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Anatomy of a management buy-out

Common ailments and remedies when considering a private company buy-out

Contents

Introduction

North American M&A activity was robust in 2014, with over 19,574 private and public transactions closed, representing an increase of 5.1% over M&A activity in 2013[1]. As the credit markets continue to open, private equity funds ("PE") have been able to use higher debt levels to fund acquisitions, particularly management buy-outs ("MBO" or "buy-outs"). Buy-outs and in particular those funded by private equity, are no longer rare occurrences. In fact, PE funds and lenders have become more receptive to helping strong management teams take over the reins of successful organizations. PE funds are fond of listing the '3ms of investing', management, management and management! With the right team, a buy-out could be a very attractive opportunity for any PE fund or lender.

Our intention in producing the first installment of "The anatomy of a management buy-out; common ailments and remedies when considering a private company buy-out" is to outline what a successful buy-out looks like, and why you may want to consider one. Along the way we will also highlight common issues we have seen in past transactions, and how to avoid them. Before we discuss the opportunities a buy-out may provide, we must first understand the fundamental details.

> "A vendor who has grown their company over many years has to realistically look at their options when it comes time to plan the next phase of the company's strategic plan. These options can include pursuing a third party transaction (private equity, or a strategic purchaser), winding up the operations, or more common, allowing management to buy a controlling position of the company (MBO). It would be short sighted for the vendor to not consider all of their liquidity options."

Ivor Luk, Partner, Transaction Services

[1] Source: Capital IQ, Thomson Reuters

The backbone

What is a management buy-out?

A management buy-out is the acquisition of a business by its core management team, usually (but not always) in coordination with an external party such as a credited lender or PE fund. The size of the buy-out can range considerably depending on the size and complexities of the business, but one aspect that all MBOs have in common is the core management team taking an equity stake in the business. Depending on the intentions of the current shareholder base, the buy-out will represent a controlling acquisition stake in the business, if not a full 100% acquisition.

The motivation for the buy-out typically arises from the owner/vendor looking to retire and wanting to provide the current management team an opportunity to take part in the future growth of the business. Common practice is to have the management team fund the buy-out with a portion of their own capital in order to ensure they are actively incentivized to grow the company. The amount management is required to invest is typically material enough to ensure their ongoing commitment to the success of the business.

Stakeholder motivations in a buy-out can be complex, but they tend to come down to one thing, value. Current shareholders want to be fairly compensated for their hard work over the years in helping to build the company, while management wants to ensure they purchase the business at a fair price to generate future value. The lenders, too, will expect to participate in this success in some form. These competing interests make buy-outs complex transaction processes; however, with clear communication and setting reasonable expectations, all parties can ensure a smooth transition.

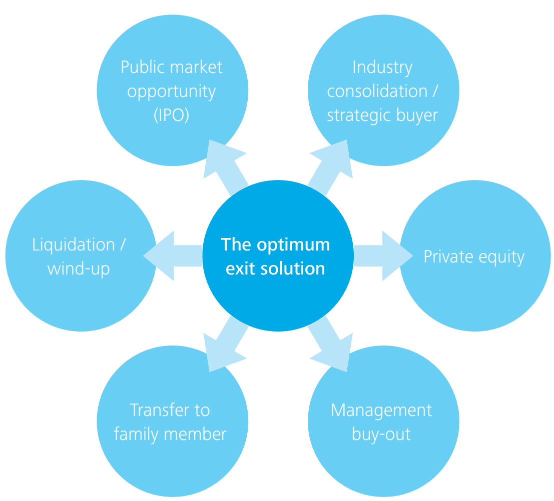
Diagnosing the buy-out

Who should consider a management buy-out and why?

A buy-out can represent a solution to those owners who have a successful company, but don't have a succession plan in place. It goes without saying that without a vendor who is prepared to sell, there is no deal; however, many vendors do not take the time to seriously consider all of their liquidity options.

In some instances, a buy-out may be the vendor's best option due to the nature of the business, and the lack of succession options. For those vendors who are in a position to pursue multiple options (Figure 1) they should consider the elements of a buy-out and the main reasons for pursuing.

