Management Buy Outs

A practical guide to MBOs for entrepreneurs, directors, managers and shareholders

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1 Introduction

What is an MBO?
A Management Buy-Out is the purchase of a business by its management, usually with the help of external financial backers. Most management teams will only undertake one MBO in their careers (or two if they sell the business to the next generation management). As such, it is very common for the management team to be inexperienced in both the concepts of the MBO and also in raising the finance.

MBOs can arise from a variety of circumstances:

- a sale of a subsidiary (usually “non-core”) from a large group, possibly quoted or in difficulty, and in need of a cash injection;
- a planned succession of a family owned business to the next generation; or
- the retirement of owner/directors.

Although there are many reasons for the MBO team to undertake the transaction, the prime rationale for most individuals and teams is the chance to run their own business.

There is also the realisation that the capital gain that can be made in the long term from growing your own business, and then selling it, can greatly outweigh the income received from the salary as an employee, albeit with much higher risks. In today’s age of concern over the value of future pensions, the business can be seen as a major part of the individual’s long term wealth strategy.

A cautionary note
An MBO is very hard work for all those involved and all parties to the deal must understand this before starting the process. For the MBO team it is even harder: the completion of the deal is only the start of the process – they then have to produce the results they have promised in the business plan.
Help needed
You are likely to require assistance throughout the transaction in areas such as:

• negotiating the deal including price and payment terms;
• raising the finance required and advising on the best deal;
• preparing a business plan and financial projections;
• advising on the complex tax issues involved; and
• advising on the most efficient structure for the transaction and the resultant trading business.

This guide is intended to cover the main areas that will generally be encountered in an MBO. It will explain the main terms encountered as well as setting out the stages that are involved.

Other guides
This guide is intended to be used in conjunction with our other guides to ‘Effective Business Planning’ and ‘Equity Finance’. It does not generally repeat the subject matter covered in those publications, but does summarise some of the key issues.
PKF Francis Clark

As in all things, it is vital to get the best advice and with Francis Clark as part of your team MBOs can be survived. The Corporate Finance team at Francis Clark has a wealth of experience of MBOs and has a team of dedicated staff who will work with you to steer you through the problems and difficulties you will encounter on the way to a successful conclusion.

For further information, speak to our Corporate Finance partners Andrew Killick and Paul Crocker, or your usual Francis Clark contact, or visit: www.pkf-francisclark.co.uk/dealmakers

“I have had the pleasure of working with the Francis Clark M&A team a number of times and specifically at times when we were undertaking an MBO and an AIM listing.

Quite simply they take the grief out of what can be stressful situations by providing a very real understanding of the challenge thereby delivering excellent advice and clear options while they manage the process competently and securely.

They are the best that I have worked with.”

David Morgan,
Chairman of the Bray Leino group.

PKF Francis Clark advised David and his fellow shareholders on their combined MBO/acquisition, the subsequent £24m sale to The Mission Group, as well as numerous previous and subsequent transactions.
2 Glossary of relevant terms

PEOPLE

Vendors
Present shareholders of company, usually the retiring directors.

Equity provider
An individual or institution that provides financial backing to an MBO in return for a stake in the ownership of the business. Includes Business Angels, Venture Capitalists and Private Equity Houses.

PROCESS

Heads of Agreement
A fairly short agreement between the MBO team and the vendors setting out the main terms of the agreed deal such as price and exclusivity period. It is usually drawn up either by ourselves or the solicitors involved.

Exclusivity period
A period of time agreed between the vendors and the MBO team during which the vendors will not enter negotiations with or seek offers from any other buyer.

Business plan
A document created by the MBO team to explain where the business has come from and where it is going (see our separate publication “Effective Business Planning”).

Deferred consideration
An arrangement whereby the vendors do not receive all the sales proceeds at completion, instead deferring some of the receipt until a specified future date, usually two to five years after completion.

Earn out
Deferred consideration that is linked to future performance/profits.

