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Management Buyout Strategies

A useful guide for owners & managers considering a management buyout

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INTRODUCTION

Many years ago management buyout transactions were largely confined to buyouts of small privately-held companies. In the vast majority of cases, when the owner wanted to sell a company, the owner simply sold the business to a larger public or private entity.

During the past decade, this trend has been totally reversed. Today, management buyout transactions account for almost half of all merger and acquisition transactions. In today's era of de-conglomeration, management buyouts are typical throughout the entire spectrum of merger and acquisition transactions, ranging from buyouts of small privately-held companies to multi-billion dollar buyouts of large public companies.

The increasing popularity of management buyout transactions has been paralleled by the rapid growth in financing sources for management buyouts. Twenty years ago, the basic financing sources consisted of asset-based loans coupled with seller financing. Today, financing sources range from the basic to the exotic.

As financing sources have increased, so too have the uses and applications of management buyout transactions. The following are some of the more typical situations where management buyouts are now utilized:

- Owners of closely-held companies have used management buyouts to sell their companies to management, rather than to outside buyers.
- Public companies that are takeover targets have used management buyouts as a tool for taking a company private.
- Companies that have been partially or substantially owned by an ESOP for a number of years use management buyouts to provide a "liquidity and exit vehicle" for the ESOP and the participating employees, while increasing the ownership level of key managers and maintaining the company's independence.

The purpose of this booklet is to explain how management buyouts work and to illustrate how various management buyout transactions can be structured in order to accomplish both the buyer's and the seller's objectives.

DEFINITION OF A MANAGEMENT BUYOUT

A management buyout is any buyout in which one or more management employees acquire part or all of the ownership of a company. Thus, a management buyout is distinguished from a corporate buyout. A management buyout need not be leveraged, although it almost always is. In most cases, management buyouts are engineered by the existing management. In some cases, however, a new management team buys the company for the purpose of creating a turnaround in sales and profitability. The essential requirement of a management buyout is that part, or all, of the equity is purchased by one or more individuals who will participate in the active management of the business. This is in contrast to a corporate buyout or third party buyout where all of the equity is purchased by a third party, and management has no direct participation in the transaction other than through stock option plans and similar arrangements.

A typical aspect of management buyouts is the use of an equity sponsor. In most buyouts, the management group joins forces with a sponsor group who invests alongside management to acquire the company. This sponsor typically provides the management team with the bulk of the equity to acquire the company as well as the all-important debt financing which will be utilized to structure the most advantageous form of leverage. Additionally, equity sponsors often provide significant expertise in negotiating and structuring the acquisition, as well as providing additional experienced management personnel if more depth is needed to take a company to the next level of growth.

In return for their involvement in the transaction, management typically receives not only equity based upon the level of their direct investment, but also a significant "carried interest" in the company based upon the attainment of certain future goals. Equity sponsors, who are traditionally passive investors, are usually very eager to grant significant ownership to productive management teams that have a clear vision and an achievable strategy for growing their companies. This differs significantly from third party buyouts, who either replace management altogether or only include them for relatively minor equity stakes in the company.

WHY MANAGEMENT BUYOUTS ARE POPULAR

Management buyouts are increasingly popular for a number of economic and financial reasons, including the following:

- As Corporate America has increasingly sought to reduce costs, increase efficiency and generate more profits, management teams have had to assume more front-line responsibilities for creating and implementing growth strategies, and have had to be more accountable for their corresponding success or failure. As a result, many management groups have begun to view their own desires of acquiring significant ownership as increasingly justifiable.
- As the American industrial economy has matured, more and more companies have reached the point where there is little or no room for additional growth. Accordingly, cash flow can now be plowed into servicing debt more rapidly rather than into growth and expansion, allowing management groups to leverage their companies while still generating high returns.
- In today's market, the individual pieces of many conglomerates are worth more than the sum of the parts.
- Public and private investors alike have come to the realization that companies are better managed when the management group owns a meaningful piece of the company.
- By using leverage, companies that generate inadequate return on investment to the seller can generate a more than adequate return to the buyer.

COMPANIES THAT QUALIFY

Companies that qualify for management buyouts range from privately-held and family-owned businesses to thinly traded public companies, subsidiaries and divisions of larger public companies, and even large public companies themselves.