Figure 1: Private company liquidity options



Vendor buy-out motivations

- The vendor may pursue a buy-out because they want to compensate management with an equity stake in the future growth prospects of the company. From this point of view, the vendor crystallizes his investment in the company while rewarding the core management team that helped her generate the return.

- Selling to management significantly decreases the risk of exposing confidential information. As an owner it can be unnerving to proceed with a sale process with a third party due to the overwhelmingly sensitive nature of the company's operations. A buy-out represents an opportunity for the vendor to sell a controlling interest in the company without having to provide confidential information to a strategic purchaser (i.e. a competitor).

- Management represents a sophisticated buyer who is already well educated on the operations of the business, therefore the timeline of the sale process may be shortened and the risk of not closing may be less when compared to selling to a strategic purchaser.

- Management may not continue with the business if a third party transaction takes place. In this situation, the vendor may be forced to pursue a buy-out or be handcuffed.

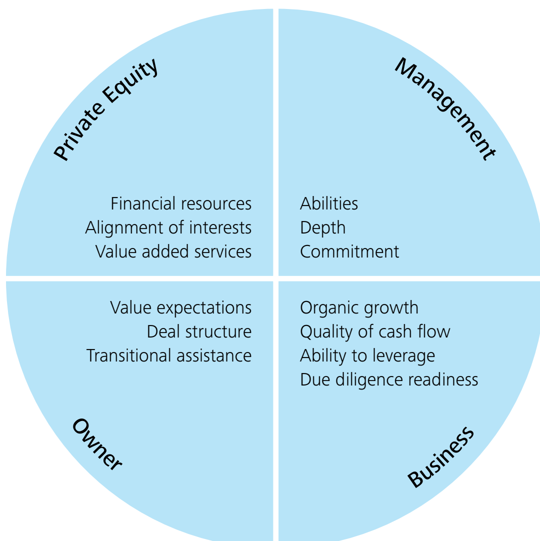
- The cyclical nature and niche aspects of the business may not be understood by an external party, therefore a buy-out may represent the best option for the vendor.

It is important to understand that the key to a successful management buy-out is entering the process for the right reasons. If value is the highest priority for a vendor, a management buy-out may not be preferable as the management team will not have access to the same amount of capital as a strategic purchaser would. These and other motivations are key to understanding what a successful buy-out looks like.

Knowing the patient

Criteria for a successful buy-out and the parties involved

Figure 2: Parties involved in the buy-out and their main interests/ value they bring



The principal conditions that have to be met for a feasible buy-out include:

- **All-star management team** – there must be a sound and well-balanced management team;
- **A strong cash generating business** – the business must be commercially successful;
- **Due diligence planning and readiness** – the business must be in a readily saleable condition to take to market;
- **Private Equity** – there must be a willing private equity group prepared to provide capital and expertise, and the buy-out must be capable of supporting an appropriate funding structure.

Each condition is discussed below.

All-star management team

The quality of management is, without exception, the most important consideration in any management buy-out. Investors are generally looking for a balanced team of managers who work well alongside each other and cover the key areas of the business. Leadership is quintessential, but a successful buy-out is a joint effort by the right mix of managers.

Management should expect to present and defend their strategic business plan and how they expect the company will grow in the future. Lenders and PE firms will want to see a strong cohesive management team that has a clear picture of where they want the business to go and how they will get there. It is not enough to have a growth plan in place, management needs to be able to defend it and demonstrate a strong understanding of the business dynamics.

A strong cash generating business

It is of fundamental importance both to the short-term and long-term success of the buy-out that the business is capable of operating independently as a commercially viable entity. The business needs to be able to generate adequate profit and cash to sustain the business as it develops, provide an adequate return to shareholders, and support ongoing capital expenditure requirements, if necessary.

Due diligence ready and deal planning

Well prepared businesses are optimally positioned to respond to the many challenges that will come through the due diligence process, led by not only financial lenders but also the private equity sponsors. For a company that is not prepared this can be a daunting process. Once the structure of the deal is determined, the institutional investors and lenders will wish to commence their due diligence enquiries. The object of this exercise is to ensure that there is nothing which contradicts the financiers' understanding of the current state and potential of the business. Key due diligence elements include:

- **Commercial due diligence:** Research of the products, and customers of the business and the markets in which it operates, often carried out by the investing institution itself.
  - The company can be ready for commercial due diligence by preparing a well thought out (vetted) strategic plan with which the vendor and management are fully aligned.
  - Understanding the key products of the company, the markets that are crucial for the success of the company, and which customers comprise the backbone of the market are critical when going through commercial due diligence. Management especially must demonstrate a thorough understanding of these bases, along with detailed data that quantitatively supports their claims.