Due diligence
An investigation into the affairs of the target business by potential financial backers.
## LEGAL TERMINOLOGY

<table>
<thead>
<tr>
<th>Term</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Share Purchase</td>
<td><strong>Share Purchase Agreement</strong> - A set of legal documents transferring ownership of the business from the vendors to the MBO team. These documents will usually be drafted by the MBO team’s solicitors and then negotiated with the vendor’s solicitors.</td>
</tr>
<tr>
<td>Warranties</td>
<td>Terms included in the SPA whereby the vendors confirm that, for example, assets / liabilities have been fully disclosed (such as corporation tax) and that certain events are not occurring, for example, the business being sued. If the warranties prove incorrect, damages can be recovered from the vendors.</td>
</tr>
<tr>
<td>Indemnities</td>
<td>Terms included in the sales agreement whereby the vendors state they will cover stated events or liabilities such as outstanding legal cases, normally on a £ for £ basis.</td>
</tr>
<tr>
<td>Covenants</td>
<td>Terms included in the various offers of finance to the MBO team which state that certain key business ratios such as debtor and interest cover will be maintained over the next few years.</td>
</tr>
<tr>
<td>Transfer of Undertakings (Protection of Employment)</td>
<td><strong>Transfer of Undertakings (Protection Of Employment) regulations 1981. Legislation that exists to protect employees’ rights when the businesses they are employed by is sold. Broadly, the acquirer of the business is obliged not to alter the rights of the workforce and their rights under employment law (such as redundancy, notice periods) continue unaffected by the change of ownership of the business, even if the business is transferred to a new company.</strong></td>
</tr>
<tr>
<td>Legal completion</td>
<td>The date at which the business is actually sold, all paperwork is signed and when the real hard work begins for the MBO team.</td>
</tr>
</tbody>
</table>
## Typical stages of an MBO

### Introduction

An MBO can proceed though a number of typical stages:

<table>
<thead>
<tr>
<th>Stage</th>
<th>Timeframe (approx)</th>
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<tbody>
<tr>
<td>Initial negotiations with vendors</td>
<td>2 weeks to many months</td>
</tr>
<tr>
<td>Initial approach to financial backers</td>
<td>1 to 4 weeks</td>
</tr>
<tr>
<td>Compilation of business plan</td>
<td>2 to 6 weeks</td>
</tr>
<tr>
<td>Further negotiations with vendors</td>
<td>Days/months</td>
</tr>
<tr>
<td>Due Diligence by financial backers</td>
<td>2 weeks to 2 months</td>
</tr>
<tr>
<td>Finalisation of deal structure</td>
<td>Few days to 2 weeks</td>
</tr>
<tr>
<td>Detailed offers of finance</td>
<td>1 to 2 weeks</td>
</tr>
<tr>
<td>Legal paperwork</td>
<td>2 to 4 weeks</td>
</tr>
<tr>
<td>Final negotiations</td>
<td>Days/months</td>
</tr>
<tr>
<td>Completion meeting</td>
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</tbody>
</table>

Many of the above stages can be run simultaneously. The overall MBO period can last from two months for the simple deal with no outside equity involved, to one year for the more complex deals with large amounts of external finance needed. The average MBO (if there is such a beast) takes three to six months. We have undertaken a small number of MBOs in under one month, but this is extremely difficult.

The above stages are covered in more depth in the following pages.
Initial negotiations with vendors

To cover items such as:

• an indication of price required;

• timescale for the project setting out the expected completion time, making allowance for taxation issues for the vendors and time required for raising the necessary finance;

• the exclusivity period;

• identity of professional advisers for both MBO team and vendors, including accountants, solicitors, property agents and others;

• an agreement as to how much time the MBO team can spend on the project within working hours; and

• an agreement for funding the payment of professional fees.

“Could you be a little bit more specific than an ‘arm and a leg’?”
These negotiations will take place over a number of meetings and often start before the professional advisers become involved.

They will culminate in the creation of the Heads of Agreement. The main issues that are covered in the Heads are set out in Appendix 1. Example Heads can be obtained through your local PKF Francis Clark contact.

In general, it is better to have experienced professionals helping each side as soon as possible in this process to ensure all relevant matters are addressed up front. This can also help to take any personal tension out of the situation where colleagues that have worked together for many years are now sitting on opposite sides of a negotiating table.

**Initial approach to financial backers**

An initial approach to financial backers is usually made before the business plan is fully drafted. Initial documents such as recent accounts will provide an early indication to the backer as to whether they would be willing to invest time in further investigating the proposition. Ideally, the team should aim to have a selection of backers available, including two banks and two equity providers (if needed).

