Livingstone

PRACTICAL GUIDE

BUY-OUTS FOR MANAGERS

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Livingstone

Livingstone has set the standard for mid-market mergers and acquisitions advice since the organisation was established in London in 1976. Today Livingstone employs 65 staff across three offices in the United Kingdom, United States and Spain.

Our exclusive focus on unquoted corporate finance advice and experience of completing over 400 transactions has enabled us to build the leading M&A and private equity advisory house specialising in cross-border transactions with values of between £10 million ($20m) and £100 million plus ($250m).

We deliver creative corporate finance solutions to successful entrepreneurs, major corporations and private equity investors around the world from our teams in Europe and the United States. We offer strategic guidance and practical support regarding:

- Exit strategies
- Company sales and divestments
- Corporate acquisitions
- Capital-raising
- Buy-outs and buy-ins
- Debt restructuring

Livingstone focuses on five core sectors and has dedicated teams operating in the Business Services, Consumer, Industrial, Media & Marketing and Technology markets.

We deliver an outstanding service to our clients by creating dedicated, partner-led teams drawn from the significant resources and expertise of our offices in London, Madrid and Chicago.

Our ability to provide clients with a seamless infrastructure for trans-Atlantic deals is unique in the mid-market and supported by an exceptional pedigree for completing cross-border transactions all around the world.

1 The ingredients

What is a management buy-out?

A management buy-out is the purchase of a business by its existing management, usually with the help of financial backers. Over recent years, several hundred buy-outs have been completed annually.

The bulk of the funding will come from financial institutions in the form of equity and debt. Different types of financial instruments have tended to obscure the difference between the two. Debt is usually provided by specialised acquisition finance units of UK clearing banks or investment banks, while equity is provided by venture capital or private equity houses.

The opportunity for a management buy-out may arise in a number of ways:

- a group may decide to sell a business because it has become non-core;
- a company may find itself in difficulties and need to sell all or part of the business;
- the owner of a private company may wish to retire; and
- a receiver or administrator may sell a business as a going concern.

Three factors are essential if a management buy-out is to be achieved: an effective management team, a strong business and a suitable exit opportunity. Each is examined in detail below.

The management team

The quality of the management team is the most important element of a successful buy-out. Financial institutions need to be convinced that the management team has all-round strength and can manage the business independently. Tax, treasury and research and development may have been handled at group level and the management team may need strengthening in these or other respects.

The management team will need to demonstrate a high level of commitment to the buy-out and to the subsequent successful growth of the business.

The equity investors will expect each member of the management team to invest personally. The amounts involved are intended to be significant commitments by the individuals concerned and will vary according to the circumstances but are likely to be the equivalent of at least six months' gross salary. Provided the personal risk is acceptable, the equity investor will welcome a larger investment by the management team. Opportunities for other managers and staff to invest smaller sums can be provided. It is quite commonplace for the leader of the management team to have the opportunity to invest more than other key team members.

In most cases, the leader of the buy-out team will be the present chief executive. It will be his or her job to ensure that the management team is not overly distracted during the buy-out. It is often appropriate to delegate the day-to-day involvement in the transaction to one or two individuals, and for them to provide regular updates for the team.

A strong business

Most management buy-outs involve high levels of debt, especially during the early years. Accordingly, a positive cash flow is required. A business will be less attractive to financial backers if the cash generated is absorbed by additional working capital, uncontrolled growth or a high level of capital expenditure.

As a general rule, the following characteristics help a buy-out:

- a consistent track record of turnover and profit growth or demonstrable scope for improvement;
- a strong competitive position within a growing, stable industry;
- a spread of products and services;
- no undue dependence on any particular customer or supplier; and
- strong asset backing or demonstrable cash generation.

As a result, most businesses lend themselves to a buy-out if they possess the above features. There is a common misconception that 'people' or 'creative' businesses are more difficult to buy out. This is not true provided that the business shares most of these features.

Suitable exit opportunity

As most buy-outs depend upon both equity and debt finance, the repayment of both needs to be considered at the outset.

The leading debt provider will usually expect both interest and capital to be paid back out of cash flow over a specified period, often five – seven years. Debt providers will not want to rely on an exit for the repayment of the loan.

Providers of equity capital, however, will require an exit for the bulk of the profit they expect to make from backing the transaction. In most cases, they want to realise their investment within three to five years of the buy-out. Investors tend to maximise the annual compound rate of return by an early exit.

The probable exit opportunities are:

- a sale of the company to a trade buyer;
- a flotation of the business on the London Stock Market, the Alternative Investment Market (AIM) or Easdaq; and
- the management team may buy out the shareholding of the institutional investor, or even a manager wishing to leave or retire, if the business has generated sufficient profit and has adequate cash or borrowing resources.

