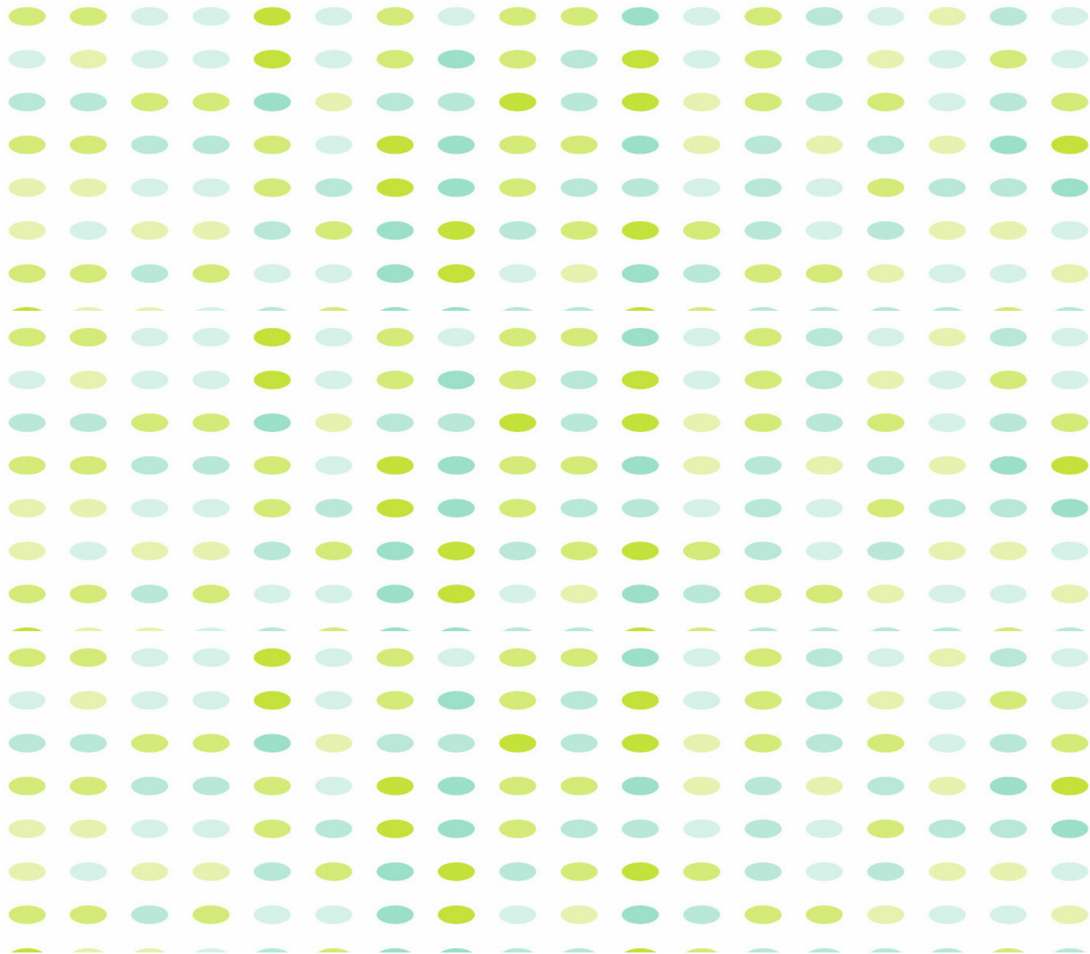
The SWAIN guide to Buy-outs and Buy-ins



In conjunction with:

Exigo Corporate Finance

Value Your Business

The SWAIN guide to Buy-outs and Buy-ins

The South West Angel and Investor Network (SWAIN) connects private investors or “Business Angels” with companies looking for investments. SWAIN specializes in helping small and medium sized companies to find equity finance, and assists private investors in the South West to search for investment opportunities in businesses with growth potential. The following guide has been produced to help you understand Buy-outs and Buy-ins and the value that good commercial corporate financiers can bring to your deal. It is especially targeted at companies looking to combine investment with an effective exit but the potential Business Angel will also find it of interest.

Management Buy-Out (MBO) / Buy-In (MBI)

A Management Buy Out (MBO) is the purchase of a business by its existing management.
A Management Buy In (MBI) is the purchase of a business by an external management team

An MBO or MBI is usually a life-changing event, offering the opportunity to create significant wealth from a relatively small personal investment. Of course there are risks involved but the rewards have been staggering for thousands of managers who have been fortunate enough to raise the finance to buy their business. At times the process can seem daunting, but an MBO/MBI is a logical process too often mystified by buzzwords and ‘dealspeak’ and compounded by time pressures. This guide is designed to provide you with a practical overview of what is involved, including a look at the stages involved and an overview of financing and structuring a deal.