- **Market report:** The commercial due diligence may be reinforced and amplified by a marketing study carried out by consultants.
  - Management should understand their product markets thoroughly and be prepared to answer questions about market positioning, share, and growth opportunities. If management believes there are new markets that can be penetrated, they need to demonstrate a thorough understanding of the market and a potential execution strategy. These claims need to be supported by quantitative data.

- **Accountants' report:** The content will vary, but accountants' reports generally include a review of the historic performance of the company, net asset, taxation position, and assumptions underlying management projections, along with the quality of earnings and working capital considerations.
  - Ensuring the business has well detailed and high quality internal accounting reports will help ensure the accounting due diligence goes smoothly. This can be achieved by working with your accounting advisor early on to ensure internal processes are of high standards.

- **Legal due diligence:** This will tend to focus on the implications of litigation, title to assets (especially property), and intellectual property issues.
  - Working with the company's legal advisor to ensure records are in order is key.

Private Equity – (the PE firm and/or mezzanine lender)

In recent years, capital has become a commodity with large PE funds and small family capital houses flooding the market.

Key to the buy-out is ensuring not only that the PE fund has the financial resources to finance the buy-out and future growth of the company, but also that it brings the right sector expertise to help the company grow and generate significant shareholder value. As advisors, we have seen the proliferation of niche PE focused funds in high growth sectors such as organic foods and test and measurement. These funds are not only well capitalized, but well educated, and can help formulate targeted strategic plans that are unique to different sectors. Management must thoroughly research and understand the focus of the PE fund before they move forward with the buy-out.

All of these elements of the buy-out must be considered before a deal is closed. Once parties are aligned, the structure of the buy-out must be determined.

"Selling to management has its advantages, including the ability to preserve confidentiality and limit due diligence; however, the valuation obtained tends to be lower than other options due to management's limited access to capital. As a result, the seller is often required to finance part of the purchase price through a vendor take back."

Kenneth Johnston, Partner, Valuation

Finding the right physician

Funding requirements and the structure of a buy-out

The total finance required for a buy-out will be made up of the purchase price, transaction costs, any funding required for capital expenditure or working capital, any bank debt taken over, and a potential vendor take back. By definition, a vendor take back is a type of consideration often used by buyers to finance or bridge the total purchase price gap between the vendor and the buyer. In most instances, the vendor take back is in the form of annualized payments over subsequent years after the transaction closes.

The business must be capable of supporting the buy-out financing from the cash it generates from its operations (i.e. it must be able to service the funds raised to effect the buy-out). It follows that there is an upper limit on the price that can or should be paid for the business. It is therefore essential that a sensible valuation for the business is arrived at an early stage.

