

Exit Strategies: The Management Buyout

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Management Buy Out (MBO) transactions are in essence when one or more managers buy the company they work in. The MBO is a common exit strategy for small business (up to \$10MM revenue) owners. It may not produce the highest price the market has to offer, but should bring a “fair market” price. Advantages of MBO’s are that they can be consummated relatively quickly once the right elements are in place, and they have a high success rate when approached and structured properly. Most MBO’s have these characteristics in common:

1. the exiting owner sells all or most of his or her stake in the business to management
2. the manager(s) put in their own cash
3. there is usually some outside financing

Exiting owners frequently pursue an MBO when they don’t have children interested in or capable of owning and running the business and they are as interested in seeing their devoted employees carry on as they are in maximizing value. Managers frequently seek an MBO because it gives them the opportunity to advance their career, control their own destiny, and realize a capital gain if the buyout goes well. Sometimes managers buy as a defensive measure to protect their jobs and their livelihoods. In today’s economic slump, the owners of companies in financial distress may want to liquidate certain assets or divest a business unit to generate cash, and may be more receptive than usual to an MBO offer at this time. However bank financing will be difficult under those circumstances.

Risks in Selling to Management

- Confidentiality lost
- Will test your relationship
- Management often feel they deserve a discount
- No competition - a negotiation of one
- Limited experience, skill set, or funds may require special terms and raise payment risk
- Failed MBO can prevent or delay a 3rd party sale

In larger businesses, MBO opportunities often arise when ownership decides that a particular business activity is outside its core and elects to sell it off or shut it down. MBO’s can also be a by-product of acquisitions. Let’s say Conglomerate, Inc. acquires ABC Enterprises which has 3 lines of business. A short time later Conglomerate decides it likes business units A and C, but doesn’t need B. It may sell B by giving the managers of that business unit an opportunity to buy.

A typical small business buyout is valued at a multiple of normalized “free cash flow”, which roughly means earnings after management compensation, before interest, taxes, depreciation and amortization, less capital expenditures and working capital increases needed to sustain the business. How much cash the manager(s) put in varies from deal to deal, but 20% of the total purchase price is usually the minimum needed. Bankers want the amount to represent a significant personal commitment. Let’s say there’s a 3-person management team that wants to buy the precision machine shop they work in. They can pull together \$80,000 each, or \$240,000 total. This may not seem like much when compared to, say, \$1MM put up by a bank, but it probably means a lot to the managers and their families, and it is often enough to assure the bank that the managers are serious and committed.

Sometimes managers purchase 70-80% of a company now and commit to buying the remaining 20-30% later. This helps them reduce their investment (or borrowing) and assures that the seller stays interested in helping them transition and grow the business. Their pitch to the seller is that he will get a “second bite of the apple”, which means he can sell his remaining interest at a higher price per share, assuming the business grows.

Elements of a Successful MBO:

1. Viabile business. A business needs to be producing sufficient verifiable earnings on a stand-alone basis for a third-party lender to finance an MBO. The business doesn't have to be profitable if the seller offers flexible financing terms and has faith that the managers have the know-how and reserve capital (which is rare) to mount a successful turnaround.
2. Quality Management. In order to obtain financing for an MBO, the manager(s) must have sufficient savings and excellent personal credit. They must possess the skills and experience needed to replace the exiting owner(s) and grow the business. Most small business management teams have one or more significant voids, such as technical or financial skills.
3. Fair market price. The parties have to genuinely want a "win-win" outcome, or the deal will likely fail. Owners usually want the highest possible price (unless desperate to generate cash). At the same time, not overpaying is essential to the managers' future success, and their backers will require it. For a deal to occur, the MBO price generally has to reflect "fair market value". A business valuation by an experienced independent appraiser is the best way to establish value in an MBO situation.
4. Seller and buyer are willing, able, informed and committed. We see too many managers waiting and hoping the owner will eventually sell to them on favorable terms, and too many owners assuming their manager(s) will be willing and able to buy on their terms when they are ready to exit. The parties are not fully informed, no real commitments have been made, and no concrete ownership transition plans are in motion. Commit to terms, timing and transition plans early on.

While simple in concept, MBO's are often complex, emotionally charged, risky and time consuming. MBO's have a higher probability of success when win-win oriented specialists assist both parties with financial analysis, valuation, negotiations, due diligence, legal and tax considerations, structuring options, financing and documentation. The stakes are too high not to do it right.

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