A GUIDE TO MANAGEMENT BUY-OUTS
ABOUT CATTANEO

BACKGROUND

- An independent corporate finance lead advisory practice established in 2005
- Dedicated to providing outstanding service to clients in both public and private arenas
- Team comprises corporate finance professionals with experience gained across Private Equity, Investment Banking, Corporate Stockbroking and International Accounting Firms
- Based in Birmingham, United Kingdom, operating internationally
- Full range of corporate finance services
- Deal size from £0.5 million to £100+ million

WHAT WE DO

Cattaneo specialises in bespoke corporate finance advice and execution services for private and public companies, investors and management teams tailored to meet our clients’ needs.

- Cross border acquisitions and disposals
- Private equity
- Debt finance
- Fundraising (including start-up, development capital and cash out)
- Management buy-out (MBO) / Management buy-in (MBI)
- Business plans and financial models
- Valuations
- Initial public offering (IPO)
- UK Listing and AIM Rules
- UK Takeover Code (including acting for overseas acquirers)
- Pre IPO funding
- Takeover, both hostile and recommended including Rule 3 advice
- Corporate governance
- Strategic investment
INTRODUCTION

This guide is designed to provide an introduction to MBOs and what they entail. It has been written for managers of businesses who are contemplating buying the business that they currently run – or are even just wondering if it is possible.

CONSIDERING A MANAGEMENT BUY-OUT?

Then you have probably asked yourself one or more of the following questions:

- I’ve heard the term MBO but what exactly does one involve?
- Is an MBO an option for me?
- How do I bring up the subject with my employers?
- Is my management team strong enough?
- How much will I be expected to put up myself?
- How do I value my business?
- What are the roles of the bank, private equity house and management team and how do they make their returns?
- How do I go about preparing a suitable business plan?
- What is the role of the corporate finance adviser?
- What other advisers are involved and what will it all cost?
- How long does the process take?
- The terms that are commonly used are bewildering – what do they mean?

The guide looks at the key aspects of the process and the roles of the various funders as well as that of the corporate finance adviser. We hope it will provide some insight into the questions posed above and offer food for thought as you consider embarking on your own transaction.

Do not be put off by the size or type of business you work in or the sector that it operates in – it is worth exploring to see if there is an opportunity. MBOs are an ideal opportunity for managers to satisfy their entrepreneurial aspirations and a chance to acquire a significant equity stake in their own company. This is a desire many have but only a few ever act upon as many have doubts about how to pursue that dream.
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THE BASICS
WHAT IS A MANAGEMENT BUY-OUT?

A management buy-out, or MBO, is the acquisition of a business by its existing management team from its existing owner, usually (but not always) with the help of external finance.

The common motivation for the management team is the opportunity to take ownership of the business in which they have worked for the benefit of others and so create the opportunity to build and then realise a capital gain themselves.

THE OPPORTUNITY

The window of opportunity for an MBO will not present itself very often. You may be fortunate enough to be approached by the owner but this is not often the case, so you should be alert for signs that the current owner may have a motive to sell. In a privately owned business this may be as simple as:

- A lack of family succession / the owner wishes to retire;
- A wish by shareholders to de-risk by realising cash;
- A desire by some (but not necessarily all) shareholders to exit; or
- An institutional owner (such as a private equity house) may wish to realise its investment.

If your company forms part of a group, you should consider the wider group strategy to determine the future of your business. Key indicators include:

- A change in strategic direction which makes the activities of your business non-core, sometimes manifesting itself through a lack of investment; or
- Liquidity problems within the parent company.

Once you have a feeling that now is the right time, you should carefully consider your approach. This is a key stage in the process where planning and timing are critical. The way the process will be handled will depend very much upon your relationship with the current owner. As a first step, you should seek permission from the owner to consider an MBO. It is particularly important to judge the current owner's willingness to sell and any particular sensitivities before making an approach.
An MBO request can be viewed by some owners as a sign of disloyalty and could jeopardise your working relationship going forward.

You will often only get one chance, so you should seek professional advice before entering into detailed dialogue with the current owner. As your corporate finance adviser, Cattaneo LLP will be able to help you identify and address the likely concerns of the owner before making your approach.

