



UNDERSTANDING MANAGEMENT BUYOUTS AND HOW THEY WORK

A BUSINESS ACQUISITION & MERGER ASSOCIATES WHITE PAPER



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& MERGER ASSOCIATES**

“Who is the ideal buyer for your business?” is a common question asked to prospective sellers when determining their exit strategy goals. In most cases, the responses include, “a regional competitor” or “an experienced investor.” Rarely does a business owner suggest their own management team is the ideal buyer; however, in many cases management is a great option.

What is a management buyout?

A management buyout (MBO) is exactly what it sounds like: selling a controlling interest of your business to current managers/executives. Often, these types of scenarios are supported by an outside equity group with the capital resources to facilitate a transaction. When you understand how management buyouts work, you can weigh the pros and cons of selling internally versus to an outside party.

Is a management buyout right for you?

With so many options, why would a business owner consider selling to management as opposed to a third party?

One obvious reason a seller chooses a management buyout is to recognize their key employees' dedication and contributions. Regardless of your line of business, the key to building a strong company is having the right people on your team. These people sacrifice time and energy to support the business and in some cases dedicate years or even decades of service. Many business owners feel compelled to 'pay it forward' and provide their management team with the benefits of equity ownership.

Another reason business owners consider selling to management is their firsthand knowledge of the business. **Nobody knows the business**

better. Management drives day-to-day operations and understands the nuances that make the business a success. One risk in selling to an outside party is the ability to transfer knowledge quickly and effectively. Depending on the buyer, an outside investor may require weeks, months or even years to grasp the information required to successfully maintain and grow the business. Management is typically well-positioned to take over operating control and maintain key customer and vendor relationships with little-to-no distraction in the business.

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Another common rationale for selling internally is management's ability to maintain the legacy instilled by the founder. Creating a lasting culture takes commitment and consistency over a long period of time. Many business owners fear a loss of company identity and reputation in the marketplace should they sell to an outside party – particularly a strategic buyer. Even if an outside buyer meshes well with the owner, it is nearly impossible to recreate a company's culture. Management is best suited to carry on the philosophies and principals that encompass the company's persona.

Here are three great questions to determine if your team is bankable:

1. **Can they really run the business without you?** Are you still critical to the success of the company or have you transferred most, if not all, of the day-to-day responsibilities to your team.

2. **Do they have high integrity?** Your key managers need to have their act together. While they might not have a lot of money, they should have good credit and have no issues in passing a background check.

3. **Do they want to be an owner?** Gauge the interest of a handful your key team members regarding ownership. Some managers are completely risk adverse, but many will appreciate the opportunity to participate. Ideally, 1-3 members of the team are identified who together will do a great job running the company.

Are there instances where a management buyout is not the best option?

There are several reasons why an owner would steer away from selling their business to management. Sometimes management simply does not have the acumen to run a business successfully. They may be great at their specific role or function, but collectively, they do not have the chops to make the strategic decisions entrepreneurs face day-in and day-out. In order for a management buyout to be successful, the executives need to be well-rounded and ready to take on the responsibilities of owning a company.

There are thousands of private equity firms who back strong management teams.

Additionally, the capital required to fund a transaction often exceeds management's financial capabilities. Unless you have highly compensated executives or an employee with family money, most management teams must partner with an outside capital group. Yes, some owners may be open to providing a significant portion of seller financing, but what if you'd rather cash out?

Do you meet the criteria?

If you have a good company with a strong management team generating consistent EBITDA (earnings before interest taxes depreciation and amortization) above \$1.5M a year and little customer concentration (no one customer makes up more than 10-20% of your revenue), you'll likely have at least half a dozen financial sponsors interested in backing your management team. (Know that if you want to take most of your chips off the table and keep a small stake in the company going forward, you have that option, too.)

Can you check the boxes that outline the criteria for a successful management buyout?

CRITERIA

- Strong management team
- Financial growth
- Consistent margins
- Little/no customer concentration

Once you determine a management buyout is an ideal strategy, it's important to understand how the process works. There are many ways to structure a transaction that allows management to participate in material equity stakes with nominal investments.

As noted earlier, outside capital is usually brought in to support an MBO. There are thousands of private equity firms who back strong management teams and buy out exiting shareholders. A common practice is having management and selling shareholders agree on general price and terms and then going to market to find the most qualified equity group.

How much equity will your management team get?

The best equity partners provide strategic growth support, a transaction structure offering immediate liquidity for the seller and an attractive entry point for management. This can be achieved using multiple tranches of equity.

Let's look at an example that illustrates the economics of a potential MBO structure. Assume ABC Co. is a wholesale distributor of widgets generating \$10MM in annual revenues and \$2MM of EBITDA. The founding shareholder is nearing retirement and has assembled a strong management team to run the operation day-to-day. The Seller's objective is to cash out 100% of his ownership and provide an opportunity for his management to own up to 20% equity.

A private equity firm values ABC at 5x earnings or \$10MM. Using a 50/50 capital structure, the acquisition is financed with \$5MM of debt and \$5MM of equity. In order to make the transaction appealing to management, equity is structured as two classes of stock. \$4MM is preferred equity and \$1MM is common equity. Therefore, management needs to come up with \$200,000 in order to own 20% of the common equity – this equates to only 2% of the total purchase price (see Exhibit A).

Structured appropriately, management can own a material equity stake with a nominal investment. As the equity grows and debt is paid down, the management team (alongside their private equity partner) has the opportunity to participate in the upside of equity ownership.

This is just one example of structuring win-win management buyouts. At the end of the day, the seller's objective is to be treated fairly at closing while ensuring that his/her management team is offered the opportunity to own a piece of equity in exchange for their continued loyalty to the business. There are many scenarios that provide liquidity to exiting shareholders and the opportunity for management to participate in ownership.

Exhibit A: Sources and Uses - Acquisition of ABC Co.

Sources

Senior Debt	\$5,000,000	50%
Preferred Equity	\$4,000,000	40%
PEG Common	\$800,000	8%
Mgmt Common	\$200,000	2%

Total Sources \$10,000,000 100%

Uses

Enterprise Value	\$10,000,000	100%
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Total Uses \$10,000,000 100%

Business owners have many options when it comes to evaluating their exit strategy. A strong management team should be considered when sellers want to give back to their key employees and transition operating control to the individuals that best understand the operation. Private equity is available to help fund transactions and partner with management teams that wish to co-invest in the deal. The right partner and capital structure often result in a win-win scenario for all parties.



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