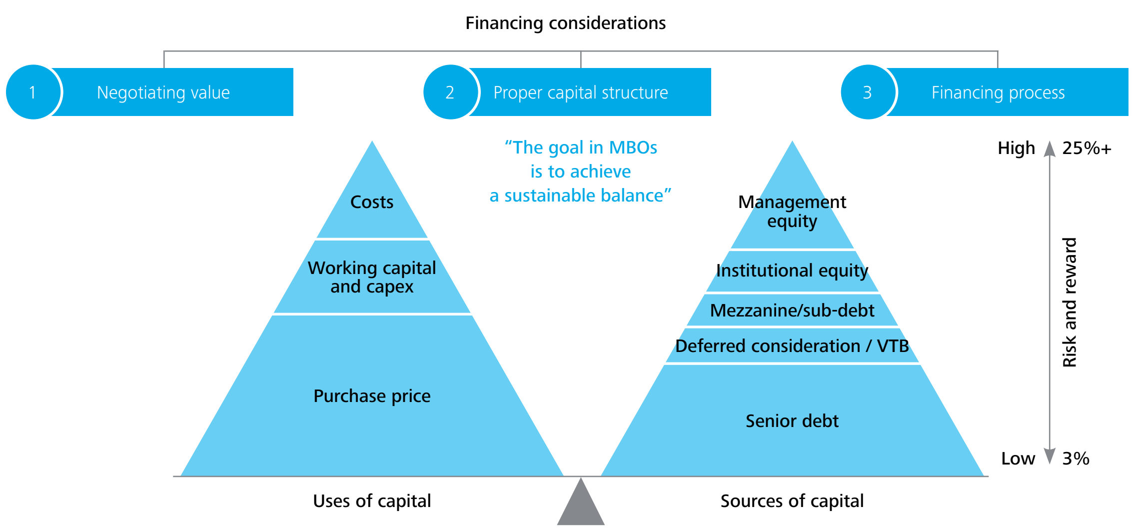
Valuation and price

To overpay for the business is the cardinal sin of management buy-outs. To do so dramatically increases the risk in the investment as it becomes possible for a business to perform reasonably well and yet still fail to achieve a return for the investors (and particularly managers) when they come to sell. Conversely, the vendor will want fair compensation for the business they helped build, which can create tension between the management group and the vendor, which is why setting clear value expectations going into the transaction is crucial.

Valuing any company is not an exact science and there will always be an element of judgment in arriving at the price.

Broadly, there are three methods employed: market based valuations, net asset valuations, and discounted cash flows.

Figure 3: Financing considerations when assessing a management buy-out



> "Management is faced early on in the buy-out process with the greed question – simply, if management tries to fund the deal with a higher portion of debt and less outside equity, then they will inevitably receive a larger slice of the pie. However, management must evaluate the long term prospects of bringing in an equity partner which will reduce the company's risk exposure to too much debt, thus making it a safer investment, and providing operational flexibility, and even access to expertise. Although equity is the most expensive source of capital, management must evaluate all options in order to meet the optimal capital structure moving forward."

David Lam, Partner, BC Mid-Market Corporate Finance Leader

Market based valuations

This method can be broken into transaction multiples and public company comparable multiples. Market based valuations are one of the most commonly used measures of value in financial circles. These valuations express value in terms of a multiple of profits and provide market feedback on value. Transaction multiples relate to researching transactions in the target sector over several years in order to determine an average multiple, although this may be at a discount to public company multiples to reflect non-liquidity status.

Net asset valuations

It can be argued that the value of the company is simply the valuation of the assets less any liabilities that it has on its balance sheet. However, it cannot provide an accurate guide to the price that should be paid because the balance sheet is usually months out of date. The market value of an asset may be materially different to the book value shown on the balance sheet, and for certain businesses, the value of the assets is no guide to the cash generating ability of the business. In other words the book value of assets may not be the value of the business. The net asset approach can be a useful secondary valuation approach depending on the nature of the company.

Discounted cash flows (DCF)

The principle of DCF is that the value of any asset is the present value of the future cash flows it will generate. This valuation method uses the cash flow projections of the business and the cost of capital raised to finance the transaction.

Overall, the right price is essentially a matter of judgment. You and your advisers must agree to the absolute maximum price you are willing to pay. This 'walk away price' should be borne in mind throughout the negotiations. Managers and prospective investors will often have differing views of the value of a business, with investors typically erring on the side of caution.

Types and sources of finance

Most buy-outs are financed through a combination of debt and equity; other hybrid sources such as mezzanine and vendor takebacks may also be used and these are discussed later on. These sources have fundamentally different characteristics, but in general, management should pursue capital from the cheapest source first (senior debt) and then entertain more expensive sources (equity, sub debt etc.). Sustainable balance means funding to pay a fair price that allows management to earn upside but still leaves enough room to grow the business, execute the plan, and weather the inevitable storms along the way.

Debt

Senior debt is the cheapest source of capital (other than family and friend monies). Debt may include bank loans, overdrafts, or lease financing and may be long-or-short term, secured or unsecured. The lender receives interest at an agreed rate, and in the event that this is not paid may be entitled to take control of and sell certain assets owned by the company. A lender does not, however, generally have a share in the ownership of the business. Lenders are favorable to a buy-out because there is typically a strong management team in place that will ensure the success of the company moving forward. The lender typically receives security on the assets of the company, and the management team may also give personal guarantees. With this type of security, the lender would be more than happy to finance the acquisition up to a reasonable leverage amount.