**HOW ARE MBOs STRUCTURED AND FUNDED?**

Most managers do not have the financial resources to purchase their business and so funding to support an MBO normally comes from banking and/or private equity institutions in the form of debt and equity respectively. The management team is expected to show its commitment by investing a significant sum relevant to personal circumstances but that may well be a fraction of the total funds raised to buy the business.

Debt and working capital facilities (loans and overdrafts / invoice discounting) are typically provided by a bank or asset-based lender ("ABL"). Equity most commonly comes from a private equity house. A venture capitalist and private equity house are similar in that they both provide third party equity to buy businesses – typically a venture capitalist looks at smaller, earlier stage, deals and a private equity house at larger deals – so we will refer to them both as private equity houses for the rest of this guide.

The least expensive form of funding is bank debt, particularly if there is sufficient security available to support it. However, it is normally the case that the value of a business exceeds its debt capacity, in which case some form of equity finance is required to bridge the gap.
Financing from the vendor is usually a matter of negotiation. It can be either in the form of deferred loans - after the bank is paid off - or equity, generally in the same proportion of ordinary shares and loans as the private equity house.

Vendor financing can be useful in bridging any price gap. However, some vendors may particularly appreciate the opportunity to reinvest part of their proceeds in the new entity and so provide them with an ongoing involvement and upside potential. In some instances, the vendor may replace the private equity house entirely.

Alternative sources of equity finance include government funds and business angel investors.

The mix of funding will depend upon the particular circumstances of the deal including the growth potential, the stability of profits and cashflows, and the asset security. The bank obtains its return by charging interest and receiving repayment of capital in priority to the equity investor. The private equity house will structure its investment as a combination of loanstock and ordinary equity shares, with the loans attracting interest and being repayable behind the bank but ahead of the equity shares. The private equity house makes the bulk of its return from its shares alongside the management team when the business is sold, hopefully for a substantial profit – this is illustrated by way of an example on page 9.

**DO I NEED ALL OF THESE SOURCES OF FUNDING?**

The simple answer to this is “no“. Some transactions do not lend themselves to large amounts of debt. Some vendors are unwilling to defer some of the proceeds in the form of a loan.

Sometimes, the amount of debt and vendor funding that is available alongside the investment from management is sufficient to pay for the business and no private equity is required. The most appropriate structure depends upon many things and your adviser will spend a lot of time working with you and the funders on the ideal structure for your deal.

Whilst the management team commits the smallest quantity of the funding, it also has to provide the know-how as the bank and private equity house cannot run the business themselves. Hence the quality of the management team is a vital ingredient in successfully attracting finance.
DO I NEED A CORPORATE FINANCE ADVISER?

Successfully negotiating the MBO process often comes down to appointing the right team of advisers. It is usual to firstly appoint a corporate finance adviser whose role encompasses project managing all aspects of the transaction.

THE ROLE OF YOUR CORPORATE FINANCE ADVISER

As your corporate finance adviser, Cattaneo LLP’s role can be defined broadly as:

- Assessing the aims and objectives of the current owners and the options available to them;
- Determining a valuation range including a maximum purchase price;
- Advising on the likelihood of obtaining funding, from which sources and on what terms;
- Devising a structure that delivers the objectives of management, funders and sellers while providing sufficient headroom to cope with identified sensitivities;
- Introducing appropriate funders using our network of contacts and experience of similar transactions;
- Advising on the content of the business plan (a good management team should be able to write their own plan but Cattaneo LLP will advise you on structure and content) and preparing detailed financial projections based on this plan (Cattaneo LLP has significant expertise in structuring multi-functional financial models);
- Advising on or leading negotiations with the sellers and with funders;
- Introducing appropriately experienced advisers to handle the legal and tax aspects of the transaction;
- Project managing the process including managing legal, tax and due diligence advisers and managing deal costs.

Once the initial MBO interest has been established, it is essential for the management team to consult an experienced and expert adviser. Managers are unlikely to be involved in more than one MBO in their lives and appropriate advice at an early stage is sensible when embarking on such a complex and sophisticated transaction. In addition, the management team will find itself under immense pressure and severe time constraints during the process, as well as having to fulfil its continuing management responsibilities. An adviser should be able to estimate management’s chances of success at the outset and so save a lot of time and energy.
EXAMPLE — £15M MBO

Let’s assume a management team of four is buying a company for £15 million (ignoring the costs of doing the deal – these will be discussed later).