These approaches are usually best made through intermediaries, who can ensure that the project is presented to the right individual in the right organisation. It then stands a better chance of making it through the preliminary assessment procedures of these organisations.
Compilation of the business plan

This document will be required to co-ordinate properly the MBO process and present the business case to potential financial backers. The writing process will involve the whole MBO team and cannot simply be delegated to the professional advisers.

PKF Francis Clark, advising the MBO team, can support this process by:

• providing an outline of the areas typically included and co-ordinating the writing process;
• critically assessing the information provided by the MBO team and acting as a sounding board to ensure the reasonableness of the assumptions made;
• assisting with market research;
• analysing risk areas and explaining implications;
• compiling the above into financial assumptions and assisting in creating the financial projections required, often using template spreadsheets; and
• providing secretarial assistance in typing and producing the final plan.

Overall, the advisers should ensure that the plan best presents the MBO to any third party. A separate publication “Effective Business Planning” is available to cover this particular area.

Further negotiations with vendors

Once an indication of financial backing is obtained, further negotiations may be required with the vendors. A reassessment of price often occurs at this stage, often resulting in an adjustment to the price or a modification to the terms of any earn out/deferred consideration.

It is likely at this stage for the process to become enmeshed in re-negotiations and for the MBO team to become dispirited. This must be anticipated and coped with - it is almost always worth the pain.

Due diligence by financial backers and finalisation of deal structure

At this stage, the exact deal structure is finalised and communicated to the financial backers who will complete their detailed enquiries into the business.

Lenders providing secured debt will generally be satisfied with a detailed business plan, property valuations, a tour of the premises and meeting the MBO team. Other debt and equity providers will require more detail and will make their own assessment of the business and the market it operates within, often using market experts. In addition, they will usually use their own accountants and solicitors to carry out any due diligence required.
**Detailed offers of finance**

All backers will submit formal offers to the MBO team, and the advisers will provide their assessment of each offer. At this stage, the proposed final backers are selected.

**Legal paperwork**

Once the deal structure is drafted and financial support is obtained, the solicitors can start drafting the relevant legal documents. These will include the warranties and indemnities, and often results in numerous technical discussions between lawyers trying to cope with every conceivable possibility.

**Final negotiations**

When all the various legal documents have been drafted and the finance offers received and assessed, there is usually one more round of negotiations with the vendors to deal with all the remaining issues and ensure that the deal itself is financially viable.

Again, this is a stage where the deal may appear to falter and the MBO team must keep the process going. However, there is no point accepting a deal that cannot be financed - if this is the problem, the MBO team must either re-negotiate the finance and/or the deal, or walk away.

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“*Every MBO falls over at least three times*”

Anonymous Venture Capitalist

“*Don’t despair*”

PKF Francis Clark
Completion meeting

After all the preparation, all parties will gather with their professional advisers around one (or more) table(s) and sign the relevant papers. This meeting can last for several hours, can be delayed or postponed and can appear endless.

There will be countless professional advisers attending the meeting, including (but not limited to):

- the MBO team’s accountant and solicitor;
- the vendors’ accountant and solicitor (sometimes one set per individual involved);
- the funders’ accountant and solicitor (possibly one each for equity and debt provider); and
- property experts as required by the solicitors.

The best advice is to lock the doors and not let anyone out until the deal is done.
4 The MBO team

Roles

The MBO team will be taking on responsibility for the entire operations of the business including, perhaps, areas where they have not previously been involved. The key elements of the team should include:

- Operations/production/technical director;
- Marketing/sales director; and
- Finance/administration director.

In addition, one individual will have to act as Managing Director, although this is often combined in most SMEs with one of the above roles.

Where the MBO team is missing one of these roles, it may be necessary to recruit an external candidate. Where an equity provider is involved, they will add a non-executive (part time) director to the board to look after their interest. It may be possible for the gap in the MBO team to be filled by the non-executive director, although this usually only happens where the gap is a financial director and there is a competent accountant already involved.

In terms of forming the MBO team, it is possible (although not common) not to include all members of the current management team. Some individuals may be uncomfortable with the MBO situation, and prefer to retain their existing role. Whilst this does mean that their personal risk is not increased, they must understand that the business risk itself is generally increased, as it will be taking on (usually) substantial external loans.
Equity ownership

The eventual ownership of the business between the MBO team may not bear any relationship to the amount of money they contribute to the deal and does not have to be split evenly. The ownership ratio should be openly discussed and negotiated to reflect the value to the business of each member, as this is what will create the future worth of the company.

