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# The manager's guide to buy-outs



BDO Stoy Hayward

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## Introduction

A management buy-out (MBO) or buy-in (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 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 in a buy-out
- an overview of financing and deal structuring
- what is expected from a business plan.

This booklet is written as a general guide and is not a substitute for professional advice. You are recommended to obtain specific professional advice before you take any action.

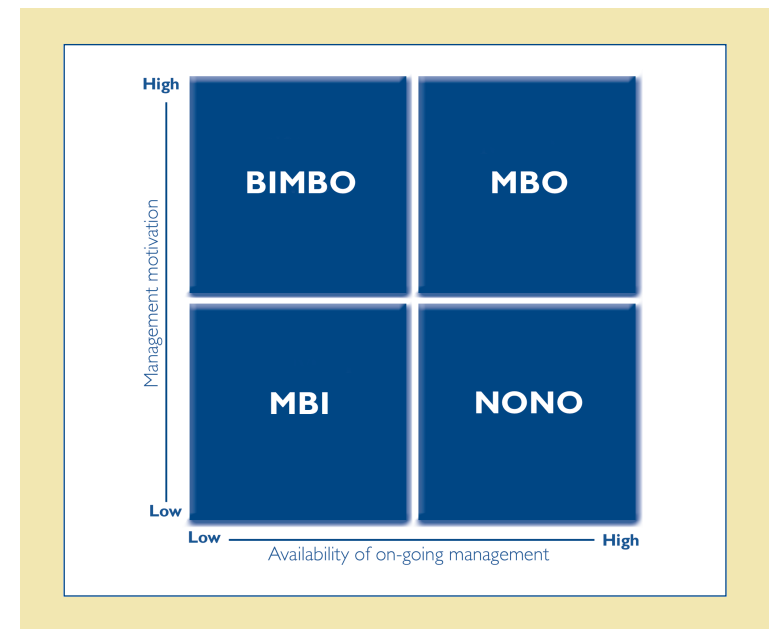
Case studies have been used where appropriate to illustrate the way in which such transactions work. In all cases, names and values have been changed in order to preserve client confidentiality.

The essential ingredients for an MBO are a strategy for growth, a motivated management team and a clear understanding of the likely exit for investors.

## Spotting the opportunity

Businesses are typically sold to management when:

- the business is part of a larger group which wishes to sell a non-core business
- entrepreneurs wish to realise their investment and sell their business
- a buy-out is the preferred solution to the issue of management succession in a public or privately owned business
- the business is a profitable subsidiary of a distressed parent company.



A trade sale is also an option in each of these cases, but a successful business is run by good management and this can create an excellent opportunity for the existing management team to raise finance to buy the business. Continuity of good management reduces any buyer's risk and it is this detailed knowledge of a business and the opportunities within it that enables the management team, backed by a financial institution, to compete head on with trade buyers.

There are, however, other reasons why an owner would sell to a management team in preference to a trade buyer. For example, if management already own shares in the business they can influence the sale process, whilst in certain cases confidentiality may be a key factor for owners deciding not to talk to trade competitors. Allowing management to put an MBO together can also be the owner's reward to the management for the wealth they have already helped to create.

The essential ingredients for an MBO are a clear strategy for growth, a motivated and focused management team and a good understanding of the likely exit for investors. Not all businesses are suitable for an MBO. Companies with poor management and little growth potential are certainly unattractive to venture capitalists, or indeed any buyer.

MBI opportunities may exist for attractive businesses that can grow but lack all or part of the management skills needed to realise the opportunity. MBI team leaders are usually former chief executives with a track record of growing businesses and building teams in similar industries. Very often there may be a good core team lacking a couple of key management team members. Buy-in/management buy-outs, or BIMBOs, are common and involve outsiders joining an incumbent management team in a buy-out. Whatever name you give to a buy-out or buy-in, many of the deal features and issues are very similar.

## Why do a buy-out?

The simple answer, in most cases, is to create the opportunity to make a lot of money and a very high return from a relatively small personal investment.

### A simple example shown can illustrate this point.

The funding for most buy-outs comes from banks and venture capitalists – the banks providing debt and venture capitalists providing equity and risk capital alongside the management team itself. These funds are made available to a new company set up specifically to make the acquisition, often referred to as 'Newco'.

Assume that a business can be acquired by its management for £20m. The management team collectively contribute a total of £400,000 to the 'sweet equity', a bank lends £10m and a venture capitalist invests £9.6m to fund the purchase. The venture capitalist's investment is made through £9.0m of loan stock (occasionally preference shares) and £600,000 of 'real equity'. The MBO team has 40% of the equity and the venture capitalist 60%.

Profits grow significantly and three years later the business is sold for £40m, less net debt and cash. What can management expect out of it? Assuming that £6m of bank loan had been repaid by the time of the sale, the proceeds would be applied as follows;

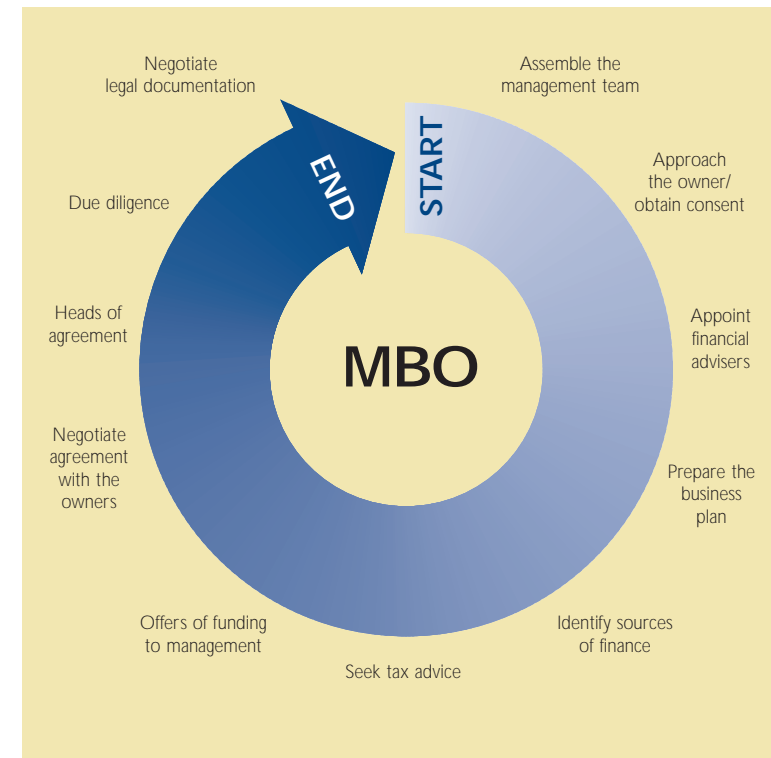
	Day one acquisition £m	Repaid in period £m	Year 4 sale £m
Sale value	20.0		40.0
Bank debt	10.0	(6.0)	4.0
Venture capitalist loan stock	9.0	–	9.0
Ordinary shares	1.0	–	27.0
	<u>20.0</u>		<u>40.0</u>
Ordinary share value split			
Venture capitalist	0.6		16.2
Management	0.4		10.8
	<u>1.0</u>		<u>27.0</u>