Management Buy Out

An MBO usually occurs when:

- companies sell parts of the business that are not core to their future strategy
- the existing owner-manager is looking to retire

As the existing management have inside knowledge of the business they can be in the best position to take the business forward. In many cases, selling to the management is the preferred option to the existing owner, rather than selling to a competitor.

Management Buy In

An MBI usually occurs when:

- the business is underperforming and would benefit from additional management input
- the MBI team have specific sector knowledge and can take the business forward

MBI's are traditionally more difficult to fund than MBO's. The lenders have to be convinced that the MBI team (or MBI candidate) have sufficient experience and the ability to deliver. An MBI candidate would typically have to have the following attributes:

- a proven successful business background
- a business leader with drive and enthusiasm
- able to risk personal capital

Thus, MBOs/MBIs come in many shapes and sizes, from the purchase of a small business by those running it to a 'take private' transaction involving a £1 billion quoted company. Nevertheless, there are common factors. Completing an MBO/MBI typically involves the following stages:

- Assemble the management team / Approach the owner/obtain consent
- Appoint financial advisers / Prepare the business plan
- Identify sources of finance
- Seek tax advice
- Offers of funding to management
- Negotiate agreement with the owners / Sign heads of agreement
- Due diligence / Negotiate legal documentation

Timescale and Costs

On average, deals typically take three to six months, but there are always exceptions. A common issue for a management team is the ability to pay fees. Most financial advisers will be prepared to work mainly on a contingent basis where they believe there is a reasonable chance of success. The fees are usually paid out of the transaction funds raised on completion of the deal. Total deal costs will include stamp duty, the fees charged by the management team's advisers (financial advisers and lawyers), and the financial institution's advisers (lawyers and investigating accountants). The banks and most venture capitalists will also charge arrangement fees for the finance provided. Try and obtain an indemnity or break fee from the owner to cover Newco's costs, in the event that the owner withdraws from an agreed deal set out in the heads of agreement.

Financing the MBO/MBI

There will be a variety of funding sources for the typical MBO/MBI. Your adviser must have experience in this area and have financial contacts to help with fund raising. Your adviser will help draw up a business plan, undertake financial modeling and will suggest an appropriate structure for the deal. Management will generally invest their own cash in return for shares in the buy-out vehicle ('Newco') but are often unlikely to find sufficient money to fund the entire buy-out. The exact mix of finance will depend on the size of the transaction and the nature and financial position of the target, but finance may be found from some or all of the following sources:

Bank Debt

Often known as 'senior debt', a bank lending money to an MBO/MBI team will insist upon adequate first ranking security for its loan. It will be essential that the target business generates sufficient cash to make repayments and cover interest. This can be comparatively cheap finance if available. Another advantage is that the bank will want relatively little say in the running of the business, although it will impose some restrictions in the lending and security documents.

Private Equity

Private equity investors will usually make their investment in ordinary shares of a different class from management, as well as in preference shares or loan notes (which would rank behind senior debt for repayment). Private equity investors usually will want to have significant involvement in the management of the business and to have board representation. The investors see this element of control as a key safeguard for their investment, but if they have sufficient experience of the type of business in question then this may be an advantage rather than a burden!

Business Angels

Individuals are also a source of equity finance. They will usually invest smaller sums than institutions although, where they organise themselves into syndicates, larger amounts may be available. An advantage is that they will often have a more flexible approach than an institutional investor.

Mezzanine Finance

This is often encountered in larger buy-outs and is half way between senior debt and equity investment. It will usually take the form of a loan ranking behind senior debt, either unsecured or with second ranking security. Compared to bank finance there will be a higher interest rate and/or the chance of participation in the upside of an MBO/MBI to reflect the higher risk they take. This 'equity kicker' is often structured in the form of an option (or warrant) to subscribe for shares at a favourable rate on an exit.

Asset Based Finance

A useful addition to or substitute for bank finance is asset based finance, money lent on the security of fixed assets such as plant and machinery or on receivables such as book debts.

Thus, a buy-out needs to work for lots of stakeholders but in particular the management team, other equity investors and debt providers. These groups all need to be comfortable with the risks and whether they can earn an acceptable return. Different buyers will place different values on a business and there are numerous models for establishing indicative valuations. Whatever method is used, the business' current and future cash flows and profits will be central to the valuation. Stakeholders will also work back from a range of target returns to establish an affordable or 'fundable' valuation.