This can be difficult to assess, but the simple choice of an even split of equity should not be used as the first option and as a means of avoiding this difficult conversation. Any obvious disparities between the input of each team member can become a source of irritation if not addressed at the outset, and this can (and should) be avoided.

Time requirement pre-MBO

A practical matter that has to be considered, and is sometimes included in the Heads of Agreement, is the role of the MBO team before the deal completes. During this time, the MBO team face an unenviable conflict of interest, whereby they wish to ensure the company remains profitable to obtain the best financing package for the MBO, but do not wish to make excessive profits, as this would tend to increase the price they are going to pay. In addition, the MBO will place considerable time burdens on them that will have to be balanced against their current workload. Overall, this matter is better addressed openly as part of the initial negotiations.
5 Valuation of the business

Introduction
Valuing a business is a very imprecise science (in that there are rules but they are usually vague and rely upon many subjective judgements). However, in any MBO, an estimate of value is a starting point.

Basic valuation techniques
There are a number of ways to value a company, including (but not limited to):

- multiplying the underlying profits by a factor, known as the Price Earnings Ratio (PER) obtained from discounting plc ratios or from databases such as PERDa (a database PKF Francis Clark maintains);
- predicting the cash that will be produced by the business over the next few years, building this into a suitable model (such as PKF Francis Clark’s DCFC model) and discounting this back to arrive at a present value for the company;
- specific sector related valuations which may relate to turnover or net assets; or
- re-valuing all assets to present values (mainly used for property companies).

We use a combination of the above methods in our overall assessment of valuation.

Profit multiple
Underlying profit
The underlying profit used in this method is usually derived by taking the most recent profits and adjusting them for such items that were either one-off or will not continue after the MBO. Such items usually include:

- payments, such as salary, pension and company cars, made to individuals who will not be required after the MBO, for example, payments made to retiring directors/shareholders’ spouses;
- remuneration and other benefits for retiring shareholders acting as consultants;
- excess remuneration for individuals where their replacement will be on a reduced salary;
• one-off substantial gains and losses made on the sale of company assets;
• interest paid on directors’ loans;
• excessive (or no) rent paid on buildings owned by the vendors or being retained during
  the sale by the current shareholders;
• adjustments for profits/losses made on sales to other group companies; and
• the alteration of the tax charge to a notional charge at normal corporation tax rates.

Relevant multiple

Once the underlying maintainable profit is estimated this must then be applied to a profit
multiple, the derivation of which is even more subjective than assessing the maintainable profit
in the first place.

Firstly, we would look at details of specific recent deals in your business sector to create a
suitable estimated profit multiple. We track specific sectors such as food or retail on a regular
basis so we will be able to advise of a relevant ratio.

In addition, we use our own unique database (known as PERDa) of comparable deals
involving private companies in the UK and Europe. This has been compiled on a confidential
basis using a number of firms. It has been recognised by HMRC as an acceptable benchmark
for valuations.

Future cashflow valuation

This method seeks to create a set of financial projections to assess the amount of free cash
that would be available to an acquirer, and is therefore regarded as the purest financial
valuation technique.

Although complex, we have created a series of tools to enable us to undertake this exercise
in a fairly straightforward manner.

Combination

We would combine the above results, and look at any other relevant factors such as value
to turnover or gross profit, to create a range of values for the business.
**Valuation for MBOs**

Whilst the company may have been valued carefully under the above methodology, the final price paid may bear no relation to this figure, as it will usually depend on matching two further factors:

- how much the management team (with their backers) can afford (discussed below under Financing the Deal - section 7); and
- how much the vendors need to fund their retirement plans, or to meet other expectations.

In most cases, the vendors will tend to overestimate the value of the company. Unless they are willing to defer receipt of part of the sale proceeds (see Structure of the Deal - section 6) or the MBO team are providing a substantial cash injection, the vendors’ expectations will have to be revised during the initial negotiations.