<u>Industry Characteristics</u>. The most important ingredient in a management buyout is stable, predictable cash flow. Accordingly, the industry characteristics that are necessary for management buyout transactions are as follows:

- Established, mature industries. Newly emerging industries are often not suitable for management buyouts due to the necessity of plowing back cash flow into research and development, growth and expansion.
- Relatively unaffected by recessions. Management buyouts are usually financed by a combination of debt and equity. Industries that are cyclical in nature are usually not suitable, since a steady cash flow stream is necessary in order to service the debt requirements.
- Not subject to rapid technological or consumer obsolescence. Most hi-tech companies are not suitable for management buyouts because of the prospect of rapid technological obsolescence and because of the need to plow capital back into the continual generation of new products.

<u>Company Characteristics</u>. The company characteristics that increase the likelihood of a successful management buyout include the following:

- Capable and experienced management with a proven track record of generating profitability and the ability to establish and implement sound business strategies
- Management willing to invest in the company
- Proven reliable cash flow not subject to large cyclical swings
- Serviceable level of long-term debt
- Reasonable annual capital expenditure requirements
- Proprietary, value-added product lines or businesses rather than commodity-type products, which are subject to large, price fluctuations

ASSEMBLING THE TEAM

Management buyouts should not be attempted unless the entire management buyout team is either in place or can be assembled. The essential members of the management buyout team include the management group, the equity sponsor, CPAs experienced in merger and acquisition transactions, and legal counsel experienced in merger and acquisition transactions.

<u>The Management Team</u>. The key components of the management group include, at a minimum, the chief executive officer, the chief financial officer, and the head of marketing. Each of these key positions should ideally have already been with the company for three or more years. Each of these positions should be filled by strong, capable managers who are self-starters and who are willing to invest in the company in return for a piece of the equity.

In smaller sized buyouts, the management group need not exceed three to four key individuals. The larger the buyout, however, the more necessary it becomes for the group to include more of the staff, including the head of accounting, the head of data processing, the plant manager, the floor superintendent, the quality control manager, etc. The larger the buyout, the more necessity there is also for backup management in all of the key management positions.

The Equity Sponsor. In almost all management buyouts a qualified and experienced equity sponsor is an absolute necessity. The equity sponsor serves as a "partner" with management, providing not only the necessary expertise to negotiate and structure the transaction, but also the equity and debt capital to support managements buyout offer.

- The first function for the sponsor group is to work with the management team to determine if the management buyout is feasible from a strategic standpoint, from a competitive standpoint, and from a financial standpoint.
- The second function is to work with the management team to determine the optimum price and the maximum price that can be paid in a management buyout transaction.
- The third function is to assist the management team in negotiating the buyout terms and conditions with the various parties to the transactions.
- The fourth function is to design the optimal capital structure.
- The fifth function of the equity sponsor is to provide the majority of the equity required to consummate the transaction on behalf of the management group.

The equity sponsor will also provide the necessary debt financing, in negotiating the best possible loan terms, and structure the least restrictive loan covenants and operating ratio requirements. The sponsor will prepare a financing deal book for presentation to their various lending relationships who may be involved in the transaction. The deal book will explain all aspects of the transaction and contains a sensitivity analysis showing the financial impact of adverse financial and economic circumstances.

Finally, the equity sponsor will assist the management group in determining the proper growth and exit strategies, and will assist in the execution of these strategies when the time arises. This will typically include providing additional capital for future acquisitions and capital expenditures.

The CPA. A qualified and experienced national or regional CPA firm should be retained by the management group after an equity sponsor has joined the team. An experienced CPA firm is absolutely essential in advising management regarding the tax and accounting issues that will be involved in a transaction and in assisting management in the due diligence process.

It is essential for the management group to retain its own CPA firm and not to rely on the firm that has previously represented the seller. Although the existing firm may be more knowledgeable about the company's operations, it owes its allegiance to the seller, and it will have numerous conflicts of interest with respect to due diligence matters and disclosure matters if it attempts to represent both parties to the transaction.

Legal Counsel. Similarly, the management group should retain its own legal counsel as soon as it has been determined that the buyout is feasible. Frequently, the legal counsel will be a firm that is recommended by the equity sponsor, since the sponsor will be familiar with law firms that have developed expertise in management buyout transactions.

VALUING THE COMPANY

Once it has been determined that the company meets the industry characteristics and the company characteristics necessary for a management buyout, the next most critical step will be to determine the probable purchase price of the company. In the usual case, the equity sponsor prepares a preliminary valuation. This preliminary valuation is usually a two-step process.