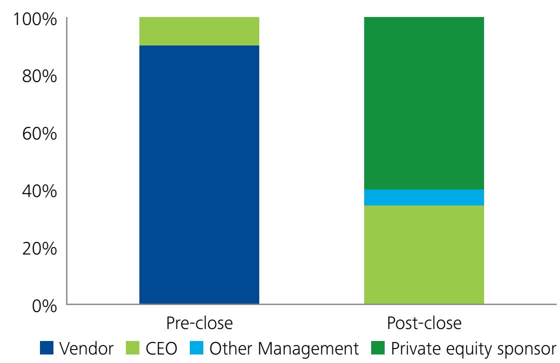
Mezzanine debt (or sub-debt)

Mezzanine finance is often used to bridge the gap between the secured debt a business can support, the available equity and the purchase price. Because of this, and because it ranks behind senior debt in priority of repayment, unsecured mezzanine debt commands a significantly higher rate of return than senior debt and often carries warrants to subscribe for ordinary shares.

Equity

Equity is the term used to describe shares in a business conveying ownership of that business and represents the most expensive source of capital. Management needs to consider the different funding options available and what the optimal capital structure is for the company. An example of a pre-transaction and post-transaction capital structure may look very similar to Figure 4.

Figure 4: Pre-close and post-close equity structure buy-out example



In this example, the vendor is completely bought out. The CEO and other management obtain almost 40% of the company, while the PE fund (sponsor) acquires 60% of the company for a controlling position. This arrangement will vary depending on the specific transaction and what is required.

Private equity is the most common capital source for buy-outs, with the majority of PE funds seeking to invest in established, expanding companies that can generate significant investment returns (25%+).

If a business fails, the shareholders will only receive a distribution on winding up after the lenders and creditors have been paid. An equity investment, therefore, has a higher risk attached to it than that facing a lender and thus, the return shareholders demand is typically higher.

When putting together an appropriate structure, it is important to consider the following:

- Cash flow is the most important factor and it is of crucial importance that the buy-out team has a detailed understanding of projected cash flows. Profit generation is important, but capital expenditure, depreciation, interest, dividends and other factors such as restructuring costs come into the equation, making cash generation the key driver of valuation.

- The 'quality' of the cash flows is another consideration, which includes the predictability of future orders (backlog), the prospects for the marketplace, and the types of customers. The higher the quality of the cash flows, the more debt a company should be able to raise.

- Depending on the nature of the company's trade there may be certain periods when expenditure exceeds income. Likewise, the timing of tax payments and outflows may dictate when the company will be short of cash in certain periods. When determining an appropriate structure it is important to plan for these fluctuations.

- In general, at least some of the bank debt will need to be secured by assets held by the company. In addition to the projected cash flows, the banks will also consider the realizable value of the assets they will take security over.

- Tax considerations such as the tax deductibility of interest (but not dividends), and the timing of tax payments.

The various sources of finance, the range of financing alternatives, and the number of factors taken into account means that securing a buy-out is a matter of integrating different layers of funding. This provides a structure which enables the purchase price to be paid yet enables the business to operate with some freedom in the future.

In general, the deal structure will be put together by the financiers in conjunction with the buy-out team's advisers. However, it is important that the team has an understanding of what the financiers are trying to achieve. The main criteria of the various finance providers are as follows:

Debt Finance

Evaluating the level of debt that the business will support is the first step to coming up with a financing structure. As noted above, this will generally depend upon the cash flow of the business, the asset coverage available, and the interest coverage – the bank will have certain guideline ratios in mind for each of these. Most debt will be required to be repaid within a defined period – typically 5-10 years depending on the business. Among the key features to look for in any debt package will be:

- The interest rate;
- The repayment profile;
- The security required; and
- The financial covenants.

"Tax is an important consideration as management evaluates and implements a buy-out. The personal facts and objectives of each member of management involved will differ from each other and compared to those of the vendor. As a result, the investment structure, including vehicle, funding and compensation, needs to be tailored. Furthermore, these structuring aspects can significantly impact future cash flows, and hence, ROI, of the investment."

