Doyle Clayton

A Practical Guide to Management Buyouts

PRIVATE AND CONFIDENTIAL

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A Management Buyout (MBO) is a transaction in which the existing management team of a company acquires a significant stake or full ownership from the current owners. In the context of SMEs (small and medium-sized enterprises), MBOs offer an opportunity for managers to become owners and take control of the business, and are particularly relevant as they provide a viable succession plan, allowing the current owners to exit the business while ensuring continuity and stability under the leadership of the existing management team.

Often the management team will incorporate a special purpose vehicle to acquire the shares of the current owners, and it will be that entity that acquires the shares and is bound to pay the consideration. However, sometimes the management team may purchase the shares directly.

Advantages and disadvantages of MBOs

Advantages

CONTINUITY OF MANAGEMENT	One of the key advantages of MBOs is the continuity of the existing management team. This ensures a smooth transition and minimises disruptions to daily operations.
ALIGNMENT OF INTERESTS	The management team, being intimately familiar with the business, is motivated to enhance its value, aligning their interests with the success of the company.
KNOWLEDGE TRANSFER	The institutional knowledge possessed by the management team reduces the learning curve associated with a change in ownership.
EASE OF TRANSACTION	Dependant on the terms of the MBO, it can be easier to agree terms and complete the transaction when selling to an existing management team that already know the business, and do not need to complete extensive due diligence.

Disadvantages

FINANCING CHALLENGES	Securing funding for the buyout can be a significant challenge, especially for smaller businesses with limited assets and cash flow. However, it may be part of the terms of the MBO for a large proportion of the consideration to be deferred so that it is paid later, this can be an advantage.
CONFLICT OF INTEREST	Balancing the interests of the management team, existing owners, and financiers can lead to conflicts that need careful negotiation and resolution.
LIMITED POOL OF BUYERS	Unlike selling to external parties, MBOs restrict the pool of potential buyers, which may impact the overall valuation of the business.

Key stakeholders in an MBO

Management Team

The success of an MBO largely depends on the competence and commitment of the management team. Clear communication and a shared vision among team members are crucial for a smooth transition. Often there will need to be a well-established senior team already in place for an MBO to be successful.

External advisers

Engaging experienced external advisers, including legal and financial experts, is essential. They provide valuable insights, assist in negotiations, and ensure the MBO complies with legal and regulatory requirements.

Financiers

Identifying suitable financiers, such as banks, private equity firms, or alternative lenders, is a critical step; they not only provide the necessary funds but may also offer strategic guidance.

Financiers may not be required if the current owners are prepared to defer the consideration to be paid in accordance with a pre-agreed timeline rather than in full at completion.

Steps in completing an MBO

Preliminary Planning

Before initiating an MBO, the management team must conduct a thorough evaluation of their readiness and the feasibility of the transaction. This includes assessing the financial health of the business, the team's capabilities, and potential challenges.

Often the management team will have considerable experience of the business from years of previous employment and in that case, this step may be limited.

Valuation of the Business

Determining the fair value of the business is a crucial step. Various methods, such as discounted cash flow analysis, comparable company analysis, and precedent transactions, can be used for valuation. Clearly, to a certain extent, the pricing of an MBO is restricted by the willingness of the management team, and finance that is available.

Negotiation and agreement

Negotiating the terms of the MBO involves discussions on purchase price, financing arrangements, and the roles and responsibilities of each party.

Financing the MBO

If finance is required, securing funding is a critical aspect of the MBO process. The management team must explore various financing options, considering the business' financial health and potential future cash flows. The current owners may need to work with the management team to assist with funding, and then to be flexible on payment terms of the consideration if the funding options are limited.

Due diligence

Conducting comprehensive due diligence is essential to identify any hidden liabilities, legal issues, or other risks associated with the business. This step helps in making informed decisions and may impact the final terms of the deal.

However, as the management team already have good knowledge of the business, one of the key advantages of MBOs is that the level of due diligence required should, dependant on lender requirements, be less than would be the case on a sale to a third party.

Legal documentation

Engaging legal experts to draft the necessary legal documents, including the sale and purchase agreement, is crucial. These documents outline the terms and conditions of the transaction, protecting the interests of all parties involved.