In general, vendors can often structure the deal to the MBO team on favourable terms to reflect the benefits to them of the MBO, including:

- no need to search for a potential trade buyer, incurring time and expense;
- no need to involve external parties, reducing the concerns of the vendor over confidentiality;
- the MBO team’s involvement with the business may reduce the need for the vendor to provide comprehensive warranties and indemnities, depending upon the MBO team’s prior involvement; and
- the vendor may prefer the company to be carried on by the MBO team, perhaps ensuring continuity of location, name and staff, something that could not be guaranteed by a sale to a third party.
6 Structure of the Deal

The majority of MBOs are undertaken in one of the following forms:

- the MBO team simply acquire the vendors’ shares in their company;
- the MBO team form a company (generally known as “NewCo”), which then acquires the vendors’ shares in their company; or
- the MBO team forms NewCo, which then buys the assets of the vendors’ business (whether it is incorporated or not).

The use of NewCo generally depends on various taxation and legal issues, but it is common in any deal where the shares of the vendors’ company are acquired.

The difference between acquiring the company’s shares or assets is fundamental but very complex, with:

- the vendor usually preferring to sell their shares due to the favourable tax treatment of such sale (often reducing the tax to circa 10% of the gain realised); and
- the MBO team preferring to acquire assets. This is due to the fact that any acquisition of shares in a company results in the MBO team also acquiring any previous liabilities of the company. In addition, the tax treatment of an acquisition of assets and goodwill is more favourable in the short term to the MBO team.

Given the power balance between the vendors and the MBO team, the usual MBO involves the purchase of shares, but this must be reviewed to assess the tax advantages/disadvantages. Overall, one of the main aims of the structuring is to minimise the tax payable by all parties, and it may be possible to efficiently structure an assets’ purchase.
7 Financing the deal

The amount to be raised by the MBO team will comprise:

• the price to be paid to the vendors;

• the current borrowings of the business, as the assets of the business will generally be used to act as security for the money used by the MBO team. In order to use these assets, the current borrowings may need to be redeemed to release the current lenders’ security;

• an allowance for the working capital requirements of the business, especially if expansion is envisaged, including the payment of professional fees and finance arrangement fees; and

• an allowance for the unexpected, as raising finance shortly after an MBO due to unforeseen problems is, to say the least, more difficult.

This amount is broadly raised as follows:

• an injection of money from the MBO team (including family and friends);

• grants and/or soft loans;

• secured debt (also known as senior debt);

• deferral of the purchase price by the vendors;

• unsecured debt; and

• external equity.

The above are discussed in more depth in the PKF Francis Clark publication “Raising Finance”, but are covered here in relation specifically to MBOs.
**MBO team equity**

One of the first questions of any MBO team is how much money they have to contribute to the purchase price. There is, unfortunately, no common answer to this question, and we have undertaken deals with the MBO team contributing from nothing to hundreds of thousands of pounds.

In general, the amount contributed should not be so large as to distract the management from the running of the business, but should represent a significant commitment by the individuals involved. It will therefore depend on their personal circumstances.

An often quoted measure in the equity industry of the amount required from an individual is the equivalent of one to two year’s salary.

In terms of affecting the deal, the larger the amount contributed by the MBO team, the better chances of raising external finance, both in terms of needing less finance and also showing a sign of faith in the deal. It also helps when discussing Personal Guarantees with lenders, whereby the MBO team underwrite some or all of the lender’s loan.

**Grants and soft loans**

There are numerous grants and soft loans available to businesses in the West Country, and they can make a critical difference in funding a deal. These sources of money should always be reviewed and we have dedicated in-house experts who can provide further information.

**Secured debt**

There are numerous banks and other lenders willing to back an MBO and provide secured loans and overdrafts. The amounts available under such arrangements are limited by three factors:

- **Available security**: The banks will provide lending against a proportion of the value of assets such as property, plant and debtors (and occasionally stock);
- **Available future cashflow**: The borrowings and repayments have to be adequately covered by the cash generated by the business. Most lenders prefer the total committed payments to be covered between 1.5 and 2 times by the operating cash surplus generated by the business; and
- **Ratio of debt to the value of the business, known as the gearing level**: The higher the relative level of the debt, the less able the business will be to survive unexpected shortfalls in cashflow.
Deferral of the purchase price by the vendors

The more consideration that can be deferred, the less will be required from external sources. However, the amount deferred will have to be funded out of future cashflow or further borrowings. In addition, the more the amount deferred, the higher the total price usually demanded.

