Corporate finance: guiding the way

The corporate finance adviser plays a pivotal role in an MBO transaction, essentially project managing the entire deal, sometimes right from its inception along the often bumpy road towards completion.

In association with:

Andrew Moss
Duncan Sheard Glass
0151 243 1213
adm@dsg.uk.com

John Gilligan
PKF
020 7065 0241
john.gilligan@uk.pkf.com

Bill Eastwood
Eastwood Anglo
01636 636132
bill@eastwoodanglo.com

Simon Bursell
Dains
01283 507963
sbursell@dains.com

Peter Duffield
Smailes Goldie
peterduffield@smailesgoldie.co.uk
01482 382171

Jay Ved
Sterling Accountants
jay@sterlingca.com
0208 515 2929

John Jones
Beever and Struthers
john.jones@beeverstruthers.co.uk
0161 832 4901

Nick Triggs
Fox-Pitt Kelton
0207 6636020
nick_triggs@fpk.com

Stuart Cumberland
Olivine Partners
0870 9770400
scumberland@olivinepartners.com

In their everyday work with companies, corporate finance advisers often come across firms where an MBO could be a possibility but the management team are not fully aware of the benefits of a buy-out. Andrew Moss of Duncan Sheard Glass said: "Our involvement can start as early as initiating the thought - not pushing it but making the management team aware of the fact that they could conduct a buyout. Often they don't appreciate the mechanisms involved and just assume that they couldn't raise the money."

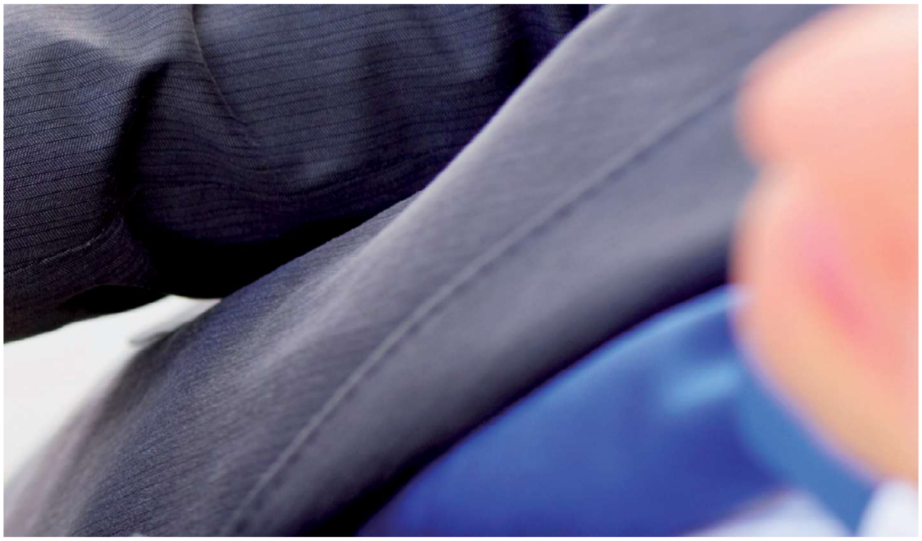
Even when a business is not officially for sale, management teams considering an MBO may contact the corporate finance adviser as a first port of call for advice in this particularly sensitive situation. In this case, discretion is key as corporate finance advisers can conduct enquiries without revealing the identity of the prospective buyers in order to preserve working relationships within the company.

Bill Eastwood of Eastwood Anglo said: "This is particularly so in the case of large groups, especially in the US, who can sometimes have a very negative view of MBOs. We can quite often conclude that the time is wrong, or that it is not possible at all. It may be a year or two before the window opens, and during this time we keep in touch on an occasional basis and may do some preliminary work whilst encouraging the team to be patient, and above all to ensure that they keep focused on growing the business for the current owner.

"Any temptation by management to slow the business with a view to buying it more cheaply needs to be firmly discouraged. As well as being unethical and contrary to fiduciary duty, it is also counterproductive to the team. It is always easier to fund a growing business, even at a higher price, than one which is seen to have stalled."

To asses whether an MBO is feasible and likely to attract funding, the corporate finance adviser will spend time understanding the target company, its strengths and weaknesses and the market it operates in. The balance sheet needs to be healthy enough to withstand the high levels of debt that MBOs generally involve in the early years. It's in everyone's interests to identify potential dealbreakers at the start of the process and for some deals, this is where the parties walk away.