The actual funding structure will depend upon many factors but it could look like the following:

<table>
<thead>
<tr>
<th>£</th>
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<tbody>
<tr>
<td>Bank loan A (amortising)</td>
<td>6,000,000</td>
</tr>
<tr>
<td>Bank loan B (bullet)</td>
<td>3,000,000</td>
</tr>
<tr>
<td>Management ordinary shares</td>
<td>300,000</td>
</tr>
<tr>
<td>Private equity ordinary shares</td>
<td>450,000</td>
</tr>
<tr>
<td>Private equity loan</td>
<td>5,250,000</td>
</tr>
<tr>
<td>Acquisition price</td>
<td>15,000,000</td>
</tr>
</tbody>
</table>

As you can see, management invests 2% of the total funding for a 40% shareholding. Now, let’s move quickly forward five years and look at a possible future outcome:

<table>
<thead>
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<th>£</th>
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<tbody>
<tr>
<td>Valuation</td>
<td>30,000,000</td>
</tr>
<tr>
<td>Less: Bank loan A and B</td>
<td>0</td>
</tr>
<tr>
<td>Private equity loan</td>
<td>(5,250,000)</td>
</tr>
<tr>
<td>Available to shareholders</td>
<td>24,750,000</td>
</tr>
</tbody>
</table>

Split:

<table>
<thead>
<tr>
<th>£</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Management</td>
<td>9,900,000</td>
</tr>
<tr>
<td>Private equity</td>
<td>14,850,000</td>
</tr>
<tr>
<td></td>
<td>24,750,000</td>
</tr>
</tbody>
</table>
In this example management receives 33 times their original investment. The reason that management can make many times their original investment is that the increase in the company's value accrues only to the ordinary shares. This is why it is often said that management invests in the 'sweet' part of equity capital.

MBOs can be ingeniously engineered, financially speaking, and the leverage effect of paying partly for the business using debt, may boost shareholders' returns. However, an MBO is never purely a financial play because the most important prerequisite and driver of shareholder value is a growth in the company's value. Without growth the model struggles to work. The management team is expected to grow the business, invest for the future and increase profits if it is to succeed in adding value over the long term.
ADVANTAGES OF AN MBO VS A TRADE SALE

(OR, “HAVE I ANY CHANCE OF COMPETING WITH A TRADE BUYER?”)

An MBO is attractive to both vendor and management for a number of reasons. Clearly, management stands to gain a number of things including independence and autonomy, a chance to influence the future direction of the company and the prospect of a capital gain. But there are also strong reasons why an MBO offer can be attractive to the vendor.

An MBO can often be realised much quicker than an outside sale. The fact that management already knows the business shortens the initial stages of the deal. Speed can be a real competitive advantage to the vendor and also means less disruption for the business and less uncertainty for the organisation and market alike.

With an MBO there is no need to provide confidential information to competitors who might use it to enhance their competitive position. Familiarity can also be important where the vendor may wish to have a continuing (trading) relationship with the business and may feel more confident dealing with the existing management where there is an element of trust.

An MBO can be structured to allow the former owner to retain a minority stake in the company. This provides ongoing involvement and exposure to future upward potential. In a trade sale this is less likely. An ongoing interest may also provide “insurance” to cover the vendor’s fears of underselling the business.

The management team is likely to have the backing of the organisation because people know them and know they will keep the company and its culture intact and preserve the employee base.

A trade sale is often a vendor’s first consideration, mostly for purposes of achieving the best price. However, an MBO can often be just as price competitive for the vendor. Whilst there is always the possibility of a trade buyer with deep pockets being found which is willing to offer a “strategic premium” to buy the business, with innovative deal structuring, the creative use of financing instruments and the use of leverage, competitive bidding can be achieved.

The funders backing the management are also not restricted by issues like “impact on earnings” and goodwill charges. Existing management knows where to improve profitability, how to manage risks and can recognise strategic opportunities.

Management have a better understanding of the business and therefore any initial offer is less likely to be reduced through the process of the sale. An MBO bid can therefore be more credible offering a greater certainty of outcome for the vendor in terms of deliverability. Also, the scope and extent of warranties and indemnities given by the vendor in the case of an MBO are generally much less than in the case of a trade sale.
Corporate financiers will often say that the three most important ingredients for a successful MBO are “management, management and management” meaning that the quality of the management team is key.