The documents required to complete an MBO will usually be less comprehensive than on a third party sale, but they will still be a significant undertaking to agree. The current owners will want to ensure that the sale agreement contains the correct protections for payment of the consideration, and it may be necessary to include provisions which give the current owners some continuing controls over the business until the consideration is paid off in full (if deferred).

Completion

The completion phase involves the transfer of ownership and the fulfilment of all legal and financial obligations outlined in the agreement. Post-completion, the management team officially takes control of the business.

It may be necessary, or at least wise, for the current owners to continue to be involved with the running of the business, or oversight, for a period after completion. They may wish to retain a seat on the board and these protections will need to be included within the MBO documentation.

Tips for a Successful MBO

Clear communication

Open and transparent communication is vital throughout the MBO process. This includes communication within the management team, with existing owners, and with external advisers and financiers.

Comprehensive explanation to the management team

A comprehensive explanation and handover to the management team leading up to the MBO will be key to ensure that they understand the benefits of the MBO, and can hit the ground running once the MBO completes.

If payment of the consideration deferred, then it will be important to ensure that the management team can continue the business as a profitable entity until those payments have been completed.

Experienced advisers

Engage experienced legal, financial, and business advisers to guide you through the complexities of the MBO. Their expertise can be instrumental in avoiding pitfalls and ensuring a favourable outcome.

Aligning interests

Ensure that the interests of the management team, existing owners, and financiers are aligned. This can be achieved through well-structured incentive plans, performance-based bonuses, and clear delineation of roles and responsibilities.

Financial prudence

Exercise financial prudence throughout the MBO process. From business valuation to financing arrangements, making informed and financially sound decisions is crucial for the long-term success of the acquired business.

Key documents required for an MBO

1. Sale Agreement
2. Disclosure letter
3. Board minutes and ancillary documents
4. Finance documents including security
5. Employment documents, including service agreements

Case studies

Successful MBOs

CASE STUDY 1: XYZ Ltd.	XYZ Ltd., a medium-sized manufacturing company, successfully completed an MBO in 2022. The management team secured financing from a combination of bank loans and private equity, allowing for a smooth transition. The continuity in leadership resulted in increased employee morale and business growth.
CASE STUDY 2: ABC Services	ABC Services, a family-owned service business, underwent a successful MBO with a well-structured financing arrangement. The new management team implemented strategic changes, leading to improved operational efficiency and profitability. Often the energy associated with the new management team's ownership will significantly increase profits generated.

Challenges and Failures

CASE STUDY 3: ABC Manufacturing	ABC Manufacturing faced challenges during its MBO, including disagreements within the management team and difficulty securing adequate financing. The process eventually fell through, highlighting the importance of addressing internal conflicts and securing financing early in the process. It is important to be flexible in the manner in which the MBO is financed because if the management team cannot obtain external funding, then the MBO will not be able to proceed with the current owners allowing, for example, payment of the consideration to be deferred.
CASE STUDY 4: 123 Technologies	123 Technologies failed in its MBO attempt due to inadequate due diligence. Uncovered legal issues post-agreement led to the termination of the deal, emphasising the significance of thorough due diligence. Whilst the management team should know about the business, given their historical involvement, the existing owners will need to be open with the management team leading up to the MBO to ensure that they know of the strengths and weaknesses of the business. This will ensure that they understand areas of risk which will need to be addressed after completion, rather than pulling out of the MBO altogether.

Legal and regulatory considerations

Compliance with company law

Adhering to company law is essential during an MBO. This includes compliance with corporate governance practices, shareholder agreements, and legal requirements related to the transfer of ownership.

Generally if all parties are in agreement to the terms of the MBO, then an experienced legal adviser will easily be able to advise the parties.

Regulatory approvals

Certain MBOs may require regulatory approvals, particularly if the business operates in a regulated industry. Understanding and obtaining necessary approvals is crucial to avoid legal complications. This may apply to financial institutions or insurance brokers for example.

Employee rights and involvement

Consideration of employee rights and involvement is critical. Communicate transparently with employees, address concerns, and comply with employment laws to ensure a smooth transition and maintain a positive work environment.