- In this example the management team (and the venture capitalist) have made a gain of 27 times their investment and a profit of £10.4m and £15.6m respectively. This is where the term 'sweet equity' comes from. However, increasing the value of a business is hard work and with all that debt, if things go wrong there is little chance of seeing much money back. A very good reason why management's stake is also known as 'sweat equity'.
- This example demonstrates that for a modest investment management can buy into a big share of the increase in the value of their company.
- There are three key ways to grow the equity value of the business. First is to grow the profits, second would be to sell the business at a higher multiple of profits than you paid for it, and third is to fund the buy-out with bank debt which can be repaid out of the company's cash flows. The greater the scope to do all three, the higher the return will be for all investors.

## Completing a management buy-out

A successful MBO involves careful planning, preparation and perseverance from the management team and its advisers. The best deals for management are achieved by advisers who can maximise value through their contacts, experience, negotiating skills and ability to control the agenda and deal process.

The key stages are shown below and will be outlined in more detail in this chapter.



### Assemble the management team

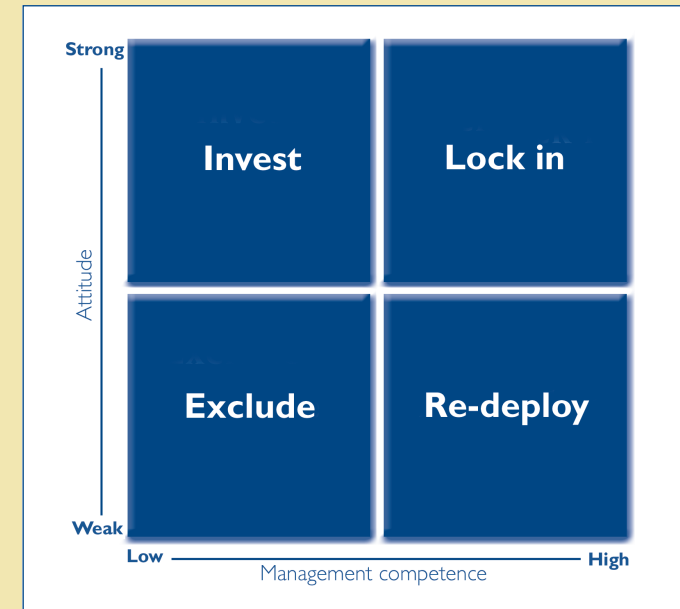
By far the most critical element to all buy-outs is the management team.

Ideally the team should be complete and cover all the major areas of responsibility. Having a CEO is essential, however this can sometimes create conflict between aspiring leaders. Differences need to be resolved and rival buy-outs should be avoided if possible. If there are areas where the team is lacking, speak to your financial advisers to assess whether this is a serious problem or one which can be dealt with during the buy-out process, or even after the deal. Completeness goes beyond simple role filling – the chemistry and balance of the team also requires careful thought.

Dealing with people issues is often the most challenging aspect of the MBO process. Strengthening the management team usually carries a personal cost: it may be necessary to consider a BIMBO or to promote and bring in people over the heads of senior staff which is never easy. Investors and lenders will place great demands on the team. Having a strong financial team is particularly important as it must be capable of delivering timely, quality information throughout the process and beyond.

Those who have what it takes should be locked in as part of the core equity investing team and should be sufficiently motivated to pursue the substantial capital gains potentially available.

### Assembling the management team



Be ready to take some tough decisions. Lock in or nurture people who have the right attitude; redeploy or exclude those who do not.

## Approach the owner/obtain consent

At some point, fairly early in the process, you will need to approach the owner. There must be a willing seller or there can be no deal at all. Some owners might not take an MBO approach seriously – early advice on fundable values can help.

The MBO team will remain employed by the company during the process and are potentially adopting conflicting roles within the business. Permission should be obtained from the owner at an early stage and prior to spending time and money on pursuing the MBO. Until this has been granted, care must be taken to ensure that you cannot be accused of breaching your fiduciary and executive duties to the shareholders.

There are no hard and fast rules governing how an owner should be approached. A lot depends on personalities and the owner's level of involvement in the business. Although the first approach would often be made by the management team, the detailed negotiations can sometimes be better led by advisers, if only to preserve harmonious working relations.

## Appoint financial advisers

The financial adviser should be approached as soon as you start thinking about attempting a buy-out. Use your adviser as a sounding board – for example, on the feasibility of a buy-out, current market conditions, valuation and the likelihood of raising finance.

Having established that there is potential to complete a buy-out, the financial adviser's role would typically include:

- advice on the content of the written and financial business plan and the investor presentations
- marketing the opportunity and raising the venture capital and debt finance
- negotiating financing terms and getting you a good deal
- negotiating with the owners and their advisers

- introducing appropriate lawyers and other professional advisers to the MBO team
- project managing the transaction to completion.

### The financial adviser

The financial adviser should specialise in deals of this type, with particular expertise in raising equity and debt finance, and should act for you throughout the deal.