John Jones of Beever and Struthers explained what funders look for in a good deal. "Backers will be looking for evidence of the business's ability to generate strong cashflow from marketable products or services and a demonstrable strategy for profitable growth and the future evolution of the business. The basic busi-



ness model has to be of a good quality, although potential future prospects are of more relevance than the historical trading record. Funders also want to see how they are going to get their investment repaid and expect to see a realistic planned exit route"

The management team itself will also come under scrutiny by the corporate financier to determine their commitment to the deal and their ability to withstand the rigours of the transaction and of course to run the business after completion. The strengths of the prospective management team are reviewed and if necessary, the corporate finance adviser will suggest bringing new people in if there is a skills gap in the team.

Preparation is essential and the management team need to be clear from the start on their objectives for the business. "When I'm advising a management team, I want to get a feel as to whether they want to be working and driving the business for two, five or 20 years," said Simon Bursell of Dains. "It is vital for management's objectives to be aligned where possible with those of the funders. For example, a venture capitalist will typically look at a three to five year exit plan."

Agreeing on a valuation for the company early on is vital to avoid protracted tussles later on. It's here that the cool head of the experienced corporate adviser can prove useful in negotiating a price. Peter Duffield of Smailes Goldie said: "We often have to restrain the management team because whilst their enthusiasm is there and plain for all to see, if you hit one or two difficult situations, often management's reaction is to increase the price and get over the problem.

"Part of our job is to make sure that that doesn't go to an unacceptable level because otherwise we end up with the potential to waste everybody's time. At the end of the day we're pretty good judges of whether a transaction is fundable at a certain level or not."

A sound business plan is essential for attracting funders and also acts as a focusing exercise for the management team to develop their strategy. Funders usually require projections for three to five years as well as data on historical performance. With that in place, the team can approach potential sources of finance for the transaction. Depending on the nature of the deal, this is generally a combination of debt and equity and alternative financing may be explored, such as asset-based lending.

Heads of agreement detailing the offer and any conditions attached to it need to be negotiated with the MBO team and the vendors and this is where the corporate finance adviser acts as an intermediary between both parties' legal teams. The corporate finance adviser also acts as a go-between for the due diligence providers and the management team.

Providing moral support

Apart from walking the management team through the many steps necessary towards completing the MBO in terms of dealing with funding, legal issues and due diligence, the corporate finance adviser acts as moral support for management teams undergoing the arduous process for the first time. Most management teams go into the deal without a full understanding of the time the deal will take and how stressful the process will be and a key role for the corporate finance adviser is to prepare the team for what lies ahead.

Bill Eastwood said: "During the process there is also an important pastoral role. Explaining that the unpleasant bits, warranties, bad leaver provisions etc are a necessary part of the process, and also making sure that each member of the

Exits
the other side of the coin

Mike Halls
Beer Mergers
01959 565191
mjh@beermerger.com

Vendors of small businesses enjoying the option of a management buyout need to weigh up the merits and drawbacks of an MBO against those of a trade deal. Mike Halls of specialist small business advisory firm, Beer Mergers, talked Corporate UK through an MBO from the vendor's perspective.

Generally speaking the principal disadvantage of a small business MBO is that the management team find it hard to match the price offered by trade buyers. Merger benefits and business synergies allow trade buyers to achieve higher profits post acquisition, and thus a higher initial value.

"A buyout team will certainly believe they can take the business to the next stage of development, but this will be a more gradual process without the specific impetus and benefits of a trade sale" says Mike. Revenues can usually grow only steadily and costs may indeed increase initially depending on the MBO funding, thus reducing profits in the immediate period post sale.

"In the small business market MBO's are often undertaken informally between the vendor and the management, who then need to produce a business plan and find funding at short notice" says Mike. Generally small businesses lack the size and power to generate funding easily, and often the resulting funding gap needs to be bridged by the vendor either retaining a shareholding or by granting a vendor loan, thus increasing his overall risk.

However, for the vendor these factors can be offset by other advantages. Because the MBO team have in depth knowledge of the business, the sale is usually easier, quicker and less formal than a trade sale, and generally has lower costs. Existing relationships and trust built up between owners and management also enable deals to be more flexibly structured.

Whilst the imminent changes to CGT have had an impact on the market recently, this has not been as dramatic as often reported. Unsurprisingly the main effect has been to encourage purchasers to use the changes as a bargaining tool to drive prices down before the April deadline.

Beer Mergers certainly believe that small businesses will continue to remain attractive for trade buyers and management teams alike. Despite negative background comments about the economy, in Beer's experience there are an awful lot of very successful small businesses in the market, the owners of which will continue to seek succession through management buyouts.

Stuart Cumberland   Andrew Moss   John Jones   Peter Duffield

team does really want to go down the stressful and demanding route of running a business post buy-out. We need to understand the difference between last minute nerves, which we attempt to overcome, and a genuine desire not to do it. For this reason we try to point out all of the downside at the start of the process."