The first step is to determine the company's true operating cash flow. In the case of privately-held companies, it will frequently be necessary to reconstruct the company's cash flow and operating profits to add back deductions and expenses that are taken to minimize the company's taxable earnings.

Similarly, in the case of divisions or subsidiaries of public companies, it will be necessary to reconstruct the company's earnings by adding back arbitrary corporate overhead allocations, and by subtracting the cost of hiring additional managers to run the company on a stand-alone basis. In both cases, it will be necessary to determine whether the company's capital expenditures over the past few years have been more or less than will be needed over the next several years to support the company at its budgeted level of sales and profits.

The second step in the process is to determine the appropriate multiple of Earnings Before Interest and Taxes (EBIT). In the typical case, the maximum multiple of EBIT that can be supported under a management buyout is 5 or 6. Once the appropriate multiple has been determined, the equity sponsor should prepare a sensitivity study to determine if the transaction will work under adverse circumstances.

In the typical case, at a multiple of 5 times EBIT, a company can service debt with both a 20% increase in interest rates and a 20% decrease in pretax income. Conversely, at a multiple of 6 times EBIT, a company can still service debt with a 20% increase in interest rates or a 20% decrease in pretax income, but not both.

Although the buyer can seldom afford to pay more than 6 times EBIT, there are exceptions. One exception to this rule is where a company can reasonably expect a greater than average increase in profits over the foreseeable future without substantial increases in capital expenditures. A second exception is where companies have hidden earnings, so that the buyout price is not in excess of 6 times the reconstructed EBIT. A third exception is where companies have hidden assets or nonessential assets which can be sold off to pay down the purchase price, so that the remaining purchase price is not in excess of 6 times EBIT.

STRUCTURING THE BUYOUT

The financial structure that will be suitable for any particular management buyout depends upon a host of variables, including the purchase price in relation to asset values, the purchase price in relation to cash flow, the amount of existing debt that must be paid or assumed, the growth potential for the company, and the flexibility of the seller with respect to payment terms.

The following three case histories are designed to illustrate the more typical financial structures that are used in management buyout transactions. Each of the case histories, however, has been simplified in order to illustrate the principal aspects of the financial structure.

<u>Case #1: Asset-Based Loan Plus Management Equity Plus Sponsor Equity</u>. Company A was a privately-held East Coast metal fabricator with revenues of $15 million, no debt, and an EBIT, after add-backs for discretionary owner expenses, of $1 million. The management group submitted a $5 million cash offer to the owner of the company, which represented the middle of the valuation range at 5 times earnings. Since the company was involved predominantly in manufacturing and had significant tangible assets in the form of equipment and facilities, the management team and its equity sponsor were able to secure $4 million in asset-backed financing from a senior lender.

Management contributed $300,000 to the equity and the equity sponsor group invested the $700,000 balance. For its direct investment, management received 30% of the equity of the company. However, because management had illustrated to the sponsor group that there were immediate costs savings that could be garnered as well as new accounts that could be added in a short period of time, management was given the opportunity to earn 20% or more of the equity in the company based upon achieving certain established earnings targets.

<u>Case #2: Cash Flow Lender Plus Management and Sponsor Equity</u>. Company B was a privately-held, West Coast distributor of electrical parts with rapidly growing revenues of $20 million, debt of $2 million, and an EBIT of $2 million. The management group used the following calculation to formulate its offer to the shareholders:

EBIT	$2 million
Multiple	$5.5 X
Gross Proceeds	$11 million
Less Outstanding Debt	($2 million)
Net Cash Offer to Owners	$9 million

Again, as in the last example, the management team submitted a $9 million all-cash offer to the owner, plus the assumption of debt, which they felt represented the middle of the valuation range at 5.5 times earnings. Since the business was involved predominantly in distributing, it did not have significant tangible assets in the form of equipment or facilities that could be leveraged. However, the company did have significant cash flow and growth potential.

Therefore, the management team and its equity sponsor structured the leveraged portion of the transaction with a cash flow lender, who is typically used in situations where the company has a stable, predictable earnings stream but little in the way of asset collateral. These lenders usually charge a higher interest rate than senior lenders on the basis of the increased risk associated with a cash flow loan. In this example, the lender refinanced the existing debt and agreed to lend an additional $7 million to the transaction.