The buy-out process is a time consuming and difficult period for you, despite this the MBO team must remain focused on running the business for the benefit of the shareholders and ultimately themselves. Crucially, the financial adviser has a general project management role over the whole deal, in particular liaising with the other professionals, financiers, the current owner and your team to ensure completion is achieved quickly and efficiently.

## Prepare the business plan

Once the owner has been approached and permission to pursue the buy-out has been obtained, you should complete your business plan.

The business plan is a key document as it represents the major aspect of your team's preparation for the MBO. It explains the rationale for buying the business, states your strategy, provides financial projections to reflect the strategy and is the platform for raising the finance and agreeing your equity interest and the acquisition price.

The financial adviser can assist in the completion of the business plan by advising on:

- content, length and structure
- issues to be addressed
- expectations and likely reactions of the financial institutions who will receive it.

Further details on compiling the business plan can be found on page 36 of this book.

## Identify sources of finance

The financial adviser's job is to identify potential sources of debt and equity finance, to effectively market the opportunity and secure meetings between the management team, investors and lenders.

First impressions count and meetings and presentations to investors must go well. It is important to take time to work on the presentation and your adviser should help you prepare with rehearsals and constructive criticism.

The presentation allows management to explain their proposition in a more interactive environment and determine whether there is chemistry with investors. Investors and lenders will want an elaboration of the business plan and the chance to assess your strengths and weaknesses before deciding whether they can back the team.

### The venture capitalist

Venture capitalists are financial institutions that make investments mainly in private companies. In most buy-outs, the venture capitalist will provide finance mainly through interest bearing loan stock, as well as investment in the ordinary equity shares of the business. The venture capitalist and your team will usually share the same equity interest, proportional to their respective share holding. In some cases, a ratchet mechanism may be used which gives a disproportionately higher return to management once key financial milestones have been achieved and investors have earned a minimum return.

The funds that the venture capitalist invests are either from funds raised from other entities such as pension funds, which have been entrusted to the venture capital house for a set period of time to invest, or from its own or its group's balance sheet (ie direct investments). Whatever the source of funds, the venture capitalist needs to make a substantial return on its investment.

## Seek tax advice

Tax advice should be sought early on. Whilst tax should not dominate the agenda, it will influence the deal structure, share option plans and funding methods and is therefore relevant for both the owner and buy-out team. Not taking good tax advice at an early stage can be costly, whilst taking late tax advice can significantly change the deal causing material delay.

## Offers of funding to management

Having met the banks and venture capitalists, the financial adviser will negotiate indicative funding proposals that will outline the terms of the finance, how much your team is expected to invest and what equity you will receive. Your adviser will help you compare offers and negotiate the best deal. Managing a process which creates competition between investors and banks certainly helps and significant improvements in your deal can often be secured this way.

Funding at this stage will be subject to contract and due diligence. Unpleasant surprises in the due diligence stages of the transaction may damage credibility and result in terms being re-negotiated or even withdrawn. MBO and BIMBO management teams should know what the issues are; being frank and up front about issues will be appreciated by investors.

### Banks

Buy-outs are usually financed by funds from both venture capitalists and banks. Banks are usually the cheapest source of finance. The amount of debt finance depends on the security available to the bank and the cash flows generated by the business. It is common to see several types of debt with senior debt often being supported by higher yielding mezzanine finance. This will be covered in further detail in the 'Financing and structuring the deal' chapter.

## Negotiate agreement with the owners

The objective must be to complete the deal quickly and on sensible terms agreeable to all parties. Protracted negotiations with owner or a loss of momentum will dampen investors' ardour. It is fundamental to establish early in the process the price at which owners are likely to agree to sell.

It is not unusual for there to be a difference in the owner's price expectations or hopes and the price at which a deal is fundable. Expectation differences narrow on both sides during the negotiation process as deal terms and structures are developed to bridge the gap.

The price a venture capitalist is prepared to pay for a business depends on their view of their likely returns. To bridge a pricing gap, earn-outs or deferred consideration may work. In addition you could agree to a ratchet which gives the investors a greater proportion of the returns when they are low, and a decreasing proportion of excess returns over an agreed base level.

If you really believe in the upside, a ratchet can improve your deal. The downside to a ratchet is that they can get complicated, often need re-negotiating if new funds are raised and offer a much less exciting return if the business does not out-perform.

Ideally, you and your advisers will be negotiating the financing with a number of investors at the same time as agreeing the deal with the owner. This gives the greatest chance of finding a route to deliver an acceptable deal to all parties.

## Heads of agreement

There could be three or more heads of agreement including:

- the terms of debt finance with the bank
- the terms of venture capital finance and the management deal
- the terms of the deal with the owners.

These will cover key commercial terms of the deal, timetable, the scope of required due diligence and set out the basis for granting a period of exclusivity, during which time the deal can be completed.

As many of the important commercial issues and principles as possible should be agreed at this stage to minimise the potential for misunderstanding.

## Due diligence

MBO teams should not expect any surprises from the investors' due diligence, and must be well placed to provide detailed responses to enquiries. The due diligence process is a requirement of venture capital 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 audit complete earlier than usual.

As well as investigating the financial affairs of the business, investors will often commission commercial due diligence that will focus on markets, suppliers and customers. In particular, the venture capitalist will want to understand the market dynamics and opportunities as well as to seek to corroborate the views of the management team.

It is also quite usual for customer referencing to be carried out. This may be by meeting or by telephone and will deal with matters such as customers' views about the business and what influences their buying decision and choice of supplier.

**Investigating accountants**

When the venture capitalist has been selected, and the owner has accepted an offer for the business, the venture capitalist will appoint a firm of accountants to carry out a due diligence exercise into the financial affairs of the business.

Because the investigating accountants are acting for the venture capitalist and not the management team, it is a general rule that, to avoid conflicts of interest, the investigating accountants will not come from the same firm as the management team's financial adviser.

**Negotiate legal documentation**

The legal agreements will typically include:

- the articles of association for Newco
- the shareholders' agreement
- the sale and purchase agreement
- the banking and private equity financing agreements
- management's service agreements.