The demands that a buyout will place on the managers' time can pose a potential danger for a business undergoing a buyout. While the management team's time is swallowed up by meetings with lawyers, funders and due diligence advisers, there is a risk that the day-to-day running of the business is neglected. A good corporate finance adviser will try to minimise this distraction and take the pressure off the team.

Stuart Cumberland at Olivine Partners said: "It's about trying to enable the management team to keep focused on running the business and doing the day job. We try to take the strain away from them. They could take their eye off the ball and the performance could start to deteriorate. When the transaction completes, you're starting at a low point and you've got a lot of catching up to do to get the business back on track again."

Relations between the vendor and the management team are a potentially delicate area, particularly with smaller owner-managed companies where the vendor is the purchasers' boss. Mr Cumberland said: "If you're effectively negotiating for the purchase of the business from your boss, it is always a difficult process to undertake, particularly if things don't go very well. If the deal doesn't end up completing, you're still working for the person that you were potentially buying the business from. You have to tread very carefully and make sure that no bridges are broken throughout the whole negotiation process."

Culture shock – private equity

Of course not all corporate finance advisers work on behalf of the management team. Private equity buyers unquestionably dominate the MBO deal landscape and the management team often find themselves sidelined in the negotiations. John Gilligan of PKF Accountants & business advisers, said: "The position of the management in a buyout has become weaker because institutions now bypass management and go straight to the purchaser. It's rare these days for a management team to be in complete control of the buyout process whereas 10 years ago it was very unusual for them not to be in complete control."

Particularly for smaller businesses, working closely with a private equity firm for the first time can be a culture shock and for managers unused to the level of external scrutiny, this can be daunting. "The main challenge lies in understanding what the constituency that the management team are selling themselves into wants from them, understanding the demands of what they are getting themselves into and the rigour with which they will be interrogated by people who are not experts in their field," said Nick Triggs of Fox-Pitt Kelton.

"The distinguishing feature of private equity is that they are very sophisticated in terms of analysing financial information and are very creative in finding financial solutions for things. They are very bright but they don't necessarily know a lot about the specific company or the sector and this can be challenging for the management teams. You might sum that up as creating the potential for a cultural mismatch between the buyer and the management team," said Mr Triggs. "Therefore just as in corporate transactions it is extremely important to find the right match between the private house and the management team."

Capital gains tax

The Chancellor's plans to abolish taper relief and set a single 18% rate from 5th April were predicted to cause a stampede of vendors selling their businesses before the changes came in. Those dire warnings have not materialised into fact. Where deals had already been on the table prior to the announcement last year, there has been some pressure to accelerate the process to bring completion forward to before the 5th April deadline. But most corporate financiers are relieved to report that a frenzy of panicked selling did not happen.

Sellers have realised that taking the short-sighted view and rushing through a deal to make an 8% tax saving would risk skimping on thorough negotiations and due diligence and could end up costing more in the long term. "Tax normally arises where people have significant gains and the trick is to make the gains. If the gains are big enough, the tax is an irritant rather than an obstacle," said Mr Gilligan.

Economic uncertainty

Of wider concern is the economic gloom that is currently hanging over the market. While so far no significant slowdown has been felt in the rate of midmarket MBOs going through, there's no question that a climate of uncertainty is not helpful. As with any major decision, such as whether to invest in plant and machinery or to take on extra staff, the decision to stage a buyout is also affected. It may be that management teams decide to put any takeover plans on ice while they wait to see how things pan out.

An economic slowdown has an impact on the forecast projections and consequently on financing available. "Companies can't have the stellar growth plans that you would have had previously," said Mr Cumberland. "There has to be a lot of realism put into those projections and that ultimately has an effect on the price people will want to pay for the business and also on the levels of debt you can gear up on the cashflows of the business."

Banks are retreating to a more cautious pattern of lending than has been the case over the last few years. With debt availability going down and pricing on its way up, it seems unlikely that the free flow of cheap debt of recent years will return. However, the effect of the credit crunch is more pronounced at the top end of the market where many highly publicised takeovers have been shelved in recent months owing to difficulties in obtaining financing.

But funding in the middle market does not seem to have taken the same hit and corporate advisers in the segment remain optimistic. Mr Moss said: "The right deals are still going to get financed. We've talked to the banks a lot this year since the so-called credit crunch. They're all putting out the same message that as long as the deal stacks up, finance is still available."

The hard work begins

Once the champagne has flowed and the toasts have been made, the hard work of running a successful