

# Management buyouts

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Fact sheet



## Introduction

A management buyout or MBO take place when a business is bought from its owner by an existing management team. A key element of the deal is that the assets of the company are used to fund the purchase price (hence in funding terms it is also known as a **leveraged buyout** or **LBO**).

There are a number of different types of management buyouts:

- **MBO** (management buyout): buyout by existing management;
- **MBI** (management buy-in): where the purchase is by a new, external management team;
- **BIMBO** (buy-in management buyout): a buyout by an existing management team strengthened with new external managers and often backed by them or an institutional investor, such as a private equity house.

What they all have in common is that the underlying business is largely unaffected by the sale. The business continues much as before but with a different management team at the helm.

This contrasts with a trade sale, where the process of incorporating the underlying business into the purchaser's group can result in redundancies, a change of name, a sale of assets or even an unwanted subsidiary business as the purchaser makes the changes that it requires for the new business to fit its plans.

This guide is designed to give an overview of some of the issues involved in these transactions, with particular reference to the MBO.

It can only be a general guide and anyone involved in such a transaction should seek expert professional advice.

## Why an MBO?

Typically an MBO produces a lower price than a trade sale but even where a trade buyer is available there may be good reasons for sellers to choose the MBO route.

If management are an essential part of the value of the business, they may in effect control the price on a trade sale (negative reasons).

But the seller may be more comfortable seeing his business in the hands of his employees who have helped him develop it (positive reasons).

For managers, the MBO is an opportunity to receive the rewards for taking the risk of ownership. They will have the chance to own and so fully to control the business and direct its future development in the way they may have always wanted.

## Funding an MBO

Pursuing an MBO only makes sense if the deal is **fundable**. The MBO team is likely to require external funding and critical to the success in securing external funding is the strength and credibility of the MBO team and the track record of their advisers.

It is important to bring on board at this early stage experienced corporate finance, accounting and legal advisers. They will be able to advise on how much is likely to be available and this will inform the discussions on the price and **payment structure** for the MBO acquisition.

Once the feasibility of the deal has been established, a **business plan** will be required with which to approach potential lenders. Funding may come from one or more of a variety of sources, for example loan funding from banks and equity funding from business angels or **private equity** houses. Again, the professional team will advise on where to look for funding and the terms and conditions that are likely to apply to the different sorts of funding.

After taking account of the finance that the management team itself will provide and the likely funding from external funders, there may still be a gap between the seller's expectations and what the MBO team can raise. There are a number of ways this gap can be filled with **seller support**, such as deferring payment of part of the purchase price or making payment contingent on meeting financial targets after completion.

External funders will normally require the MBO team to put up their own money as risk capital and an element of seller support as part of the payment structure will be viewed favourably (and may be a requirement).

Funders are more likely to back a management team that already knows the business than a management team that is new to it (an MBI team) and may require that an MBI team either spends time getting to know the business before proceeding or invites key members of the existing management to join the buyout team.

The amount that the MBO team is required by an external equity funder, such as a private equity house to put up will be a factor of:

- the cost per one per cent of equity to the private equity house as compared to the cost to the MBO team (known as the "envy" factor);
- the "hurt" factor, which is the pain to the MBO team of losing their money if the business flops, calculated by reference to the proposed salaries of the MBO team; and
- the value of the business on acquisition and prospectively on sale if the projections in the business plan are met.

## The deal process

The first steps will be determined by whether the sale is initiated by the seller, the management team or an external investor. In each case, the MBO team will want to establish the critical commercial terms of the deal at an early stage and these will typically be encapsulated in a single document, the **heads of agreement**.

The heads of agreement is a short statement of the main content of the deal before detailed agreements are prepared. Although most of its provisions are not legally binding, it sets out the key points of the deal and in practice, if they are looking for a smooth completion, the parties will not deviate from those terms except where circumstances affecting the business change between signature of the heads of agreement and completion of the sale and purchase.

The heads of agreement will normally contain legally binding provisions on **confidentiality** and **exclusivity**. The seller may require a separate confidentiality undertaking or non-disclosure agreement (**NDA**).

The exclusivity commitment sets out an agreed time period in which the seller agrees not to negotiate with a third party and this allows the MBO team a degree of certainty that the deal will still be available after they have gone through the process of obtaining approval in principle from external funders and completed the due diligence process.

Once the parties are confident that there is an agreed outline of the deal and funding for it, they will start the process of concluding the deal. This involves **due diligence** and negotiation of detailed legal documents.

Due diligence is the process of enquiry and research designed to establish and uncover any liabilities or risks in the businesses being purchased that could affect the transaction or its value.

It can include financial and tax (the inspection of the accounting and tax records of the business, often on site); commercial (research into the business sector of the target business and the target's prospects and position in its industry sector); and legal (the interrogation by the MBO team's solicitors of a broad range of issues in relation to the target business, its assets, liabilities, employees, key customer and supplier relationships, the seller's ownership of shares in the target company and the impact of sale on the business).

Where the MBO team already works in the target business, due diligence will be focussed and limited, for instance to only those items for which the team has no current responsibility or which are of interest to their funders or which may affect value irrespective of the MBO team's degree of awareness (such as tax).

## Legal agreements

At the same time as due diligence takes place, the MBO's legal advisers will prepare the various **legal agreements** required as part of the transaction. These include:

- the sale and purchase agreement (**SPA**) including warranties, indemnities and tax covenant. Where the MBO team already works in the target business, the warranties will be focused and limited. Where there is a new external management team, the warranties will be broad and comprehensive. The seller will prepare a **disclosure letter**, which formally discloses issues and circumstances by reference to the warranties which would otherwise mean that the warranties were incorrect and which the MBO team's lawyers will comment on and agree;
- **loan note instrument** for any deferred part of the purchase price, any supporting security and **deed of priority** with bank or other loan funders;
- **shareholders' agreement** and/or **investment agreement** between the MBO team members and the external equity funders;
- the **articles of association** of the new company (known as the **newco**) which will be the vehicle in which the funding will be placed and which will make the purchase; and
- **service agreements** or **consultancy agreements** for members of the MBO team or with the seller, for instance to cover the handover of the business.

## Conclusion

MBOs are amongst the most difficult transactions to achieve involving a number of different parties.

Having said that, many corporate finance deals are successfully concluded as MBO deals and for those with experience of them, there is a familiar pattern and there are familiar issues.

It is essential to achieve a successful outcome that the advisers chosen have the expertise and experience of acting and advising on MBOs.