The shareholders' agreement and articles of association will deal with the conduct of the company and in particular the respective rights of the management and venture capital shareholders. The basic principles underlying the way venture capitalists invest and the protections and rights they and management teams can expect are fairly well established. However, good legal advice is essential to ensure that the complex agreements are understood and work for all parties.

**Lawyers**

The various parties involved in a buy-out require specialist legal advice. Your team will come across a number of different legal firms during the process. Normally, you can expect to have dealings with lawyers acting for the vendor, the bank and the venture capitalist as well as those acting for you.

Your lawyers will focus their advice on the:

- heads of agreement between the owner and Newco
- sale and purchase contracts
- the shareholders' agreement between the venture capitalist and management team
- any warranties given by the management team to investors
- Newco's articles of association
- banking agreements
- directors' service contracts after the buy-out.

**Conventional practices**

Conventional investor practices reflected in the legal agreements might be quite unfamiliar to a buy-out team and include:

- business plan warranties
- what happens if members of the management team leave
- what happens if the company defaults on its financing agreements
- the ability to exit the investment.

**Business plan warranties** Investors usually ask the management team to warrant certain factual information set out in the business plan. They will want to be comfortable that, in the circumstances, the assumptions underlying the financial projections are reasonable.

Asking for warranties and your disclosure against them should be seen mainly as an information gathering exercise restricted to the facts. So, for example, this does not involve you warranting the forecasts themselves, which by their nature, are uncertain.

**Management team leavers** Dealing with management team leavers is often a sensitive point. The investors' perspective is that if you have the opportunity to invest a relatively small amount to enjoy potentially high returns, those returns should only be available if you stay and grow the business until exit. This is something of a double edged sword and it is quite usual that a leaver would be required to sell back all or some of their shares. A 'bad leaver's' shares will normally be acquired at cost or nominal value. A bad leaver is usually someone who has acted fraudulently

or someone who has deliberately failed to contribute to the running of the business. Good leavers are 'no-fault' leavers, for example, as a result of illness or maybe a family crisis. If they have to sell back some shares it should be at market value.

**Defaulting on financing agreements** If the company defaults on financing agreements and is not able to remedy the position quickly, investors will usually reserve the right to take control of the board and, if necessary, appoint new management. Venture capitalists do not have the skills and knowledge to run the companies they invest in so this happens rarely in practice. In most cases investors will prefer to work with management to resolve a problem and may provide additional finance to protect their initial investment.

**Exiting the investment** Where investors own a majority stake, they will usually seek the right to force a sale of the company. They achieve this by having legal provisions which allow them to 'drag along' management shares so that they are available to be acquired by a purchaser. The last thing a venture capitalist wants is to be locked into an investment it cannot exit. In some cases drag along rights only come into effect after an agreed time has elapsed since the buy-out. Exercising drag along rights is not that common as most investors will have taken time to understand management exit plans before deciding whether to invest.

Where the management team has granted 'drag along' rights to their investor, they should seek 'tag along' rights to ensure their shares tag along with the venture capitalists to any deal so that their interests are dealt with equitably and in the same way.

If there is uncertainty about exit timing, management could attempt a secondary buy-out and arrange for a re-financing to exit the original investors. It may be possible to negotiate an option that would give management a reasonable period to find an alternative (financial) buyer.

## Timescale and costs

On average, buy-outs typically take three to six months, but there are always exceptions and some have taken a few weeks and others have gone on for much longer. 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.

Some of the deal costs may be underwritten by the owner once a price has been agreed in principle. Having an owner who is prepared to underwrite some of the professional fees will help in reducing the size of the contingent fees and total deal costs. 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.

You will want a good relationship with your backers - the warmer the better.

## Financing and structuring the deal

A buy-out needs to work for lots of stakeholders but in particular the management team, venture capitalists 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. Venture capitalists will also work back from a range of target returns to establish an affordable or 'fundable' valuation.

### The venture capitalists' perspective

For venture capitalists, a fundable price is a function of several factors, including:

- the amount of debt that can be supported by the company
- the likely range of exit values that could be achieved in, say, a three to seven year time frame
- the risks of underperforming or not exiting.

### Gearing

The level of debt, or gearing, which is used in buy-outs can come as a shock to some managers. It is common for debt levels to be in the region of three times earnings before interest and taxation (EBIT), depending on the type of business and its prospects. It must be remembered that high debt means high risk but also that this gearing is one of the key ways the returns are earned from buy-outs.

The venture capitalist's investment is risk capital and will rank behind the banks, but in most cases ahead of the management team. It is mainly in the form of loan stock, and a much smaller amount of ordinary shares – the real equity. On a sale the bank will be repaid first or its debts assumed by the purchaser, followed by the venture capitalist's loan stock with the surplus available to the owners of ordinary shares.

The greater the capacity for raising bank debt to finance an acquisition, the lower the amount of venture capital required, therefore, at a given exit value, the higher the returns to shareholders. Of course this must be balanced with the risk of default if the business does under-perform.

### **Exit value**

The future value of the business on exit will be calculated by making reasonable assumptions about future profitability, and what future value this would have to a purchaser or to the market on flotation. The value of the equity invested will also be enhanced by the debt that has been repaid by the company before the final sale.

The risk for the investor is that the management team is unable to deliver the forecast profits and/or organise a sale. As well as carrying out due diligence on the company and the market, venture capitalists will place great emphasis on evaluating whether the management team are capable of delivering on their business plan.

### **Inability to exit**

Venture capitalists are focused on making capital gains in the medium term. It is not uncommon for the loan stock to be repaid over a period if there has been no sale, say after five years. This way, investment funds are returned before an exit, which can improve the venture capitalists reported performance. In the early years when the company is growing and repaying bank debt it is often not possible to pay dividends. In the absence of an exit, investors will sometimes start earning their return through a contractual dividend which may not be available to the management team. The rights to these dividends and the amounts are usually agreed when the buy-out is first put together. By making their money more expensive in this way, venture capitalists believe this makes management teams, who are reluctant to sell, focus on finding a buyer and obtaining a final exit for all shareholders.