In a substantial majority of cases, however, the most likely exit will be a sale to a trade buyer.

For an attractive exit, it is important that the business:

- has achieved satisfactory sales and profit performance for the preceding two or three years, compared with other companies in the market sector;
- is capable of sales and profit growth during the medium term;
- is not unduly dependent upon either one or a few customers; and
- has a management team committed to the development of the business.

Consequently, a management team will have to demonstrate how they will achieve continued sales and profit growth throughout the foreseeable future in order to get financial backing. Attempts by a management team to mount a management buy-out simply to retain their jobs would not receive backing unless the prospects for a successful exit are demonstrated.

As a potential purchaser will generally require the management to continue after the acquisition, the management team should not assume that they will exit at the same time as the institutions.

The casting vote regarding exit is a matter for negotiation. There are likely to be detailed discussions as to the circumstances in which either management team or investors can sell their shares and the rights and obligations of other shareholders in such circumstances. Investors will not want to coerce a successful management team into an exit.

It is quite common for a participating or accelerating dividend to come into operation after, say, two or three years, giving the equity investors a right to a proportion of profits. This form of finance is expensive and is intended to focus the management team on the advantages of an exit. In addition, a majority of the equity investors' investment may be in the form of loan notes or preference shares repayable or redeemable to a fixed timetable, sometimes at a premium.

2 The buy-out process

The stages of a buy-out

Typically, the stages involved and the likely sequence of events are:

- agree on members of the management buy-out team, and the choice of managing director;
- select and appoint financial advisers to the management team;
- assess whether the opportunity is suitable for a buy-out;
- obtain approval or accept the invitation to pursue a management buy-out, if the opportunity is suitable;
- determine or evaluate the vendor's asking price;
- write the business plan;
- meet three or four carefully selected equity investors;
- obtain written offers of financial backing from each investor;
- appoint legal advisers to the management;
- select the preferred lead investor;
- negotiate the best possible equity deal for the management;
- negotiate the purchase of the business, with a cost indemnity and a period of exclusivity;
- carry out due diligence using investigating accountants;
- obtain debt finance and syndicate equity investment if necessary;
- prepare and negotiate legal documents; and
- achieve legal completion.

The business plan

The business plan needs to convince the investor that the proposed buy-out is an attractive investment. It is primarily a selling document and should demonstrate the management team's commitment to the buy-out and the subsequent development of the business.

The business plan should be written by the management team. Their financial adviser should provide a critical and constructive review of the plan and the financial projections. The plan should ideally be no more than 15 to 25 pages long, plus appendices.

A typical business plan should include:

- an executive summary, preferably no longer than one page, covering the main points and setting out the situation with the vendors and the amount of finance required;
- a concise history of the business and a description of the products or services, markets served, distribution channels, location and size;
- an analysis of the market and the competitive position of the business;
- a description of the main assets and any key features of the way the business operates;
- a profile of the management team, their positions and responsibilities, their qualifications and experience plus an overview of the staff; and

- summary results over the last two or three years and projections for the next three years showing profit and loss, cash flow and balance sheets.

The projections should be positive, credible and specific. Where the projections show rapid growth or a change in the nature of operations, the background and reasoning will need to be clearly spelled out.

An indication of likely acquisition cost should be included if known, together with any further funding requirements. It is generally not appropriate to outline funding structure.

The role of financial advisers

The financial advisers should be appointed at the outset and wholly involved until the day of legal completion.

The role of the financial adviser in assessing whether a management buy-out is feasible is a crucial one. If there is doubt about whether adequate backing will be available, it is essential that the financial advisers should check on a 'no names' basis with three or four carefully selected equity investors at director level. No management team should ever pursue a management buy-out unless there is a strong probability of success. Financial advisers must give dispassionate and candid advice on the chances of success. When a management buy-out is not achieved, for any reason, there is a risk that the relationship with the group, or owners of a private business, may be damaged irreparably. Career prospects could well suffer as a result.

If the management team has been invited to pursue a management buy-out, or the owners have raised the possibility in passing, then initiating matters should be straightforward. On the other hand, if a management buy-out has not been mentioned there could be a risk in requesting to pursue one, even if the subsidiary is clearly a non-core business or the owners are close to retirement age. A request to pursue a management buy-out could be either viewed with suspicion or even regarded as disloyal, particularly if the business is operating at a loss.

Without the group or shareholders' consent, the management team is precluded by law from disclosing any confidential information to an equity investor or debt finance provider. A business plan cannot be provided without specific consent. Equally, the investor and lenders would not want to incur the risk of being sued for inducing a breach of contract.

This can create a 'chicken and egg' situation for the management team. Quite rightly, they need to know that a management buy-out is achievable at a mutually acceptable price before requesting the opportunity to pursue one or accepting an invitation to do so.