Brad Gordica, Partner, M&A Tax

Equity Finance

The level of equity may be influenced by the amount of debt that the business can support. Often equity will comprise of common shares and preferred shares ("ordinary shares"); the latter usually attracts a fixed interest and may well be redeemable within a defined period. The holder of the former are entitled to participate to an unlimited extent in the ownership of the company – which includes the associated risks and rewards. It is in this class of equity that managers will normally invest in.

On a sale of the business the loan stock is redeemed and the ordinary shareholders would then split the rest of the sales proceeds between themselves according to their ownership stake. It is at this stage that the investors hope to make most of their return.

The key features to look for in any offer of equity finance will include:

- The deal structure (the relative split of ordinary shares, preferred shares and other instruments);
- Management's equity share (and the funding that they are required to provide);
- Whether any equity stake is dependent upon achieving a particular level of performance (a ratchet);
- Non-financial terms such as any constraints over the operations of the business; and
- The dividend and interest structure.

Vendor Finance

Vendor finance can be either in the form of deferred loans from, or shares subscribed by, the vendor. The vendor may take shares alongside the management in the new entity. This form of finance has been more common in the current economic climate as it bridges the price gap between vendors and buyers.

The financial structure will evolve throughout the transaction; however, it is important that at an early stage, the vendor, the management team, and their advisers arrive at a rough outline of the structure that they believe is appropriate, as the financial structure often determines the price an investor can afford to pay for the business.

Figure 5: This table illustrates the key owner objectives and how they align with the strategic options available

Owner objectives	Financial investor	Strategic	IPO	MBO	Leveraged recapitalization
Liquidity	✓	✓	✗	✓	✓
Valuation	✓	✓	✓	✗	✗
Continued ownership	✓	✗	✓	?	✓
Operating control	✓	✗	?	✓	✓
Funding for growth initiatives	✓	?	✓	✗	?
Current market environment	?	?	✗	✓	✓
Administrative ease	✓	✓	✗	✓	✓
Future upside	✓	✗	✓	?	✓
Retain culture	✓	✗	?	✓	✓

Treating the complications

Common issues when performing a buy-out

The nature and structure of each buy-out will be different; however, understanding the common mistakes is the first step to ensuring a successful process. Common pitfalls include:

- Not considering all possible options before pursuing a buy-out, which may lead to regret or re-trading as the process proceeds. The vendor of a successful business has a number of options when it comes to crystallizing their investment. As such, they must proceed with a thorough analysis of what option best suits their particular situation, and where they can generate the most value, whether that be the quantitative gain or the long term stewardship of the organization.

- Initiating the deal without considering both parties perspectives and not ensuring the alignment of all stakeholders' key objectives is one of the most common pitfalls as it creates an environment of re-trading.

- The impending possibility of a buy-out may lead to principal-agent problems, moral hazards, and perhaps even the subtle downward manipulation of earnings so that management can get the best deal possible.

- Management approaching the owner with a buy-out or walk scenario, which may make the owner feel handcuffed into doing the deal – almost blackmailed – and can create significant animosity between the parties and hinder the buy-out process. There must be a mutual alignment between the owner and management.

- Does the management team have the appetite to do what is required to make the buy-out work, and are they ready to be owners? Is there a clear leader who can take control of the process and speak for management, or is it a diluted structure? These are key questions management must ask themselves before entertaining a buy-out.

- Has the vendor, and management communicated effectively with staff about the potential transition, or have they let rumors abound unmitigated.

- Asymmetric information possessed by management may offer an unfair advantage relative to current owners, which needs to be considered in the purchase agreement through reps and warranties.

- Determining if the business is ready to go through a sale process. Underestimating time/effort required to complete a successful buy-out is more common than not in transactions.

- Typically management underestimates the personal commitments and securities that the lender will require to fund the buy-out. Management should discuss the requirements early on so that they understand the responsibilities attached with the transaction.

All parties' objectives and perspectives have to be considered and aligned at the earliest possible stage of the buy-out process to ensure a smooth transition. Management and the vendor should ask the hard questions early on and not enter into the buyout process blind. By avoiding common pitfalls, all parties will be in a better position to achieve their transaction goals.