## **The lender's perspective**

Debt acquisition finance comes in various forms. The type, amount and terms will depend on the security available and the ability to service and repay debt from cash flow. Typical debt acquisition finance might include one, or a combination, of:

- senior debt
- asset finance
- mezzanine or junior debt.

### **Senior debt**

Senior debt is usually the lowest cost financial instrument in an MBO. Lenders will take first charge over the assets of the company and have the greatest security. Senior debt is typically repaid in a five to seven year timeframe but, depending on the business, may be longer. If the company has freehold property a longer term mortgage may be appropriate. It is not unusual for senior debt repayment profiles to be 'back-ended' to some extent.

### **Asset finance**

Asset finance is secured on particular assets – usually stock and debtors. The lender will advance cash based on a proportion of the value of eligible assets. In the case of the stock, lenders will pay particular attention to slow moving stock and the suppliers' terms including reservation of title clauses. In the case of debtor finance, slow paying debtors may be excluded as not providing sufficient security.

### **Mezzanine**

Mezzanine or junior debt finance ranks behind the other main forms of debt finance and has far less security available. It generates a higher return for the lender through a combination of a higher interest rate and a redemption premium or warrants to subscribe for ordinary shares. Increasingly banks have become keener to offer these premium rate products.

Banks who provide the acquisition finance will usually also provide the working capital facilities.

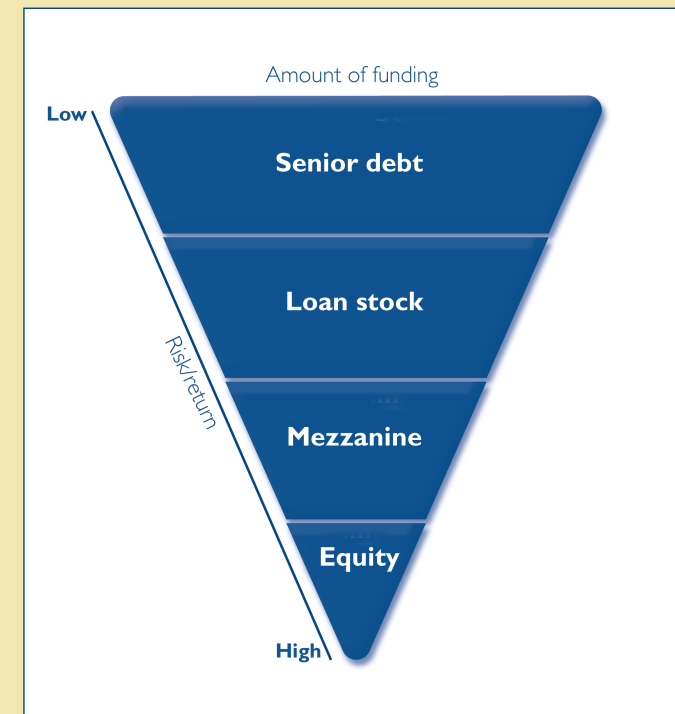
### The management team's perspective

Management have to run the business with the financial structure developed at the time of the deal. It is essential that the structure works for all shareholders and importantly, the company. Management will seek as much personal equity as possible by maximising bank debt and minimising venture capital without crippling the company with the financial structure. So whilst less venture capital means management will be able to secure a higher share of the equity, if the company cannot repay its debts this will be of no value.

The management team will be expected to personally invest their own capital into the buy-out. The exact amount has to be a meaningful amount to each individual. One rule of thumb is a year's salary, but this will vary, depending on personal wealth and the extent of any existing shareholding in the company. From the point of view of the venture capitalist, the team's contribution helps to ensure that all parties are committed to growing the business and creating capital gain.

The high levels of debt in the business might require a change in the way the business is managed. Tight cost and working capital control, strong financial controls and reporting are mandatory, and the trade off between cash and profit can be brought acutely into focus. If the financial structure is too tight, the lack of flexibility can result in missed opportunities.

### A leveraged structure



Equity provides the highest potential for investment returns but also carries the highest risk. Most buy-outs have high levels of bank debt and/or loan stock.

### A leveraged return in practice – Case study

Mymanor is a second generation, family owned and run, manufacturing business. It has regularly made profits (before interest and tax) of £4m to £5m over the past few years but with little investment in growth. Run for cash, the family shareholders have enjoyed substantial dividends. In recent years the founders have taken a step back from the business and the founder's youngest grandson has increasingly taken control of its growth and development and has brought in additional professional management. The founder shareholders and related family wish to realise their investment and give the grandson and new management team the opportunity to purchase the business and create their own wealth.

Management is optimistic about the future of the business and is confident that with £2m of additional investment they can reduce manufacturing costs and introduce new product ranges which should result in profits growing to £8m within three years.

Funding is required for the transaction at an agreed value of £35m, total deal costs and stamp duty of £1.5m and £2m for capital expenditure, making a total of £38.5m.

- The management team secures 35% of the equity for an investment of £350,000
- Bank debt is repaid over seven years in equal amounts
- Venture capitalist loan stock pays 8% interest per annum
- Mezzanine finance pays 10% interest per annum and has warrants to subscribe for up to 5% of the equity on a sale. This reduces the management team and venture capitalist's effective equity to 33% and 62% respectively.

After three years, the management team has been successful in growing the business and introducing new product ranges and profits increase to £8m. A trade buyer has made an approach and the business is sold at an enterprise value of £56m (effectively on a multiple of seven times EBIT, the same as the entry multiple). As a result of the sale, the proceeds available for the shareholders are shown below:

	<b>Day one acquisition £m</b>	<b>Repaid in period £m</b>	<b>Year 3 sale £m</b>	
Sale value	35.0		56.0	
Capital expenditure	2.0			
Fees	1.5			
Total funding	<u>38.5</u>		<u>56.0</u>	
<i>Financed by</i>				
Bank debt	15.5	(6.6)	8.9	
Mezzanine finance	5.0	–	5.0	
Venture capitalist loan stock	17.0	–	17.0	
Ordinary shares	1.0	–	25.1	
	<u>38.5</u>		<u>56.0</u>	
<i>Ordinary share value split</i>				
Venture capitalist	0.65		15.6	62%
Management	0.35		8.3	33%
Mezzanine	–		1.2	5%
	<u>1.00</u>		<u>25.1</u>	100%

Management, in this example, invested only £350,000 to make a capital gain of just under £8m after three years.