Fortunately there is a simple and acceptable way around this apparent dilemma. Financial advisers should be willing to have an exploratory meeting in absolute confidence and, without any cost or sense of obligation, to advise upon:

- the likelihood of achieving financial backing;
- the maximum purchase price likely to be feasible;
- the probable financial structure of the deal; and
- the names of recommended financial institutions that will most want to back this opportunity.

In these circumstances, the financial advisers can telephone the appropriate decision-maker, on behalf of an 'un-named client', to ask if a sale would be considered. If the answer is an emphatic 'no', the management should forget about a management buy-out, at least for the time being, but not rule out finding another business suitable for a management buy-in. If the owners indicate a willingness to consider a sale, the management team should raise the possibility of a management buy-out when a suitable opportunity arises.

The financial advisers should indicate whether or not the managing director is likely to be acceptable to the equity investor. If the institutional investor does not find the proposed managing director acceptable, it will not invest in the management buy-out team. The choice of managing director needs to be confirmed at this stage, because the business plan must state the proposed role for each member of the management team.

Once the management buy-out opportunity has arisen, the management team and the managing director have been confirmed as acceptable to equity investors, the financial advisers and the management team need to work closely together.

At times, the management buy-out process can become frustrating and stressful for all concerned. It is vital that the management team and its advisers are compatible at both professional and social levels. Above all, the financial advisers should be supportive of the management team throughout.

The key contribution of the financial advisers should include:

- advising on the format and content of the business plan;
- choosing three or four prospective equity investors most likely to be keen to invest in the type of business and size of deal;
- seeking a cost indemnity and a period of exclusivity from the owners;
- negotiating the best possible equity deal for management from the preferred equity investor;
- working with the equity investor to negotiate the lowest possible purchase price and most advantageous deal structure from the owners; and
- introducing the management team to appropriate legal firms with proven experience of management buy-outs.

The role of legal advisers

There is usually considerably more legal documentation involved in a management buy-out than in a sale to a trade buyer. Some management teams are unsure why one set of lawyers cannot act for the management team, the equity investor and the providers of debt finance.

While the various parties have a common interest in pursuing the legal agreement to buy the company, the management team needs its own lawyers to handle their agreement with the equity investor. It is vital that the management team appoints competent lawyers with an established management buy-out track record. Both the vendor and the financial institutions may use 'heavyweight' law firms and the management should invest time in 'beauty-parading' prospective law firms to ensure relevant expertise and competitive fees.

The Articles of Association of Newco, essentially the bye-laws for operating the company, and the Shareholders' or Subscription Agreement between the management team and the equity investor need to be negotiated. The agreement initially drafted by the lawyers acting for the equity investor may impose too onerous restrictions on the managerial freedom of the management team to operate the business. For example, there may be a requirement to obtain the approval of the equity investor to recruit or dismiss staff over a given salary level, or to authorise an item of capital expenditure over a given limit. While the principle may be accepted by the management team, it may be necessary to negotiate higher limits to ensure adequate operating freedom.

The arrangements for members of the management team who leave the business prior to the exit are likely to need considerable negotiation. Investors will want the shares to be sold at the lowest possible price to incentivise replacement managers. The departing manager, however, will want to receive full value.

The attitude of investing institutions to these issues varies. Some will seek to make a distinction between 'good' and 'bad' departures and be prepared to increase the value attributable to a manager's shares over time. Others will seek a simpler basis, agreeing a valuation formula to be applied regardless of the circumstances surrounding the departure.

Service contracts between Newco and the management team must be negotiated before legal completion. The starting salaries and duration of the service contracts must be acceptable to the management. If interest on mortgages or loans to purchase an equity stake is to be repaid monthly, then the salaries should be increased to avoid a drop in the standard of living. It must be realised that subsequent salary increases for the management team will not only need the approval of the equity investor, but are likely to be strictly regulated.

Generally speaking, the lawyers to Newco will handle the acquisition agreement between the vendors and Newco and the loan agreement between Newco and the lenders.

Timescale

Most buy-outs take up to six months. When buying from a receiver, speed is essential and the equity investor will respond accordingly. Private equity houses occasionally publish case histories showing a management buy-out legally completing within three months. These are the exceptions.

A typical timetable of events is:

Month 1
- agree on the management team;
- appoint financial advisers;
- obtain agreement to pursue a management buy-out.

Month 2
- write the business plan and send it to equity investors;
- hold initial meetings with prospective equity investors;
- seek a cost indemnity and period of exclusivity.

Month 3
- obtain outline written offers from prospective equity investors;
- negotiate improved terms with equity investors;
- appoint preferred equity investor and lawyers.

Month 4
- negotiate the acquisition from the vendors;
- sign heads of agreement;
- investigating accountants complete due diligence.