Funders need to be convinced that the team has the all-round strength to manage the business independently. A high level of commitment to the MBO and to its subsequent successful growth is also essential. Entrepreneurship is key here but the management team must also have a clear strategy for building the business.

In general, the management team will include up to three or four managers. Other managers and staff may also be given the opportunity of investing, although this maybe done through share options.

**TYPICAL MANAGERS IN AN MBO ARE:**

- Managing Director or CEO;
- Finance Director;
- Sales Director; and
- Production, Technical, or Operations Director
HOW MUCH MONEY WILL WE NEED TO INVEST PERSONALLY?

Each member of the management team is expected to invest personally. The amounts involved are intended to signify commitment from the individuals concerned but will be small relative to the total size of the financing required. The team leader / CEO will usually invest more than other key team members.

A “rule of thumb” is for the CEO to invest around one times their annual salary but it will depend upon personal circumstances. It is quite common for members of the management team to borrow money from a bank in a personal capacity to finance their investment and your corporate finance adviser can guide you on this aspect.

Should the management team already have some shares or options in the target business, the funders will usually expect you to reinvest your capital gain because they will want management to be “buyers” not “sellers”.

VIABLE BUSINESS

The business must be capable of operating independently as a commercially viable entity.

This is especially important when it concerns an MBO of a division of a larger group and you will need to ensure the company is not dependent on intergroup trade; it must have sufficient critical mass; it must have access to the necessary trademarks, licenses and brand names; and there must be no long term dependence on group services such as distribution, sales and finance.

The management team will need to demonstrate, via a robustly constructed business plan, that as well as there being a commercially viable business, there is a demonstrable growth strategy and it has a strong competitive position preferably in a growing sector.
WILLING SELLER

At the risk of stating the obvious, without a vendor who is prepared to sell at a realistic price, there can be no deal.

Management needs to understand the motivations of the seller and consider their rationale or strategic reasons for disposing of the business. Many vendors may not consider an MBO until it is suggested to them.

At the first opportunity, it is up to the management team to take charge of the situation when it appears as if their company might come up for sale where factors such as age or health may be becoming a factor for the current owner. Equally, in suggesting the idea of an MBO to the shareholders, the management team has to point out the advantages over a trade sale. Initiating MBO discussions can be delicate and advice is important.

WHEN SHOULD WE APPROACH THE VENDOR?

Without a willing vendor the deal will not happen, so the vendor will need to be approached early on in the process. It will depend on individual circumstances as to who should approach the vendor – either the management team or the adviser.

Before making a formal approach to the vendor it is sensible for your financial adviser to undertake an initial feasibility study to confirm to you that any proposed deal will be viable and fundable.

Dealings with the vendor need to be handled carefully as the team will be employed by the business during the MBO process and possibly thereafter should the deal not complete. Sensitivity is paramount. Until vendor approval to progress the MBO opportunity has been obtained care should be taken to observe your fiduciary duties as directors. The timing and nature of the approach is a critical area and one on which your adviser will guide you.
WHY ARE EXIT OPPORTUNITIES IMPORTANT IN AN MBO?

Before your funders invest they will want to assess the opportunities for selling. This may seem somewhat premature but remember the private equity house (and management team) realise their gains predominantly on exit so, how, when and to whom they will exit is key to their investment appraisal.

Private equity houses need to be able to realise the value of their shareholding at a significant capital profit often over a three to six year time horizon. They will achieve this in a variety of ways:

- Sale of the company to a trade buyer;
- Sale of the company to another venture capital/private equity house;
- Management may occasionally be able to buy out the shareholding of the private equity house through a secondary fund raising; or
- A flotation of the business on the Stock Exchange.

The most likely exit route will be a sale of the business to a trade buyer and the private equity house will want to be satisfied before investing that a pool of likely buyers exists and that your business will be an attractive proposition to a trade buyer at some future point in time.
THE MBO PROCESS

OVERVIEW

Once the initial MBO interest has been established, it is essential for the management team to consult an experienced and expert adviser.