Management contributed $350,000 to the equity and the equity sponsor group invested the $1.65 million balance. For its direct investment, management received 18% of the equity of the company. Management was also granted the opportunity to earn 20% or more additional equity in the company due to the company's potential for future growth.

Case #3: Asset-Based Loan Plus Subordinated Debt Plus Management and Sponsor Equity. Company C was a privately-held, Midwest plastic injection molding company with revenues of $40 million, debt of $4 million, and an EBIT of $4 million. The management group used the following calculation to formulate its offer to the owner:

EBIT	$4 million
Multiple	$6 X
Gross Proceeds	$24 million
Less Outstanding Debt	($4 million)
Net Cash Offer to Owners	$20 million

As in the previous examples, the management team submitted a $20 million all-cash offer, plus the assumption of debt, which they felt represented the high end of the valuation range at 6 times earnings. Since the business was involved in manufacturing, it did have some tangible assets in the form of equipment and facilities. However, the majority of those assets were already collateralizing the existing debt of $4 million. The management team and its equity sponsor therefore had to design a multiple tiered capital structure.

A senior lender was brought in to refinance the existing senior debt and lend an additional $6 million to the transaction. A subordinated debt or "sub-debt" lender was also brought into the transaction. These lenders are typically used in transactions where cash flow margins are smaller, the amount of debt required is larger, and/or there is no collateral to secure the loan. These lenders traditionally charge substantially higher interest rates than senior or cash flow lenders and often are granted a small percentage of equity, in the form of warrants, to further compensate them for significantly higher risk. In this example, the subordinated debt lender provided $10 million of subordinated debt to the transaction and acquired, for a nominal price, warrants redeemable for as much as 10% of the common equity.

Management did not have the financial resources to contribute any equity. Therefore the equity sponsor group invested the entire $4 million balance. For its involvement, management was given the opportunity to earn 20% or more of the equity in the company based upon achieving certain mutually agreeable earnings targets going forward.

POST BUYOUT STRATEGIES

Consolidations. Once the buyout transaction has been consummated, the management team should begin working with their equity sponsor to consider various strategies for generating external growth. For fragmented industries, which are ripe for consolidation, or which have already begun consolidating, there are two strategic alternatives for taking advantage of these conditions. Each can serve to build the size and breadth of the company's product offerings, expand its geographical presence, and increase its market dominance.

Roll-Ups. In this approach, the management team uses its company as a "platform" for further acquisitions and begins to aggressively acquire smaller businesses, which can be "bolted on" to the company relatively easily. Typically, companies in other geographic segments or those with complimentary product offerings or a compatible customer base make suitable targets.

Considerable cost savings can accrue to the newly combined company through reduction of overlapping functions and the centralization of certain activities such as administration, purchasing and marketing. Additionally, considerable cross-selling opportunities can be realized if a number of synergistic companies can be acquired and "rolled up" into the framework of the existing platform company.

This growth often leads to the opportunity for the management team to attract the attention of investment bankers who may see this new, high growth company as an ideal candidate for an IPO. This in turn may provide the management team even further opportunities by providing the company with publicly-traded stock, which it may use as currency to accelerate its acquisition and expansion strategy.

EXIT STRATEGIES

A management buyout should not be undertaken unless the management group has also given thought to exit strategies. Typical exit strategies include the following:

- A public stock offering
- Sale back to the company
- Sale to an ESOP
- A recapitalization
- Sale to a strategic buyer
- Sale to a financial buyer

OUR ROLE

Menke Capital Corp. serves as an advisor to management teams of companies interested in structuring management-led buyout transactions. Acting as an advisor to management, Menke Capital Corp. assists management groups in all phases of the buyout process including structuring and negotiating the transaction, raising the equity, and raising the most beneficial forms of debt.

CONCLUSION

Management buyouts have become increasingly popular in recent years as a result of the increasing awareness of these transactions. However, management buyouts can only work in those types of companies that meet the industry characteristics and the company characteristics that are compatible with a fairly high degree of leverage. The decision to undertake a management buyout is a complicated decision that requires a high degree of expertise and experience. The implementation of a management buyout requires the involvement of an equity sponsor who has had previous experience in these areas. Menke Capital Corp. has the requisite expertise and experience in these areas, and we are readily available to assist interested parties in structuring and financing management buyout transactions. The principals of the firm have been involved in a significant number of transactions across a broad range of industries. We are eager to work with existing owners and management groups to evaluate, structure and finance successful management buyout transactions.