The venture capitalist, having staked £17.65m, sold their interest for £32.6m (£15.6m for their equity and £17m for their loan stock). In addition, during the three years they have received an annual interest payment of 8% on their loan stock, giving them an overall compound annual return of 30% - also known as their internal rate of return, or IRR.

The mezzanine provider has a share of the upside and interest on its loan of 10% per annum, giving it an IRR of 17%.

Key points to note from this example are:

- by taking on this level of bank debt, the risk profile of the business is increased. The financial obligation in the first year represents a significant proportion of profit and, more importantly, cash flow. However, it is the debt that allows the venture capitalist and management team to make a return that is significantly higher than the underlying growth in the company.
- effectively, what management acquired was 35% (diluted to 33% by the mezzanine warrants) of the increase in the value of the business.
- the level of bank debt is high and probably higher than the company would have been able to borrow before the MBO. Specialist acquisition finance teams at certain banks work alongside venture capitalists to get a high degree of understanding of the business and management team and to assess the debt funding capability of the business.

## Choosing the venture capitalist and banks

As well as a hard nosed financial assessment of the funding being offered, other factors less easily quantified are important and you should talk openly about these.

Key points to consider in choosing a venture capital partner include:

- who will you deal with after the MBO process is complete? The person involved in completing the deal may be replaced by the venture capitalist's portfolio manager. This is not necessarily bad news, but you need to meet and be comfortable with who ever you will be dealing with
- what have other management teams' experience been with a particular venture capitalist? Do not hesitate to ask for, and follow-up on, references
- are they flexible and user friendly? An experienced adviser can tell you a lot, but the references taken will be invaluable
- have they done similar deals? The venture capitalist is selling to you too - do not be afraid to quiz them
- do you like them?

As well as knowing which venture capitalists and banks may be interested in a particular type of business, the financial adviser will be able to fill you in on some of these softer issues. You will want a good relationship with your backers - the warmer the better.

When everything is signed, you'll want to pop a champagne cork or three.

## After the buy-out

The first point to make is that you and your team will feel the need to catch up with things you were unable to do during the buy-out, but when everything has been signed, you'll want to pop a champagne cork or three.

Of course the deal was hard work, but the real task of creating value by growing the business and repaying the debt starts in earnest now, and a key concern for the management team will be its relationship with employees, customers and suppliers.

### Suppliers and Customers

Suppliers who review credit terms and see a company with high debt levels may be concerned. Pre-emptive action to explain what has happened and who the financial backers are, should help. The deal also offers the chance to contact customers and tell them what has happened, who has left and what the company's plans are.

### Employees

Employees may initially be concerned about the change in ownership but this is also an opportunity to communicate the strategy for growth. Share options or employee share ownership schemes, to bind in a wider number of key employees, might be key to being able to retain and attract high quality people, and will help establish a capital growth culture.

### Monitoring

After the deal has been signed, the venture capitalist and banks are mainly focused on monitoring the investment by means of board papers and a monthly information pack. Usually the venture capitalist will either take a seat on the board, and/or ask for the appointment of a non-executive chairman. These non-executives should work for the company not the venture capitalist, and bring relevant experience and expertise. They will ask lots of questions but will leave the day-to-day running of the business to you.

### **A change in plan**

A while after the buy-out you may find your strategy to grow changes and evolves beyond the initial plan and you may identify opportunities to grow that were not covered by the business plan, like an acquisition or major investment. Investors and bankers will be keen to be involved in evaluating these opportunities and backing new initiatives. Similarly, if trading does not go to the original plan, investors and banks will want to understand how management now see the opportunity and any revised strategy to grow the business. As major shareholders, there will be a high demand for information and a need to be consulted and included in the major decisions which impact the business and its financing.

### **Grooming for sale**

In the run up to a sale or flotation the venture capitalist will become progressively more involved with the business, and will help introduce corporate finance advisers. If the exit is to be achieved by means of flotation, additional non-executive directors could be appointed with the brief of grooming the company.

## **The business plan**

If you are looking to raise finance for a buy-out or buy-in, you will need to prepare a business plan.

### **Role of the business plan**

Every management team seeking finance for a management buy-out will need to prepare a succinct business plan in which the company's future strategy is articulated and quantified, which is used to fulfil a number of roles:

- it is the document by which you sell your business to potential investors, ie venture capitalists and banks
- it is used by potential financial backers to appraise the opportunity and value the business
- it forms the basis upon which the financial backers will initially assess the management's performance once the deal has been done.

The business plan should contain the following key elements:

- a thorough description of the company's activities, the markets in which it operates, its strengths, weaknesses and critical success factors
- an explanation of where the business is going and how it is going to get there
- a description of the management team and their ability to deliver.

### **Who prepares the business plan and when?**

The golden rule is that the plan should be prepared by management. Your adviser should advise on the content, act as a sounding board and provide constructive criticism to ensure your message is effectively delivered.

The members of the management team are the people the financial institutions are backing so it is important that they own the document and the strategies and plans contained in it. Venture capitalists are wary of business plans that appear too biographical, so it is better for the plan to reflect your style and character throughout.

The role of the financial adviser is to advise you on the preparation of the plan, and on the likely reactions and expectations of the reader – venture

capitalist and banker. You may need specific assistance in organising the financial information but, critically, the underlying assumptions must come from management.

### Style and length

The document is a selling document – it should be truthful, clear, concise and with a compelling strategy for growth. Aim to make it:

- positive and punchy in style, avoiding excessive jargon or industry-speak
- capture the reader's attention and then keep it
- contain sufficient information to support the points made. This will inevitably mean that many technical subjects or issues need to be explained in simple layman's terms.

Overselling a proposition with unrealistic or misleading statements and financial projections will not survive the due diligence process and damage your credibility. On the other hand, underselling will fail to excite investors. Getting the balance right is important.

