed proportion.

- **Private equity**

For companies with strong growth prospects, Private Equity (PE) is another potential source of funding. PE can provide capital in exchange for an equity stake in the business or company. This can range from a significant minority through to 100% ownership.

The equity finance provided by PE is often a combination of ordinary and preferred shares or loan notes. Preferred shares are essentially hybrid securities with characteristics of both debt and equity.

The company's Articles of Association will specify how the preference shares differ from the ordinary shares. The appropriate mix of preferred shares or loan notes and ordinary equity depends on the individual characteristics of the business. PE firms may also request a role on the Board or to be involved in the decision-making of the company going forward.