Managers are unlikely to be involved in more than one MBO in their lives and appropriate advice at an early stage is sensible when embarking on such a complex and sophisticated transaction. In addition, the management team will find itself under immense pressure and severe time constraints during the process, as well as having to fulfil its continuing management responsibilities. An adviser should be able to estimate the management team's chances of success at the outset and so save a lot of time and energy. Assuming the chances are good, then the management team will need advice on how and when to approach the vendor. Prior to a formal MBO offer being made, the adviser will be willing to have exploratory meetings in absolute confidence, and to advise upon the feasibility of the MBO.

The MBO process involves negotiations with many parties and can be fraught with complexities. To the management team, this process is time consuming, wearing and often emotional. It goes through numerous steps and no two MBOs are ever the same. However, the following stages can usually be identified.

FEASIBILITY
- Analyse opportunity
- Assessment of viability
- Initial funding views

AGREE A DEAL
- Negotiate deal with vendor
- Draft & sign Heads of Agreement

FUNDING
- Prepare Business Plan
- Prepare projections
- Prepare presentations
- Approach funders
- Comparison of funding offers
- Negotiation of terms with funders
- Select preferred funder(s)

COMPLETION
- Due diligence
- Legal process
- Working capital
- Tax planning
- Covenants
- Management of funders
- Management of other advisers
- Champagnes!

POST DEAL
- The hard work begins
- Cash management
- Covenants
- Completion accounts
- Conditions subsequent
FEASIBILITY

Approaching the owner with a sensible, well considered and achievable offer will be the key to establishing yourself as a credible buyer.

The key to valuing a business effectively is in understanding all the factors which contribute to its worth. Cattaneo has considerable experience in valuing businesses and we will be able to bring our experience of the sector and similar businesses to bear as well as utilise our research capability to analyse recent comparable transactions and identify likely price pressures.

**FACTORS TO CONSIDER:**

- Past profitability;
- Future prospects (markets, customers, new products);
- Asset values; and
- Cash generation.

Importantly, we will be able to assess the alternative options available to the owners and advise on the balance of power between owners and managers as well as the likelihood of trade interest. And finally, as your adviser we will be able to give you an early indication of the funding you are likely to be able to raise to support the transaction.

Although the financial structure will evolve throughout the process it is important to consider at an early stage a rough outline of the possible and appropriate structure to assess what price could be supported. If the vendor’s price expectations are known, they can be compared with the maximum price that could be supported by an MBO. The feasibility study should be carried out fairly quickly and if the conclusion is that an MBO is practical, the next step will be to approach the vendor to obtain approval to pursue the MBO.
AGREE A DEAL

Unless the subject has been raised by the vendor, some managers regard the initial approach as the most difficult and sensitive issue. Who makes the initial approach and when were discussed earlier in this guide.

The management team has to agree with the vendor on the rules of engagement and the steps in the process, the timeline, approach and goals. The vendor will usually set guidelines concerning the supply of information in order to seek a level playing field with the MBO team and other potential buyers. Using the adviser or funders as the lead negotiator with the vendor can help to preserve the relationship between the management team and the vendor. The management team can focus on promoting the MBO as an attractive option for the vendor and beneficial for the business. If this is managed well the potential for the vendor to solicit competing offers can often be reduced.

The relationship with the seller demands skilful handling throughout the process. The financial adviser will assist in this. Explaining and making understood the true economics of the MBO to the vendor and creating trust from the outset are crucial. Too often potential MBOs fail because of problems of communication, personality, perceived conflicts, lack of knowledge and failure to rise above traditional vested interests.

FUNDING

The actual mechanics of funding an MBO have been discussed earlier in this guide. Often this stage will run at the same time as the deal is being negotiated with the vendor.

In addition to meeting and evaluating the management team, funders will expect you to set out your plans for the business (including detailed profit, cash flow and balance sheet projections) and demonstrate how these will be achieved.

This will involve the formulation of a detailed business plan, which shows the current position of the business and your plans for its future. Cattaneo will be able to help you prepare this document, ensuring that all the key issues are addressed. However, it is important to remember that it is your plan and you must believe in it.

In order to instill confidence, and stand up to detailed due diligence, this document must be a realistic reflection of what the team believes it can deliver in the future and must also address the key risks facing the business and the market in which it operates. Before submitting your plan to the chosen financial institutions, we will 'test' the robustness of your plans and projections.