However, it can occasionally be more tax efficient for the vendor to receive the consideration over a period of time, and this should be built into the price negotiations.

"We'd like to make a bid for a management buy-out - if you'll lend us the money."
Unsecured debt

Lack of security is one of the main obstacles to raising debt finance for an MBO. For businesses with a proven track record of cashflow generation who are looking to raise a substantial amount of debt, certain banks may consider lending unsecured sums against this cashflow. In general terms the repayments (including interest) would have to be covered at least two times by the proven profit stream for this type of lending to be appropriate and feasible and the loan would have to be repaid within 5 years.

There have been a number of new lenders in this sector over recent years, and whilst it remains a challenge we have completed a number of MBOs by the use of these funds.

Equity

The last element of the MBO finance mix (and most expensive) is external equity, either from an institutional equity provider or an individual (Business Angel).

The actual make-up of the equity provider’s investment will vary greatly but will generally comprise ordinary shares (identical to those owned by the MBO team) and loan stock. This will earn a rate of interest usually more expensive than bank lending and which will be redeemed by the company over a period of time. Most equity providers look for an overall return in excess of 30% per annum, but the majority of this is earned by the anticipated growth in the value of the company. The actual on-going funding cost comprises the preference share dividend and redemption.

One of the principal differences created by the introduction of external equity is the requirement to concentrate on a potential exit route for the equity provider. Whilst the MBO team may be happy to run the business for the next 20 years or so until retirement, the equity provider’s main return comes from selling their stake in the business. The MBO team therefore need to be able to give the equity provider an idea of how their stake will be realised, usually either through a trade sale, refinancing of debt or another MBO.

There is a mix of debt and equity known as mezzanine debt, which for all practical purposes can be likened to an expensive loan with the provider being given a small level of equity. Again there have been some new providers of mezzanine funding in the market place over the last year or so which can help bridge gaps in the finance jigsaw.

The balance of the finance between secured and unsecured debt and equity is complex, and relies heavily on the accuracy of the financial projections. However, the MBO team must ensure that sufficient slack is built into the projections. This may increase the amount of equity that has to be given to the equity provider but ensures that unforeseen complications in the early period of the MBO can be survived without the need for further finance.

This whole topic is covered in more depth in our equity guide, ‘Equity Finance’.
Financial projections

The business plan will need to contain financial projections forecasting the company’s results and cashflows for the next three to five years. Although accountants can provide assistance in this area, the initial assumptions must come from the MBO team, and should involve all members of the team to ensure their reliability.

The most common problem encountered in preparing projections is the sales forecast, as margins and costs tend to be internal matters that are generally easier to predict. Sales depend upon a third party - the customer. However, the sales forecast is critical to the whole business plan.

The best place to start the projections is from the marketing section of the business plan. This should break down the market and set out the sales tactics the MBO team are going to use to generate sales. The assumptions must be realistic and achievable.

Once the sales forecasts are prepared these can be rolled out into a profit forecast using the known margins and costs. From the profit forecast, cashflow forecasts can be produced using a number of assumptions, such as credit period taken by customers, etc.

Forecasts are inherently inaccurate and are relied on by the potential backers as indicative rather than prescriptive. They are used to indicate the broad level of funding that is required and should therefore include prudence factors to ensure that the business is properly funded from day one. In addition, sensitivities should be prepared to demonstrate how susceptible the business is to small changes in the underlying assumptions, such as margins and sales growth rates. These can be used in conjunction with data on the break-even position of the business (the level at which the company makes no profit/loss) to help assess the ability of the business to survive unexpected upsets.

Overall, the projections must allow for unexpected cash deficits, as it is difficult to obtain further funding soon after an MBO. As well as assisting in the preparation of the projections, it is one of the main roles of the advisers to ensure the prudence and reasonableness of the projections.

Professional fees

Upon successful completion of an MBO, the fees of the MBO advisers are generally picked up by NewCo, meaning that the MBO team is not out of pocket personally.

The scale of the fees involved in an MBO can be higher than previously encountered by most businesses in their dealings with accountants and lawyers, as they reflect the higher level of input and expertise required.

