The Management Buyout — Anatomy of a Deal

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A management buyout, known as an MBO, is the purchase of a business operation from its owners by its existing management team usually with the help of financial backers. An MBO presents management with the opportunity to acquire the division, subsidiary or company they are already running and is typically financed by money provided by external sources. Sometimes the current owner is involved with the financing. The profits and cash flow of the operation usually provide the basis for the purchase and for the repayment of outside financing.

In general, an MBO is an acquisition of, or a divestiture from, a large or public company by all or some of its current management team. In our industry, the MBO is often the choice for a select management group, together with additional outside financing, to buy a privately owed company from its current owners.

An ESOP (employee stock option plan) is an alternative to the MBO and is best suited when acquisition of the business is desired by most/all of the employees. While an ESOP opens up the acquisition to a larger pool of employee/buyers, it can be the more expensive way for employees to achieve an ownership stake. Also, an ESOP leaves the current owners with continuing fiduciary duties, liabilities and other risks. These factors often make the MBO a more attractive type of purchase deal for employees to acquire their company. An MBO can also reward a competent and loyal management team, assure employees that the operations will remain stable, and generally keep the existing business intact to increase its size, scope and profitability.

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Recently, Leaders LLC (together with J. R. "Buzz" Campbell) assisted a management team, lead by Bryan Gentry, in the purchase of its division, Messer GT&S, from Air Liquide. Air Liquide had acquired Messer GT&S as part of its acquisition of MG Industries USA from Germany's Messer Griesheim in 2004. In the GT&S MBO, the Seller, Air Liquide, recognized that there would be significant benefits in dealing with the existing management. For example, in an MBO, due diligence can be completed faster by selling to management rather than to an outside entity, thereby making such things as representations and warranties less onerous. And important in the GT&S deal, was the opportunity for the seller, Air Liquide, to negotiate a contract with the buyer, to continue the sale of a significant volume of gases to the new company.

In an MBO, banks and/or a private equity groups (PEG) normally provide the majority of the financing required. In planning ahead to a successful exit strategy, the debt and working capital financing provided by the bank will be the cheapest form of finance. The equity and secondary ("mezzanine") debt provided by the PEG are more expensive to the management team as the PEG takes on more of the financial risk should things not turn out well. In the GT&S transaction, the bank is Sovereign and the PEG is PNC Equity.

The GT&S MBO used additional levels of funding making it more complicated than most. For example, the real estate in the GT&S deal was purchased separately, through a sale-lease back arrangement with a specialized lender, requiring its own negotiations to coordinate the banks and their collateral.

In a more typical MBO, one bank has the senior security in all of the assets being acquired and provides 50 to 60 percent of the funding. The bank will generally look to provide financing of no more than four times the operation's EBITDA (earnings before interest, taxes, depreciation & amortization). The bank will require that it is repaid in priority over the other funding and equity sources. Given this priority the bank's downside risk is lower and, therefore, has a lower reward/pricing structure.

The next levels of funding (from the PEG) will provide funding equal to two times the EBITDA, typically split into a mezzanine layer with junior security behind the bank, and an equity layer of financing. The expected annual returns are usually 25 to 35 percent depending on the mix of the assets providing the security, the governance structure of the new entity, and the amount of equity provided by the management. The annual expected return for the PEG is achieved by a "guaranteed" return (14 to 16 percent) on their capital, prior to any payments to management, and warrants for a percentage of the common stock. The PEG would expect to exit their investment in five to seven years through a private sale of the company, a refinancing by the management team, or the company going public.

The reason management teams undertake an MBO, and agree to all of the costs and restrictions associated with a leveraged transaction is because an MBO gives management the ability to make a significant gain from a relatively modest personal investment. The management team typically invests 5 to 10 percent of the funds required to make the acquisition and is expected to demonstrate a high level of commitment to back up their limited personal investment. But even 5 percent of an acquisition can be a large figure to an individual in an MBO, and it is not uncommon for members of the management team to borrow money from a bank in a personal capacity to finance their investment. This, of course, adds yet another layer of financial complexity to the MBO.

Each MBO is obviously different, but typically it takes three to six months to complete a transaction. The various steps of an MBO include:

- Assemble the Management Team
- Engage a Financial Advisor
- Review the situation to see if it is suitable for an MBO
- Evaluate the potential price and structure options

- Approach the Seller to obtain an exclusive position
- Write a Business Plan
- Identify appropriate funding sources
- Obtain tax advice
- Obtain and negotiate offers of funding
- Negotiate the Letter of Intent
- Perform Due Diligence
- Negotiate the Purchase and Sale Agreement
- Negotiate the Closing documents and other Agreements

Performing and managing the above steps of the typical MBO can be an emotional roller coaster so management will need to work very closely with their financial advisor on a daily basis. It is therefore vital to select an advisor who will provide the necessary industry experience and support when the transaction becomes difficult — as they invariably do.

In the GT&S transaction, Leaders insight and its affiliation with J.R. "Buzz" Campbell, proved to be invaluable to the success of this MBO. Campbell's industry expertise, personal knowledge of the players involved, and his ability to identify their overall needs, helped to overcome many obstacles along the way.

An MBO can be costly with closing costs amounting to 5 percent or more of the transaction value. Your financial advisor should be able to structure most of these closing costs to be contingent upon completion of the transaction.

Managing the business post-closing also needs careful advance planning. A detailed plan for the first 100 days outlining the immediate tasks is a must to capitalize on the energy created internally and by the external news of the deal. The PEG may want to appoint a chairman or other non-executive director to bring relevant experience and/or plug any skill gaps in the management team. Positioning the business and planning for a fruitful refinancing or exit needs to be part of the MBO transaction from its inception. Assistance from your funding partners in formulating this plan and developing an effective business position for all stages of the company's development is critical.

Gentry and his team had such a plan for GT&S, as well as the necessary skills to execute it from the beginning. (See related story, "GTS — Combining the Capabilities of the Majors with the Characteristics of a Distributor", *CGI*, Aug/Sept, 2005.) The PEG with whom they partnered, PNC Equity, also had experience in a similar industry and understood the immediate needs of the GT&S business. All the players involved were anxious to not only grow the company organically, but also through acquisitions. Acquiring additional businesses that can be integrated quickly and cleanly into existing operations is often the fastest way to increase the company's EBITDA and, thus, its value. So far, it appears this strategy has been successful for GT&S.

If you would like additional information on this subject, please contact Leaders at 207-773-2200 or send an email to Anania@Leaders-LLC.com. Leaders would be glad to discuss the many benefits of an MBO to both buyers and sellers.

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