Funders will take a long, hard look at the business plan and at you as a management team. Consider how well you know your marketplace, as funders may arrange for an independent review of the market in which your company operates.
The ability of the business to make returns for investors will ultimately determine the availability of funding. Many private equity houses are seeking to exit from an investment within three to six years and the business plan will need to demonstrate that the necessary level of return can be achieved from your business over this timescale. Debt funders will be keen to examine the cash flow forecasts of the business in order to assess the likelihood of the business supporting interest and capital payments.

WHAT SHOULD BE INCLUDED IN THE BUSINESS PLAN?

A typical business plan will include the following:

- Executive summary covering a brief overview of the business and the rationale for the transaction together with the key strengths of the business;
- A short history of the business;
- Overview of the products or services;
- Profile of the management team;
- Analysis of the business’s top customers and its key suppliers;
- Analysis of the market and key competitors;
- The company’s operations – its premises, systems and employees;
- Strategy for growth;
- Historic financial analysis (normally the last three years);
- Analysis of the projections (typically for the next three years on a monthly basis) and their assumptions. The projections should be positive, credible and specific; and
- Assessment of any risk areas and how they can be mitigated.

To raise the required funding the management team will need to meet and present the business case to a number of banks and private equity houses that the adviser considers suitable. If, following the initial meeting, a funder is interested, they will provide an indicative offer of the funding they are prepared to provide and the terms on which they will provide it. It is likely that the funders will want to meet again with further follow up questions before they convert their indicative offer into one that has the outline support of their credit or investment committees.

It is a key part of the adviser’s role to assess each funding offer and to negotiate the best terms for the MBO. Best terms will include price but also take into account many other factors such as amount and equity requirements, repayment terms, positions of default, exit expectations, ongoing monitoring / governance requirements, personal chemistry, etc.
COMPLETION

Once the price and key terms have been agreed with the vendor and funders it is normal for the vendor to grant a period of exclusivity during which due diligence investigations, financing and legal documentation can be completed.

The private equity house and bank will arrange for due diligence investigations to verify the information provided and to ensure that they fully understand the current state and potential of the business. Up to this point the decision to finance the MBO will usually have been largely based on information supplied by the management team and the funders’ own assessment of the market and the business. The scope of the due diligence will vary depending on the business and may include financial, market, legal, management, technical, taxation, pension and environmental.

WHY WILL WE NEED TAX ADVICE?

Expert advice is needed before the MBO is legally completed in order to ensure the maximum financial benefit for the management team after paying income and capital gains taxes (arising on the ultimate sale) and also to ensure the company has the necessary protection in respect of any tax irregularities that may subsequently come to light. Issues that need to be addressed include:

- The structure of the transaction and the requirements for any tax clearances;
- The availability of tax relief on the interest paid on borrowing for personal investment;
- VAT registration for the new company and advice on the recoverability in relation to deal costs;
- Opportunities to minimise capital gains tax and inheritance tax liabilities on future gains;
- Tax indemnities from the vendor; and
- Payment of stamp duty.
Once due diligence is underway the drafting of the legal documents commences. Depending on the complexity of the deal, the number and the type of agreements will differ. Management teams are usually surprised at the volume of legal agreements covering the purchase of the business, Shareholders’ Agreement, Articles of Association, funding documents for both the private equity house and the bank, service agreements for the management team and many ancillary documents.

It is essential for all the employees that any pension issues are properly dealt with. The management team must ensure that they are not deprived of their rights as former employees because of the MBO or by virtue of them now being shareholders.

The period of exclusivity is usually the most demanding on the management team, with due diligence investigations and the finalisation of the funding and legal documentation running at the same time, together with any final negotiations with the vendor. However, completion of the deal is now close at hand and once these various issues are successfully concluded and contracts signed, the MBO is complete. A time for a quick glass of champagne before the hard work really starts!
TIMESCALES AND COSTS

An MBO is a complex transaction involving numerous parties, often with conflicting needs despite an overall common goal. Consequently, the time taken to complete an MBO varies significantly. Unless the transaction has arisen from a distressed situation (e.g. actual or threatened insolvency) then it is likely that the transaction will take between three and six months to complete. It can be further protracted if there is a “stand-off” between buyer and seller.