Management buy-out success story

R.S.T. Instruments Ltd.

Overview

R.S.T. Instruments Ltd. headquartered in Maple Ridge, BC, is a category-leading geotechnical device manufacturer with products installed in all seven continents and sales in more than 120 countries worldwide. Selling more than 100 original products, RST has gained market esteem as the top innovator in their industry.

Founded in 1977, RST was revitalized in 2004 when three employees purchased RST via a management buy-out. Over the past decade RST has expanded its product line, its employee base, its facilities, and its international distribution. From 2005 through 2013 they experienced uninterrupted growth.

In July 2014, the three shareholders sold a majority stake of their business to a U.S. based, private equity company, Hammond, Kennedy, Whitney & Company, Inc., which resulted in the three shareholders realizing a positive return on their original buy-out investment in 2004.

Process

The core management team was made up of three key figures, the CEO, COO, and Director of Field Services. All three members brought a needed skill to the management team and enabled them to take over RST and grow it.

All three shareholders were required to provide personal guarantees for lenders to support the buy-out.

The key to the success of this buy-out was that all three shareholders had aligning interests and believed in the growth story of RST Instruments.

The vendor at the time was focused on other businesses and understood the value that the management team brought to the table.

A guiding principle during the negotiations was to balance the objectives for the share sale, liquidity, and financing with the need to uphold strong relationships between the vendor and the management team.

Outcome

The purchasing management team acquired 100% of the shares held by the original owner.

A capital structure was put in place to facilitate the company's growth prospects and provide flexibility to operations.

This came in the form of senior debt, sub-debt, and capital from the respective management team.

In the end, the shareholders realized their strategic plan and sold the company for a significant return.

Conclusion

When done right, a management buy-out can provide liquidity to an existing shareholder/vendor while allowing management to take an ownership stake in the business. It can be a win-win for everyone, while ensuring the future success of the business. With over $500 billion in PE fund "dry powder" looking to be deployed, the market for buy-outs is optimal with companies reaping the rewards.

Remember your doctor’s advice

To reiterate, here are the key points of consideration when thinking about a management buy-out:

- Prior to pursuing a management buy-out, it is imperative that the vendor consider all liquidity options available to the company, which may range from a 100% strategic sale to a private equity investment. Entering the buy-out process without fully considering all of the options is a diagnosis for trouble.
- Owners and management should be crystal clear about their own objectives/goals in pursuing a buy-out. Reflect on your deal objectives, whether that be maximizing valuation or securing long term contracts for employees, and let those objectives frame the negotiations going forward.
- Determining a sensible valuation at an early stage in negotiations is important, and contributes to finding the right balance between fair compensation for the existing vendor, while not burdening new ownership with unsustainable debt levels.
- Consider the cheapest source of capital first (senior debt), and the most expensive source of capital last (equity).
- Be truthful and ask yourself, how prepared is the Company to go through a third party due diligence process? If it is not ready, seek out the help of professional services or consultants. Trust us, preventative medicine is far more preferred than emergency surgery.
- Due to the potential complicated financing structure of an MBO, it is important to engage business professionals and advisors to ensure a smooth process.

“The key to a successful MBO for the management team is to as fully as possible transition the management of the business before the buyout occurs. This means having all critical functions managed by the buyers, including sales, operations, research and development, customer service and accounting. This reduces the risk of any ‘skeletons in the closet’, and demonstrates to funders that the management team can successfully run the business, opening up more funding sources, including lower cost debt options.”

Robert Napoli, VP at First West Capital

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- Insolvency services
- Performance Improvement
- Merger Integration

"While MBOs are often regarded as "friendly deals", the seller needs to be mindful that there are inherent potential conflicts of interest for the management group, as they are both the buyer and the agent of the owner. Careful consideration must be given to the working relationship going forward if negotiation breaks down."

Ashton Scordo, Corporate Finance

notes

It is an exciting time for business owners, with more options than ever to fulfil short or long term strategic imperatives. Although misunderstood, like a brown angry bear strolling the quiet streets, management buy-outs will continue to grow as owners look to transition their successful businesses to the next generation of leaders, and perhaps in the process secure jobs of the future.

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