Whilst not generally an issue if the deal completes, it will probably be a significant problem for the MBO team to fund should the deal not proceed. It may be possible to make arrangements with your advisers, if they assess the likelihood of the transaction competing as acceptable, that their payment is linked to the success of the deal. This usually involves agreeing a smaller upfront fee, and then a success linked bonus, but each deal differs in exact arrangements.
In some circumstances it is possible to have the MBO fees underwritten by the target company, which can reduce the final fees payable by reducing the risk of the professional advisers.

Finally, in making an allowance for professional costs in any projections, remember that VAT may only be chargeable or recoverable on parts of the professional fees charged, and this should be carefully included in any overall costs assessment.
8 Management Buy Ins

Introduction
Management Buy Ins (MBIs) could be viewed as similar in concept to MBOs, as both involve the acquisition of a business by an individual (or a group of individuals). There are, however, substantial differences which make MBIs much more difficult to undertake and especially fund. Any equity funder will show that returns on MBOs on average are extremely attractive, whilst returns from MBIs have been mixed at best.

Risks
These risks (and the potential mitigating factors) can be reviewed as follows:

1. **No direct knowledge of the specific internal issues and running of the target business:** There is little that can be done about this risk, apart from spending extensive time with the target business and management. However experience of managing a business through a change period (which the introduction of a new management team will naturally cause) will usually be of some direct benefit.

2. **Deal structuring:** One of the main ways of de-risking any deal is for the vendor to accept that part of the consideration is deferred and paid over a future period. In nearly all of the successful MBIs in which we have been involved, this vendor deferral has given the funder sufficient confidence that the vendors themselves are willing to take a risk on the ability of the company to fund future payments to them.

   A final element of this financial de-risking is the amount contributed towards the deal by the MBI candidate. In MBOs this can often be minimal, but a substantial investment by the MBI candidate(s) contributes significantly to the confidence of all financial backers.

3. **No/limited experience of the target’s business sector:** Often, for instance, a marketing director will see himself as being able to market any particular product/service. Whilst there are bound to be some similarities across some trades, the hard earned direct experience of the industry of an MBO team is difficult to match.

   Obviously the closer the industry experience of the MBI candidate, the easier any integration will be. Any experience should be self evident during the due diligence phase, when the MBI candidate(s) should be able to contribute significantly to the commercial due diligence process.

4. **No/limited experience of the size of the target company:** We have seen many candidates from larger business (with a fully functioning board/admin/finance teams, etc.) struggle to adapt to life in SMEs. Again, only direct experience will be of use in mitigating this risk.
5. **No/limited experience of the stage of growth of the target company:**
   Alternatively we have seen MBI candidates adapt well to a business in which they have no
direct experience, but which is in a particular phase of the growth cycle (e.g. perhaps at
start-up/launch of new product or requiring turnaround) with which they are highly familiar.
However, it must be said that these experiences are more the exception than the rule.

6. **Deal rationale:** Most MBI candidates are buying a business to either become their
own boss or in a drive to build a business and achieve a significant capital gain. Those
in the latter category are likely to be more driven to make a success of the business
than those in the former.

7. **Involving the current target’s management team:** Technically this can turn the MBI into
a BIMBO (MBI/MBO), and greatly de-risk the deal due to the involvement of the MBO
team and their knowledge of the existing business.

From the above, it can be seen that it can be far more difficult to arrange and fund an MBI,
but it is not impossible.
9 Other matters

Taxation

An important task for both sides’ professional advisers will be to reduce the tax payable by the vendors, so as to maximise the proportion of the amount paid by the MBO team that is actually received by the vendors.

The tax rules covering disposal of business assets changed in 2008, when the old Business Asset Taper Relief was replaced with a flat rate of 18% (now 28%) on any gain but mitigated by a tax relief called Entrepreneurs’ Relief.

Entrepreneurs’ Relief effectively reduces the tax payable on the individual vendor’s first £10m to 10% if the following conditions are met:

• the gain results from the full or part disposal of a trading business;
• the vendor has held at least 5% of the equity (and voting rights) of the business for at least a year prior to the disposal; and
• the vendor is an officer (director or company secretary) or employee of the business for at least a year prior to the disposal.

The £10m is a lifetime limit and the relief must be claimed when submitting the vendor’s personal tax return.