Of course, with a degree of pragmatism and willingness it is possible to complete a deal much more quickly, within a matter of weeks, particularly if the funding takes the form of asset-based lending and there is no private equity involvement. This is because the asset-based lender’s principle focus is on the security value of the assets rather than on the dynamics of the business, its markets and management.

In terms of the cost of an MBO process, as a rough guide this could amount to between 5% and 10% of the deal value depending on the size of the deal and the sources of finance. Cattaneo is comfortable participating in flexible fee structures involving sharing the risk and reward of the transaction reaching a successful conclusion. We can also take equity in the deal as part of our remuneration and, furthermore, we can invest our own money alongside the management team thus demonstrating our belief in the structure and terms of the transaction as well as the longer term prospects.

WHO PAYS IF THE DEAL DOESN’T HAPPEN?

Your corporate finance adviser will ensure that the majority, if not all of these costs, will be contingent upon a successful completion of the MBO, therefore protecting the management team from any material personal liability. To the extent the vendor is willing to underwrite some costs then this can reduce the overall cost burden when the deal completes as well as demonstrating the vendor’s commitment to the transaction.
AFTER THE MBO

Congratulations, the transaction is completed and you and your equity partners are the new owners of the business.

There is a lot do over the next few weeks – including catching up on matters that have been deferred whilst you have been burning the midnight oil getting to this stage. Many management teams put together (as part of the business plan or separately) a “100-day plan” to cover the detailed aspects that need to be addressed in the weeks following completion.

Communicating to staff, customers and suppliers is a key early task. It is possible that your funders have insisted that any key customers or suppliers are advised of the deal pre-completion to ensure business will continue on the same basis. However, it is still important for you to communicate to all of the key groups your vision so as to carefully instil the necessary confidence in the new ownership. It is likely that you will need to give some comfort about the robustness of the funding.

It may also be necessary to install new independent systems for financial reporting, etc. if you were previously part of a larger group. Even if the business was independent the systems may need to be strengthened to ensure that they provide necessary and timely information to you and your funders.

A private equity house is likely to require the appointment of a Chairman and/or Non-Executive Director (possibly a member of the private equity house’s team) to bring relevant experience and plug any skills gaps in the team. These discussions are likely to have already been underway but may not be finalised until now. A Chairman or Non-Executive Director should not be seen as a hindrance but, if the right one is chosen, they can bring their experience and skill set to the table for the benefit of the business. They can possibly open new doors for you or share their previous experience on how to deal with certain matters given they may well have seen the main hurdles before.

Finally, positioning the business appropriately and planning for a fruitful exit cannot start soon enough and will be encouraged by your private equity house at all stages of the company’s development.

Further information on this can be found in our “Guide to Exit Planning & Exit Strategy”.

Cattaneo Corporate Finance

A Guide to Management Buy-Outs
FREQUENTLY USED TERMS

**BIMBO** – buy-in management buy-out: a transaction in which the management team comprises a combination of MBO and MBI managers, normally with the buy-in element being an incoming managing director.

**Business & Asset Sale** – the sale of the business and assets of a company such that the company receives the consideration and realises the capital gain, which is taxable on the company - the consideration then needs to be extracted from the company with potentially further tax consequences.

**Cash & Debt Free** – companies are normally valued on a cash and debt free basis which means that the existing capital structure is ignored for valuation purposes on the basis that the purchaser may utilise an alternative structure – once a value for the business is derived (the Enterprise Value) the value of the shares (Equity Value) is obtained by deducting the amount of debt and adding the amount of surplus cash.

**Debt Multiple** – the multiple of EBIT or EBITDA that a bank will lend against the sustainable earnings of the business.

**Due Diligence** – the process by which a potential purchaser and/or funders make enquiries and gathers information on the target in order to confirm or evaluate the business – due diligence can be financial, legal, commercial, technical or of any other nature relevant to the potential purchaser’s evaluation of the target.

**EBITDA Multiple** – commonly used in valuing a company; the value of a business expressed as a multiple of its profit before interest, tax, depreciation and amortisation, often used as an approximation to cash flow (EBIT multiple also commonly used).