Tax Issues

Members of the MBO/MBI team should seek professional advice on how to structure their investment in the most tax effective manner. This is a rapidly changing area and detailed advice is beyond the scope of this note. Particular concerns for management of an MBO transaction are that they do not suffer an income tax charge based upon the assumption that they acquire their shares in Newco by reason of their employment rather than as independent entrepreneurs. Both MBI and MBO teams will also be concerned about the availability of income tax relief for any interest paid by them on loans taken out for the purpose of investing in Newco. It is, however, usually possible to structure the transaction in such a way that a satisfactory outcome can be achieved.

Buying the Business – Assets or Shares?

The key decision when acquiring the target business is whether to buy the assets comprising the business or to buy the shares in the company which owns the business. There are a variety of factors which will influence a decision.

Commercial Issues

With some limited exceptions, the key distinction is that on an asset purchase the team only acquires what has been agreed to be purchased and the buyer will not take on any liabilities other than those they explicitly accept. On a purchase of shares, the buyer will acquire everything in the company, 'warts and all'. This tends to encourage buyers to opt for asset rather than share purchases. In such cases however, it is important for the buyer to identify all the assets which it requires, and, since each asset must be transferred, there can be complications. Key contracts (including property leases) may require the other party's consent to the transfer. If this is likely to be difficult to obtain then it may be easier to buy shares.

On an asset purchase, the TUPE regulations may apply to transfer employment contracts from the seller to the buyer. These can impose onerous requirements to inform and consult employees. Where shares in the employing company are bought there is no change of employer and so TUPE cannot apply.

Tax concerns may also be key. Sellers may well favour share sales. Taper relief (for individuals) and the substantial shareholding exemption (for companies) are significant tax relief's available to sellers on a share sale but not on an asset sale. In addition, there can often be a double tax hit for a seller on an asset sale. If the seller is a company, it will generally pay corporation tax on any gain made on the sale of assets, and subsequent distributions of the proceeds to shareholders may also be subject to tax. On the other hand, tax relief on the cost of intangible assets and the availability of capital allowances are factors which may make a buyer favour an asset purchase. The key is to take appropriate and professional advice early enough in negotiations.

Due Diligence

The due diligence process is a requirement of investors and debt providers to support their investment. Investors and banks will typically commission wide ranging due diligence from several parties, including:

- Management referencing
- Financial investigation into the affairs of the company and a review of the financial forecast model
- Legal due diligence
- Commercial due diligence which could include interviews with customers and suppliers
- Environmental due diligence
- Property due diligence.

A smooth deal process benefits everyone. The financial and legal due diligence process can be run more efficiently if all information likely to be called upon is collated at an early stage. If the deal is likely to complete shortly after a financial year end, it can make sense to have the annual accounts and audit completed earlier than is usual.

Documenting the Funding and the Deal

Negotiation of the acquisition document will generally take place once the management team has established that it will be able to fund the MBO/MBI (at least in principle) and thereafter will proceed in parallel with the investment negotiations. Once agreement in principle has been reached on the key financial terms of the finance, formal documentation will be drawn up to reflect this.

The equity investments of management and their private equity partners in Newco are usually governed by an investment or shareholders agreement and by Newco's articles of association. These are key documents setting out the relative rights of the parties and form the basis for the ongoing running of Newco and the business. The investment agreement will specify when and how the investments are to be made and contain warranties from the MBO team to the investors. This agreement will also set out which actions by Newco and its subsidiaries require the investors' consent and specify the investors' rights to management information and board representation. It will also contain non-compete restrictions on management to protect Newco's business and goodwill.

Where debt finance is involved the documentation will take the form of facility or loan agreements together with security and guarantee documentation. The security documents will often be on the relevant institution's standard terms, with comparatively little scope for negotiation.

Conclusion

Every MBO/MBI consists in essence of two transactions - a funding and an acquisition. It is critical that adequate consideration be given at the outset to the preferred structures for both while recognising that a degree of flexibility may ultimately be required to ensure a successful buy-out/buy-in. Therefore, if you are thinking of undertaking an MBI/MBO, taking early advice from a good firm of corporate financiers can avoid pitfalls and can save you time and money. Details of such firms who are associate members of SWAIN can be found at www.swain.org.uk/sponsors/sponsors.asp

This briefing note is intended merely to provide a summary of the issues in this area and is not a comprehensive guide. It is not intended to provide advice for specific cases. If you would like to discuss any of the issues raised, please contact one of the following at Burton Sweet Corporate Finance, who have prepared this guide. Burton Sweet Corporate Finance is a regional firm based in the South West with offices in Bristol, Thornbury, Dursley, Wotton Under Edge, Weston Super Mare and Shepton Mallet.

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