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Managing the Management Buyout

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Many entrepreneurial and family business owners struggle to determine their eventual exit strategy. Perhaps they envision the eventual transition of their business to the next generation but discover that their children are either uninterested or unable to take over. The owners are nervous about reaching out to competitors and/or customers and disclosing proprietary information. What then are the options for a successful exit strategy? Some need to look no further than the management teams that run the day-to-day operations.

Selling a business to key management team employees is a tempting and oftentimes a rewarding opportunity. After all, your key employees already run the business in your absence. They are typically involved from top to bottom in the employee and financial management planning, and already have built strong relationships with key customers and suppliers.

Management buyout transactions (MBOs) can be beneficial but are also full of unique planning obstacles that if not managed properly and carefully can end without a sale taking place. Worse yet, a failed process often results in the loss of key employees who become disappointed that their future plans have vanished.

Before offering your business for sale let's take a step back and review a few key items:

1. Is everything in order? Before selling any business in a MBO, you need to conduct an internal and external review. Review your legal structure, your filing status, your ownership and minute book records, employee agreements and handbooks, customer and supplier agreements, banking relationships and debt structure, financial statements, and tax returns. Ensure that all agreements are signed, determine that you are in compliance with each, and when the terms expire. Review your personal finances with your financial advisor. Will the sale proceeds after taxes support your long term goals?

2. What will the structure of the sale look like? If your company has numerous contracts that are critical to your success and would be difficult to assign to a new company, you might need to conduct a stock sale, which presents more risk to the buyer than an asset sale. If there is a third party landlord, will the landlord allow the seller out of the lease? Will the bank on the operating line of credit release the seller's personal guarantee if there is one? If there is more than one team member as the buyer, it is critical to ensure there is a carefully negotiated shareholder agreement and determine the leader of the buyer group.

3. Who is tending to the business during the deal phase? An MBO requires significant due diligence and negotiations between not only the seller and buyer(s), but also the financial partners or banks. This can be extensive and impact the available time to manage the daily business when your buyer is also your key management team. Having an upfront agreement on the process can help mitigate these concerns.

4. What is the value of the business? Typically, the management team and owner will have very different views off what a company is worth. Generally, a business' value is derived through a form of discounted cash flow or multiplying the earnings before interest, taxes, depreciation and amortization (EBITDA) times an industry standard multiplier. However, determining the EBITDA figure might require some level of adjustment to normalize or account for expenses paid to or on behalf of the owner that are outside industry standards. Entering the price negotiation with good detail and analysis of your current financials and your future pipeline opportunities will put you in a position of strength and help reduce surprises after the buyer's due diligence is completed.

Once you have determined the sale price, you need to ensure that the buyer has sufficient ability to fund the buyout. Often times, employees will lack the capital necessary to purchase the business. Some buyers assume the seller will provide seller financing, but that will have a significant impact on the seller's goals. Traditional bank financing usually requires 20 – 40 percent of the purchase price to be provided from the buyer. Having the right mix of financing is complicated, but critical, to the success of the transaction.

There are some areas that the buyer's lender (either the incumbent or a new source) will focus on. In anticipation of this, be prepared to address them and provide support for your position. Remind yourself that you have greater knowledge of the business than they do. Supporting your position with data will

be very helpful to both parties. Here are the top 5 areas:

1. Customer Response: Revenue is the gateway to profit. The lender will evaluate the risk of lost business that could occur following the MBO. This is particularly important if revenue is concentrated. Lenders will ask whether customers are aware of the pending MBO, and how they have reacted. If a new entity must be formed (an asset sale), will the agreements be amended to acknowledge the new business entity?

2. Supplier Response: The importance of this is driven by the level of difficulty in procuring an alternate source for your product/service. This will be more difficult (a greater risk) if your suppliers provide a unique good or service, and if what they provide is critical to your business. In addition, evaluate the level of complexity of the relationship. Highly complex arrangements are difficult to replicate with a new party. If there is a significant risk, the lender will have similar questions to those they asked about your customer base.

3. How will the seller's role change? In most cases, the seller's role will diminish following the MBO. The lender will want to know the impact this will have. How involved was the seller? How will external partners react? What will be the impact on company culture? How will the buyers/new owners mitigate these risks?

4. Financial Projections: Lenders will be skeptical of any projected improvement in financial performance. Remember the knowledge gap. Be careful to clearly describe the actions that will cause the improvement and support this with data where possible.

5. Business Planning Changes: Change is inevitable. Now that the company has new owners, management will naturally operate differently. With the authority of ownership, the new team has the freedom – as well as the incentive – to make decisions they may not have previously made. It is important that lenders get to know this team. If the group is large, an influential point person should be established. Business plans provide guidance, but actual results will be different, and usually it's unfavorable. Management will follow their tendencies. This is why it's so important to know who is in charge. Knowing their motivation and tendencies is as important as the business plan.

A management buyout can present a significant opportunity to sell your business. If you are considering an MBO transaction, it's critical to start the process by looking at your goals and obstacles. Are you concerned that the ability of your buyer to fund the transaction will require you to finance the transaction? Does the idea of negotiating with your key employees create too much stress? Are you frustrated that you are only being told what you cannot do, and not being helped to find solutions? The right advisors who will help you through your concerns, and who have the experience to ask the right questions and solve your biggest fears, can be invaluable.

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