**Equity** – ordinary shares; the riskiest investment instrument in an MBO structure, ranking behind all other instruments and repayable only on a sale of the company, but attracting the upside benefits of capital growth.

**Exclusivity** – agreement by the seller to continue discussions with a single party in return for that party incurring time and cost on due diligence and legal contracts.

**Heads of Agreement or Heads of Terms** – a document that sets out the key terms agreed between buyer and seller as the basis for progressing to due diligence and legal contract – it is normally non-binding except for certain terms relating to exclusivity.

**IBO** – institutional buy-out: similar to an MBO or an MBI but where the deal is led by a private equity house rather than the management team.

**Information Memorandum** – a document prepared by the seller that describes a business for sale and sets out the information required by an interested party to evaluate the business and formulate an indicative offer.
**Indicative Offer** – an initial, non-binding offer made by a potential purchaser (or funder) which will qualify it (or not) to progress in the sale process and enter into more detailed discussions with the vendor.

**IRR** – the internal rate of return - a metric used to measure and compare returns on an investment. It calculates the return by looking at all of the cash flows from the investment over a given period, taking into account drawdowns, distributions such as capital gains and income through dividends, and the ultimate exit proceeds. IRRs are often used because they offer a means of comparing two investments with irregular timings and size of cash flows.

**MBO** – management buy-out: the acquisition of a company by its existing management, supported by a combination of some, or all, of bank debt, mezzanine, vendor loan notes and private equity finance.

**MBI** – management buy-in: similar to an MBO but the management (individual or team) comes from outside of the business.

**Non-Disclosure Agreement (NDA) or Confidentiality Agreement** – a legally binding agreement whereby the vendor agrees to disclose certain confidential information (e.g. as contained in an information memorandum) in return for the recipient agreeing to keep the information confidential and not use it for commercial advantage.

**Normalised Working Capital** – when adjusting for net debt (or cash) to derive an Equity Value from an Enterprise Value it is important to take into account any seasonal, or even daily, fluctuations in working capital (which directly affects the debt / cash position of the company and hence Equity Value) – hence working capital is normally “normalised” by removing unusual fluctuations, adjusting for non-sustainable changes and averaging out seasonality or other short term fluctuations.

**P/E Ratio** – a valuation term similar to EBITDA multiple but referring to a multiple of the post-tax profits of a business.

**Private Equity** – institutional funds invested in private companies as opposed to publicly traded shares, normally undertaken through a fund structure which comprises a general partner (the fund manager/PE house) and numerous limited partners (the investors) which are typically insurance companies, pension funds, high net worth individuals or similar.

**Sale & Purchase Agreement (SPA)** – the legal contract between buyer and seller that sets out the terms of the transaction including details of the quantum, form and timing of the consideration and the obligations of the seller in terms of warranties and indemnities.

**Share Sale** – the sale of the shares in a company such that the shareholders receive the consideration and realise the capital gain, which is taxable on them.

**Sustainable or Adjusted Profit** – the profit stream of a business after making adjustments for non-recurring items such as shareholder costs or one-off costs or income such as the disposal of surplus assets.
**Vendor Loan Note** – a type of debt in which the seller of the business provides financing for the buyer in the form of a vendor loan. The loan may be secured against the business assets (usually ranking behind any bank debt). It will typically attract interest and will have an agreed repayment structure like a bank loan.

**Venture Capital** – can be used interchangeably with private equity but may also refer to investment in "early stage" businesses which is considered to be riskier than investing in MBOs of more established businesses.

**VIMBO** – vendor initiated management buy-out: similar to an MBO but initiated, and wholly or partly funded, by the shareholders rather than a private equity house.

**Warranty** – an assurance given by the seller that facts on which the purchaser is relying are true.
WHY CATTANEO

You need an experienced corporate finance adviser with a proven track record in advising management teams.

WHAT MAKES CATTANEO DIFFERENT?

- Our flexible approach that is client centric; we want to know and understand our clients’ drivers and objectives and forge a close working relationship with them. Our advice is centred on helping clients to achieve their corporate and personal objectives.
- Our fees are weighted towards a contingent fee on success, designed to align our motivation with that of our clients.
- We have a dogged determination to provide solutions which make business sense.
- We offer value for money based on excellent experience and track record combined with a low overhead structure.
- Our team has direct experience in private equity, banking and industry.