It is also important to ensure that employees not involved in the purchase do not feel disincentivised by their exclusion. It may be wise to create specific incentives for other staff, post completion of the MBO.

Contract issues

If the business is particularly reliant on important contracts then it will be important to ensure that these will continue after completion. For example, checks will need to be made to ensure that there are no change of control provisions which would allow a contract counterparty to termination key contracts when the management team purchase the business.

Financing options

Generally, MBOs will be financed by a combination of different options dependant on the circumstances:

POSSIBLE FUNDING OPTIONS	
Bank Loans	Bank loans are a common source of financing for MBOs. However, securing favourable terms may require a strong financial history and collateral; some businesses can obtain funding more easily than others.
Private Equity	Private equity firms can provide funding in exchange for equity. Choosing the right partner is crucial, as their involvement often extends beyond providing capital.
Seller Financing	Existing owners may provide financing to the management team by deferring the consideration. Seller financing can be advantageous if other funding sources are limited.
Mezzanine and Bespoke Financing	Mezzanine financing combines debt and equity, offering a flexible financing option. However, it often comes with higher interest rates and more complex terms. Sometimes short term finance providers can be used to ensure that the MBO completes, but then the management team will refinance the funding to a more appropriate lending as soon as possible after completion.
Management Team	The management team may fund the MBO with their personal finances, although this would be rare given the finance required.
Free Cash	If the business has free cash available, then part of this will usually be released to the current owners as part of the consideration.

Tax implications

Capital Gains Tax

Understanding the tax implications of an MBO is essential. Capital Gains Tax may apply to the selling shareholders, and planning for tax efficiency is crucial.

Dependant on the structure of the business and the MBO, generally selling a business is currently more tax efficient than taking an income, meaning that completing an MBO can be a highly attractive option.

Stamp Duty

Stamp duty may be applicable to the transfer of shares or assets. Proper tax planning can help minimise the impact of stamp duty on the overall transaction cost but this will usually be paid by the management team.

Stamp Duty is currently charged at a rate of 0.5% of the overall consideration meaning that it is not usually prohibitive.

Managing the transition

Leadership Changes

Smooth leadership transitions are critical for maintaining business continuity. Communicate changes clearly and provide support to both the outgoing and incoming leadership teams.

Employee morale

Addressing employee concerns and maintaining morale during the transition is crucial. Clearly communicate the benefits of the MBO and the positive impact on the company's future.

If employees are not included within the pool of management ownership then it may be appropriate for them to be incentivised in a different way to ensure that the business continues to be highly profitable.

Communication strategies

Implement effective communication strategies both internally and externally. Keep stakeholders informed throughout the process to build trust and mitigate uncertainties.

It is important to have a clear plan which is communicated across the business so that employees know where the business is heading, and what is expected of them.

Future Considerations

Exit strategies

Plan for future exit strategies; understanding how and when the management team may exit the business ensures long-term stability and growth.

Business growth

Focus on strategies for business growth post-MBO. The management team should leverage their knowledge and skills to explore new opportunities and expand the business. It may be that the new management team can increase profitability with their increased energy and enthusiasm.

Continuous improvement

Embrace a culture of continuous improvement. Regularly assess and refine processes, operations, and strategies to enhance the business's overall performance.

Finance review

Continue to review the finance options available to the business in order to ensure that any finance used for the MBO remains as efficient as possible.

If deferred consideration formed part of the MBO, then it may be possible to pay the current owners out earlier than anticipated with alternative finance. This may then release any restrictions sought by the current sellers as part of the MBO, allowing the management team free reign to run the business how they wish.

Is a MBO right for your business?

Successfully navigating an MBO in an SME requires careful planning, effective communication, and collaboration among various stakeholders. By understanding the advantages and disadvantages, engaging experienced advisers, and implementing best practices, businesses can ensure a smooth transition that positions them for long-term success.

As the landscape of SMEs in the UK continues to evolve, MBOs represent a strategic option for sustainable growth, ownership continuity, and value creation. Further, in an environment where finance is limited in availability or expensive, a MBO may allow current owners to sell their business in line with the historical expectations.

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