The business plan is usually the first contact that a venture capitalist has with a company seeking finance. Unfortunately, it is all too often the last. There are far more business plans than businesses which actually receive funding. It is vital that time and care is taken on the preparation of the business plan and that professional advice is sought in advance of any distribution.

### Detailed contents

The sections usually contained within a business plan include:

- executive summary
- history, business, products and services
- market and competition
- strategy and business development
- management and organisation
- summary financials
- appendices.

The comments below are generic and each plan will have specific angles or messages which need to be expressed.

### Executive summary

This should be punchy and hard hitting, and summarise all the key positive points about the business in one place. Make sure that all the points made in this section are discussed and developed elsewhere.

Due to time constraints, many potential funders will only read on if they like the executive summary. It is crucial that this section is punchy and delivers the key messages to generate sufficient interest so that the reader will read the full plan. This section should be capable of standing alone if necessary.

Although this will be the first section in the plan, it should be the last to be written so that it draws together all of the key points made within the full document.

Points that you could consider for inclusion in the summary are:

- description of the deal
- what the business actually does and where it is based
- key trends in the market that should be highlighted
- main opportunities to grow the business
- the Unique Selling Points (USPs) which set your business and products or services apart from the competition
- the core senior management team
- the critical success factors to be achieved to reach your goals  
a brief summary of the key financial results and forecasts
- how will the funder realise their investment (indicating possible buyers).

### History and background

This section focuses on the company's development. You may consider inclusion of a timeline showing key points in the history of the business. In addition, the section needs to explain what the company actually does, ie what product does it make or what services does it provide and who its customers are.

The issues addressed in this section might include:

- major events which have shaped the business
- operations and location
- employees and organisation
- types of customers, their location and how their services and products are delivered
- the nature of the contractual relationships with customers
- the nature of relationships with the company's suppliers
- current ownership.

If possible, cross-refer descriptions of the company's products to corporate literature in the appendices.

### **Markets and competition**

It is important that you set the position and prospects of your business in the context of the markets in which it operates. Wherever possible try to support the information with reference to external sources of analysis and data.

You need to clearly identify which markets your company operates in and specifically:

- market size, segments, location
- the key trends in the markets (eg growth levels, key dynamics such as demographic influences, environmental issues, consumer tastes)
- the expected evolution of the markets
- current market developments and future impact
- how the company protects its own position and the key barriers to entry and competition
- the competitors in the various markets and what differentiates your business
- the current market share of the company and the relative market shares of the major competitors
- the process by which new business is won.

### **Strategy and business development**

Having set in context the current status of the company and its principal markets in the previous sections, this chapter should explain where the growth is going to come from and how it is going to be achieved.

This section would usually address issues such as:

- outline of the opportunities
- any new markets which the company will operate in and/or what new products the company will develop
- the strategies for achieving growth
- plans for acquisitions
- attracting and retaining customers
- management and HR strategies
- distribution/manufacturing/marketing/sales strategies
- any targets and objectives of the company in terms of market share, pricing and promotional policy, distribution channels etc.

The main focus of the chapter should be at least the next three years and these strategic development targets should tie in with the financial forecasts included within the plan. Reference can be made to other opportunities further into the future.

### **Management and organisation**

Having explained what the company does and what it plans to do, this chapter needs to explain who is going to deliver the strategy. In particular, the chapter needs to include:

- a description of the roles and responsibilities of the management team and their key strengths
- how members of the team compliment each other
- an explanation of how the company is organised
- consideration of any management succession issues and recruitment
- human resource policy and strategy.

Where there are obvious gaps within the management team, eg no Finance Director, or succession issues (perhaps due to impending retirements), explain the steps that you have taken to address this.

### Summary financials

This section should provide an overview of the historic financial performance of the company, together with projected results for the next three years and a summary of the key assumptions underlying the projections. More detailed financial forecasts comprising fully integrated profit and loss accounts, balance sheets and cash flows should be included as an appendix. Ideally, the first year figures should be prepared at monthly intervals, with the remaining years' figures at quarterly intervals.

The financial projections need to reflect the strategy and business development section of the plan.

Include key financial data relevant to your business or industry. The reasonableness of forecasts in comparison to historic performance in the context of independent data will help underpin and give the forecasts credibility.

Also include within this section the current financing facilities open to the business, eg:

- bank overdraft facilities and terms
- invoice discounting or debt factoring arrangements
- terms of bank or other loans.

When preparing financial projections, it is best to avoid trying to invent deal structures. Advisers and venture capitalists will model various deal structures and once a financing structure has been agreed it can be included in the projections.

### Appendices

The business plan can be supported by relevant appendices, such as:

- most recent audited accounts
- detailed financial projections (for three to five years) and assumptions
- full CVs for the management team
- a bullet point analysis of strengths, weaknesses, opportunities and threats (SWOT)

- corporate literature and any relevant extracts or press cuttings on the market in general, the company or its products.

### In conclusion

The business plan must hold the reader's attention throughout so make it punchy and interesting. Writing positively shows commitment to the business and a thorough understanding of the market. Regardless of who takes responsibility for individual sections, someone should take an editorial role to ensure consistency of style and content. It is imperative that the core management team has buy-in to the document as a whole.

Finally, do not underestimate the time and effort required to prepare a robust and credible plan; this time is invaluable.

Do not underestimate the time and effort required to prepare a robust and credible plan; this time is invaluable.

## Glossary

The purpose of this section of the guide is to explain some of the more commonly used phrases, expressions, terms and buzz words used during an MBO.

### **Arrangement fee**

One-off fee charged by banks and venture capitalists to Newco in return for making cash or facilities available.

### **BIMBO**

Buy-In Management Buy-Out (management team consisting of existing management and new management from outside the business).

### **BINGO**

Buy-In Growth Opportunity (transaction in which the buy-in receives more funds than required to acquire the target business, which is used to fund a large and rapid expansion programme).

### **Business angel**

Individual with finance to invest in privately funded business opportunities.

### **Caps and collars**

Mechanism used to fix interest rates on loan agreements between agreed stated interest rates.

