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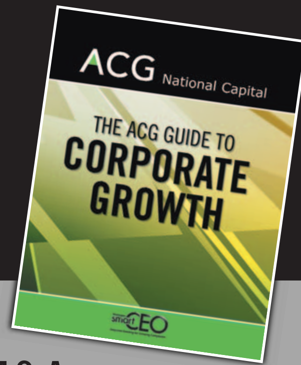

Management Buyouts as an Alternative to Traditional M&A

By Michael M. Mannix and Adam J. August

If you are a Division head and frustrated because the opportunities available are not being maximized, the best solution may be to execute a management buyout (MBO). When an MBO works, managers chart their own destiny based upon the success of the company going forward. When it fails to materialize, the disillusionment between owners and management can lead to firings or other departures of valuable Division managers. But with willing lenders and an historic level of cash flowing into private equity funds last year, financing for MBOs is increasingly available proving MBOs are here to stay.

An MBO involves a purchase by existing management of the stock or assets of their employer from the current owners. When financing is provided by third party equity or debt, the deal is called a leveraged buyout (LBO). Some MBOs appear in the context of "going private transactions", wherein management of a public company buys out the remaining stockholders in exchange for cash, debt or preferred stock. These can take the form of a merger or a tender offer. Some are going private transactions, which permit smaller companies, with fewer than 500 shareholders in any one class, to avoid the expense and complication of SOX and other public company compliance.

Selling the deal. In a typical MBO, a relatively small number of high-level executives lead a management team, establish the terms of the proposed MBO from the buyer's side, and negotiate the financing and transaction terms with the seller(s). The executive team needs to include individuals with strong operational skills in order to inspire confidence on both sides of the deal. The team also needs access to experienced advisors who can help them negotiate the financing and deal terms, and, of course, to anticipate issues likely to arise.

Frequently, the first test of the executives is to "sell" the opportunity to other potential MBO team members. Just as important for the success of the MBO is to recruit solid managers at several organizational levels in order to achieve broad based buy-in from other company personnel and instill faith that the MBO team can grow the business and repay acquisition debt following the closing. MBO team leaders must be certain that key management is squarely behind them and that financing sources are supportive and fully committed to the transaction.

What makes an MBO team a better buyer? Managers make good buyers since they are most familiar with the business, can be counted on to maintain confidentiality and are most capable of closing a transaction quickly. Familiarity with the business reduces the level of diligence typically required for outside buyers, and many diligence issues raised by potential financial partners can be resolved at the MBO team level without involvement of sellers. Moreover, contracts in MBO acquisitions contain fewer representations and warranties by the sellers and still fewer conditions to closing. The existing relationship between the buyers and sellers permits them to work efficiently in a confidential environment.

Another factor favoring management over third party suitors involves valuation. Consider this example: an MBO with a services business as a target and the management team seeking third party debt or equity financing. The value is best preserved with the continuation of the good will and relationships that existing managers have established with vendors, suppliers and customers. Even seller debt financing is more appealing to a parent company's Board of Directors when committed management remains in place following the closing.

Management is frequently the best buyer from the seller's perspective. Many issues that normally emerge with third party buyers simply do not appear in a purchase by management. Selling business owners frequently must reveal valuable trade secrets to a prospective buyer during the M&A diligence process prior to a closing. Disclosure issues can be particularly important for the public company seeking to avoid triggering public disclosure under the federal securities laws when facing negative, but expected events or results A sale to management avoids disclosures outside the company of sensitive information and virtually eliminates unexpected adjustments to deal terms related to the business.

Finally, selling to management may be the perfect way for current owners to leave a legacy to deserving management. It avoids the possibility of a time-consuming and distracting auction process, and prevents the target from being mismanaged by a new team, thereby imperiling an earnout or the repayment of seller financing.

Financing the MBO can be a tough hurdle. Sometimes the MBO requires the management team to invest their own equity in conjunction with other forms of financing. This feature complicates almost every aspect of the transaction. It can be seen as an unwelcome admission price by an important prospective member of the MBO management team. Further, a private investment among any group of investors has securities laws implications including, in most cases, the requirement to disclose all the risks and transaction terms to the team members in a private placement memorandum. In structuring the team of investors who will provide equity in the transaction, the offering must qualify for an exemption from registration under applicable federal and state securities laws. All participating investors need to be "accredited" under the securities laws. If even one is not, the entire offering requires higher levels of disclosure including conformity to more onerous accounting rules.

Another potential complication is seller financing in connection with the sale of a subsidiary in an LBO. Debt financing of the sale by the parent is evidenced by a debt instrument. Heavy debt financing of a purchase price can lead to a debt-laden balance sheet for the acquired company following the closing. The note to the parent could be characterized as a dividend making the sub is insolvent and rendering the issuance of the note improper. These legal and tax limitations on debt from a subsidiary to a parent underscore the need to involve tax advisors in the early stages of the transaction planning.

A business with a history of strong and sustainable cash flow is the best candidate for an LBO since it can generate a business plan that demonstrates how it will service the necessary debt or achieve an important earnout. An earnout is one alternative to (or variation of) debt financing whereby the seller participates in some of the business gains post-closing. With today's valuations continuing upward, earnouts can be used for management to afford what would otherwise be an unattainable acquisition.

MBOs offer significant advantages to traditional merger and acquisition transactions from both the buyers' and sellers' perspectives. Management is often in the best position to assess the overall operations of the business. Ultimately, how a buyer finances the buyout may be the most difficult component of the transaction and financing may come from management, the seller, a third party lender, or some combination thereof. Early planning with experienced advisors – accounting, financial and legal counsel – will prove advantageous in order to maximize the likelihood of success for the deal.

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