Other practical methods of reducing the taxation burden on the vendors include:

• having the company pay a substantial pension contribution to the retiring directors, thereby effectively passing some of the sale proceeds to them tax free; and/or
• increasing the sales price to include any cash balances in the company that would otherwise be drawn as salary or dividend and taxed at a higher rate of tax.

Further issues that can be addressed during the deal are:

• ensuring that the MBO team’s borrowings used to fund their equity injection qualify for tax relief; and/or
• structuring their injection so as to minimise tax and NIC liabilities on future remuneration to them.

Overall, the deal needs to be put together in conjunction with a tax expert who is familiar with this type of deal. For instance, the subject of the taxation of any deferred element of the sales price is highly complex and can be a deal breaker.

Employee shares

There are strict tax rules to be followed when issuing shares to employees/directors (as in every MBO). Failure to comply can result in significant tax charges to members of the MBO team, even though they have received no actual cash consideration (the tax is due on any theoretical discount they might have received in acquiring the company). The tax implications are fundamental and highly complex and it is vital that you speak with a tax adviser experienced in these types of transactions. We provide this tax advice as a fundamental part of our Corporate Finance work.
10 Conclusion

The vast majority of MBOs are looked back upon as a great learning experience, although often without affection by the participants. The Corporate Finance team at PKF Francis Clark will try to ensure that the process is as smooth as possible. Overall, our aim is to help to achieve a deal with which all parties are happy.
Appendix 1: Illustrative contents of Heads of Agreement

<table>
<thead>
<tr>
<th>Category</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Parties to the deal</td>
<td>Vendors, MBO team and advisers (if appointed).</td>
</tr>
<tr>
<td>Basis of offer</td>
<td>Shares or assets.</td>
</tr>
<tr>
<td>Consideration</td>
<td>Amount, composition and timing of payment. Details of any deferred or contingent consideration.</td>
</tr>
<tr>
<td>Main conditions</td>
<td>Such as satisfactory financial and legal due diligence, successful raising of finance, etc.</td>
</tr>
<tr>
<td>Directors and employees</td>
<td>Treatment of service agreements.</td>
</tr>
<tr>
<td>Warranties/indemnities</td>
<td>Define in principle.</td>
</tr>
<tr>
<td>Restrictive covenants</td>
<td>Placing restrictions of the ability of the retiring shareholders to set up in competition.</td>
</tr>
<tr>
<td>Timing</td>
<td>Detailed timetable to completion.</td>
</tr>
<tr>
<td>Confidentiality</td>
<td>If not previously addressed.</td>
</tr>
<tr>
<td>Exclusivity</td>
<td>A period during which the vendors cannot talk to other buyers.</td>
</tr>
<tr>
<td>Costs</td>
<td>Who is bearing the costs of either side?</td>
</tr>
<tr>
<td>Location</td>
<td>Address</td>
</tr>
<tr>
<td>-------------</td>
<td>--------------------------------------------------------------------------</td>
</tr>
<tr>
<td>EXETER</td>
<td>Vantage Point, Woodwater Park, Pynes Hill, Exeter, EX2 5FD</td>
</tr>
<tr>
<td>TAUNTON</td>
<td>Blackbrook Gate 1, Blackbrook Business Park, Taunton, TA1 2PX</td>
</tr>
<tr>
<td>NEW FOREST</td>
<td>The George Business Centre, Christchurch Road, New Milton, BH25 6QJ</td>
</tr>
<tr>
<td>SALISBURY</td>
<td>Hitchcock House, Hilltop Park, Devizes Road, Salisbury, SP3 4UF</td>
</tr>
<tr>
<td>PLYMOUTH</td>
<td>North Quay House, Sutton Harbour, Plymouth, PL4 0RA</td>
</tr>
<tr>
<td>TORQUAY</td>
<td>Sigma House, Oak View Close, Edginswell Park, Torquay, TQ2 7FF</td>
</tr>
<tr>
<td>POOLE</td>
<td>Towngate House, 2-8 Parkstone Road, Poole, BH15 2PW</td>
</tr>
<tr>
<td>TRURO</td>
<td>Lowin House, Tregolls Road, Truro, Cornwall, TR1 2NA</td>
</tr>
</tbody>
</table>

www.pkf-francisclark.co.uk/dealmakers