### **Captive fund**

Private equity house which receives its finance from within the group to which it belongs. Contrasts with independent funds.

### **Coupon**

The interest on a debt or similar facility.

### **Covenant**

Terms and conditions of (usually) bank lending, which need to be met or achieved to avoid breaching loan agreement with banks.

### **Deferred consideration**

Consideration paid in the future.

### **Development capital**

Finance received from bank or venture capitalists to fund expansion.

**Dividend**

Distribution of profits made to shareholders.

**Dividend coupon**

Net rate of dividend expressed as a percentage of the shares' nominal value, eg 8%.

**Drag along rights**

Where one shareholder can require other shareholders to vote or accept a course of action in the same way. Often seen where a venture capitalist has a majority stake and when they want to sell out, they can force the minority shareholders to sell out too, so 100% of the shares can be delivered to a purchaser. (See also tag along rights.)

**Early stage**

Term given to businesses which have developed product(s) but have not yet have brought them to market.

**Earn out**

Mechanism whereby the price a vendor receives for a business is linked to the future profitability of that business, with deferred payments being made to the vendor on the achievement of agreed profit targets.

**EBIT**

Earnings Before Interest and Tax.

**EBITDA**

Earnings Before Interest, Tax, Depreciation and Amortisation.

**EBO**

Employee Buy-Out.

**Equity**

Ordinary shares in a company entitling the owner to membership rights in that company.

**Equity kickers**

See Warrants.

**Exit**

Term given to the method or process by which a private equity house sells some or part of its holding or shares and realises its investment.

**Expansion capital**

See Development capital.

**Factoring**

Method of raising finance by receiving immediate payment from a factoring house equivalent to an agreed percentage of sales invoices. Also referred to as invoice discounting.

**Follow-on investment**

Further investment by a private equity house in the same business.

**Gearing**

Term given to the amount of borrowings in a business, usually expressed as a ratio to equity or a percentage of shareholders' funds.

**Indebtedness**

Amount of borrowings (including leasing) which a business has.

**Independent fund**

Venture capitalists which invests funds raised separately from the group or parent to which it belongs.

**Internal rate of return (IRR)**

The compound equivalent annual rate of return on an investment.

**Invoice discounting**

See Factoring.

**Junior debt**

Debt, secured on Newco's assets, ranking behind senior debt and mezzanine finance.

**Leasing**

Form of finance whereby specific fixed assets are purchased from a leasing company and funded by a schedule of repayments over, typically, three to five years.

**Leverage**

Method of financing involving high amounts of debt and low amounts of equity, thereby potentially optimising return to equity holders.

**Loan stock**

Term given to loans made to businesses by financial institutions, with a schedule or repayment and bearing interest.

**Collateral**

Security over a business' assets held by providers of debt finance.

**MBI**

Management Buy-In.

**MBO**

Management Buy-Out.

**MEBO**

Management and Employee Buy-Out.

**Mezzanine finance**

Debt secured on Newco's assets, ranking ahead of junior debt but behind senior debt. Often have warrants attached entitling mezzanine providers to a percentage of Newco's equity.

**MWO**

Management Walk-Out.

**Newco**

A company which is specifically set up for the purposes of acquiring the target business from the vendor and in which the management team and the venture capitalists will be shareholders.

**Options**

See Warrants.

**Ordinary shares**

See Equity; contrast with Preference shares.

**Participating dividend**

Dividend entitlements expressed as a percentage of profits after tax as opposed to a fixed coupon rate.

**P/e ratio**

Ratio of the profits of a business to the price paid for the business. Usually based on profit after tax.

**Preference shares**

Shares in a company which carry entitlement to a fixed or profit related dividend and assets on a distribution ahead of ordinary shareholders. Generally redeemable.

**Private equity**

Strictly speaking private equity and venture capital are different. Private equity is risk capital usually invested as loan stock and a small amount of real equity. However, in buy-outs, private equity and venture capital are often used to mean the same thing. See Venture capital.

**PBIT**

Profit Before Interest and Tax. This is the same as EBIT.

**P2P**

Public to Private. This is the MBO of a publicly quoted company. It combines features of an MBO and a public company transaction, whereby the public company is acquired by a privately owned Newco, resulting in a delisting of the public company.

**Ratchets**

Mechanism whereby management's shareholding increases at the expense of other shareholders on the achievement of specified milestones.

**Refinancing**

Replacement of one source of finance with another, eg a bank replaced with another on lending on different terms.

**Seed capital**

Term given to capital used to fund initial feasibility of a product. See Start-up and Early stage.

**Semi-captive fund**

Like captive, but also manages funds raised independently of its parent group.

**Start-up**

Business in the process of developing their product(s) but in the pre-manufacture or pre-trading phase.

**Venture capital**

Strictly speaking venture capital is equity only finance. Most buy-outs are not funded this way. Private equity is often referred to as venture capital and the two phrases are often used to mean the same thing by many in the UK. See Private equity.

**Venture capital trust**

Trust offering tax advantages to investors, the funds of which are managed by a private equity house, and which has the remit of investing in smaller unquoted UK companies.

**VIMBO**

Vendor Initiated Management Buy-Out. This is often used where the owners control the sale process by marketing the business to a number of venture capitalists.

**Warrants**

Rights of conversion into a stated amount of company's shares. Frequently attached to mezzanine finance. Sometimes referred to as Equity kickers.

## About BDO Stoy Hayward

BDO Stoy Hayward's dedicated Private Equity team specialises in advising managers and owners of entrepreneurial growing businesses. We apply our extensive practical experience of private equity transactions and thorough technical knowledge to help our clients maximise their opportunities.

We take the lead adviser's role, providing owners with specialist advice on options, strategy, valuation, sources of finance, negotiations and transaction structuring. Where required, we co-ordinate the entire deal process from inception through to completion.

BDO Stoy Hayward provide specialist advice to growing businesses. In the UK, we are the leading accounting organisation focusing on advising entrepreneurially owned businesses. Internationally, BDO is the world's fifth largest accounting organisation with partners and staff who specialise in advising growing businesses in over 90 countries.