Months 5/6
- equity investor syndicates equity if appropriate;
- arrange debt finance;
- prepare and negotiate legal documents;
- renegotiate the equity deal for management, if necessary;
- legally complete the management buy-out as soon as possible.

Throughout this period, the management team must continue to manage the business, or suffer the consequences immediately after the management buy-out is completed. The financial advisers must take the brunt of the workload connected with the management buy-out.

3 Tax and other issues

Personal taxation

Expert advice is needed before the management buy-out is legally completed in order to ensure the maximum benefit for the management team after paying income and capital gains tax.

Issues that need to be addressed are:

- the availability of income tax relief on the interest paid on borrowings to purchase an equity stake;
- legitimate opportunities to minimise capital gains tax and inheritance tax liabilities in due course under current taxation regulations; and
- income tax relief on the purchase price of the equity stake should the business fail after the management buy-out.

Pension and employment issues

When a subsidiary is being acquired from a group, the employees will cease to be members of the group pension scheme at or shortly after legal completion. The management buy-out team will need to take actuarial advice prior to legal completion to ensure that the value of the pension fund to be transferred to Newco will be sufficient to meet the pension liabilities for staff to be employed.

If the group pension scheme is underfunded, this could involve Newco making significant additional contributions to meet the liability. Equally, this could mean either that a lower acquisition price would need to be negotiated or the management buy-out would not be completed. Conversely, if the group pension scheme is overfunded, the transfer of a share of the surplus should be sought in order to benefit from a 'pension contribution holiday' for a period.

When share capital is acquired, the contracts of employment for staff will normally continue unchanged. As mentioned previously, however, the equity investor will want to establish new contracts for the key managers investing in the buy-out.

Where the assets and business are acquired, the Transfer of Undertakings (Protection of Employment) Regulations 1981 are likely to apply. These are complex regulations, and one provision is that, unless the terms of employment are substantially unchanged, then Newco could face claims for redundancy payments from staff.

Environmental issues

Acquirers of all kinds – corporates or venture capital-backed management teams – are becoming aware of the environmental pitfalls that can affect transactions. However, equity and debt providers funding a buy-out will be particularly sensitive to any environmental issues that might arise. Their concern will extend beyond the business having all the necessary approvals, permits and licences necessary to operate and will include the state of the fabric of any buildings and of any surrounding property. Funders will wish to establish any manner in which any property assets over which security may be granted may be affected by environmental issues as well as any liabilities which might be incurred by Newco or indeed, the funders themselves.

UK environmental legislation can make both occupiers, owners and 'polluters' liable for environmental problems. As a minimum, most funders will insist on a 'Phase One' environmental investigation of a business with manufacturing or property assets, which will add to the timetable.

Professional fees

Newco pays all fees on legal completion as the costs of the acquisition.

The equity investor and the debt providers are likely to charge an arrangement fee of between one and two per cent of the total funding requirement.

As the equity investor will appoint lawyers to act for Newco and the investigating accountants to carry out due diligence, the management's financial advisers should establish that the equity investor is responsible for these fees if the management buy-out is not legally completed, unless covered by a cost indemnity from the vendors.

The financial advisers and lawyers to the management team will often be working almost wholly on a contingent basis, their fees dependent on legal completion except for cost indemnities negotiated from the vendors.

The management team must ensure they are not personally liable for unexpected and sizeable fees, plus VAT, if the management buy-out does not legally complete. This is an important issue for the financial advisers to address.

Even though the fees for the various advisers to the management team will be paid by Newco on legal completion, the cost of fees should be agreed in writing at the earliest possible opportunity.

The board of directors

Managing the business effectively must become the top priority immediately after legal completion.

The equity investor will probably want to appoint a chairman or non-executive director. Some private equity investors tend to put the person who led the deal for them onto the board. Others will opt for an outsider, usually with relevant industry experience. If the chemistry is not right with the first candidate put forward, then the management team should ask to meet a second one.

Follow-on funding

The management team should consider carefully the extent to which they will seek additional capital following the buy-out either to fund organic growth or acquisition. In a significant number of cases, it is the avowed intention of the management team to embark upon a 'buy and build strategy' and this needs to be reflected in the whole buy-out process.

In the first instance the requirement for follow-on funding should be addressed within the business plan. Where the requirement for follow-on funding can be identified with certainty, the amount required and the anticipated returns should be included within the financial projections. Where a number of opportunities are being considered or where there is uncertainty as to timing or amount, the general principle should be discussed within the business plan with the financial projection per se concentrating on the stand-alone business.

As a rule, private equity houses and banks welcome the opportunity to provide follow-on funding. In all cases, the appetite for follow-on funding should be established at an early stage together with some degree of common understanding with regards to purpose, amount and likely risk/benefit.