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The path to personal riches

In a previous article (*ICIS Chemical Business* 11 September), Gordon Blair looked at management buy-outs, addressing the process from the owner's point of view. This week, he discusses some of the issues to be dealt with by management when considering making an approach to a company owner

A MANAGEMENT buy-out (MBO) offers a competent team in the chemical, petrochemical and associated industries the opportunity to turn years of hard work, and hundreds of thousands of pounds of investment, into several millions of pounds each. It sounds attractive; it is attractive; but the route to a successful MBO can be tortuous, particularly if the team makes the wrong first move.

If the owner of a company invites a management team to consider an MBO, and that team is of sufficient quality to attract financial backing, the company is well run and operating in a growing market, and the seller's price expectations are reasonable, then conditions for a buy-out are perfect. But even in that perfect scenario there will be a turbulent few months ahead.

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Gordon Blair, partner, Livingstone Guarantee

SAFE WAY ROUND

However, in the real world, it is rare for all of these requirements to be aligned. If no move has been made by the owners and the initiative has come from the management team, the atmosphere can be completely different.

In fact, it can be dangerous, particularly if the business is performing poorly. Suspicions may be raised as to whether or not the management team has deliberately engendered the decline of the company.

Therefore, if a management team wishes to explore the possibility of an MBO, it should approach a corporate finance adviser who will assess the feasibility of the project and make an anonymous approach to the vendors on their behalf to discover whether or not a sale would be considered.

Should the answer be no, careers have been protected, as nothing has come out into the open. If the team has been so fired up with enthusiasm that members really wish to own their own business, they should pursue a management buy-in elsewhere in the industry.

If the answer received by the corporate finance house is yes, and a transaction looks viable as the vendors indicate a willingness to start discussions, then the management team should make the approach and establish the valuation parameters. If these are unrealistically high, there is little point in investing time and emotion in proceeding any further.

If there is broad agreement, then permission should be sought to approach funders, usually venture capitalists, to work up a detailed business plan and proposal.

It must be remembered that venture capitalists only invest in one thing: management. The team must therefore include the senior directors from the existing business, particularly the managing director who is unquestionably the key player. Plans should be made to fill any gaps in the team – many corporate finance advisers have good contacts or registers of suitably qualified executives seeking buy-in opportunities.

Venture capitalists, who will be putting up the bulk of the cash, must see a demonstration of commitment to the deal, and recognition from the management team that they will have to invest their own money – typically an amount equivalent to six to 12 months' salary – to be taken seriously by the venture capitalists.

Many managers need to take out a second mortgage on their home, or cash in other assets to be used as security to fund their investment in the business, so one of the implications is that this does not just affect them as individuals, but also impacts on their families. Make sure you have discussed it and have the support of your family before you make any approach.

AMPLE CHOICE

The amount of private equity funds available in the UK and continental Europe at present is at an all-time high. As a result, there are plenty of venture capitalists to choose from. However, around 75% of all business plans submitted to venture capitalists by

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prospective management buy-out teams seeking financial backing are rejected without the team even getting a meeting.

Management teams will therefore need to select a short list of three or four private equity funds, based on their focus on the size of the transaction, interest in the market sector and track record. An adviser who works with venture capitalists on a daily basis will be able to recommend the most likely funders.

The same adviser will pre-sell the MBO opportunity so that when the business plan is submitted, the chances of an initial meeting are high. First impressions count, so a presentation should be rehearsed for the initial meeting with the venture capitalist.

HIDDEN AGENDA

Funders are seeking to back quality teams who are hungry to work harder than ever for the next few years in order to realise a substantial capital gain. If they sense that the real motive of the management team is simply to ensure their job security and nothing more, rest assured, the venture capitalist will run for the hills.

If one or more of them is interested in backing the buy-out, they will – having learnt more about the business – make an offer to fund the transaction. Then follows a period of detailed negotiation around the price to be paid to the vendors, the equity split between management and the venture capitalist.

As most transactions are debt funded, negotiations with the bank will also be required. Once everyone agrees terms, the financial legal, commercial and other due diligence process can begin, as well as the legal process.

The legal process involves the documentation surrounding the acquisition of the target company, the shareholders agreements between management and the venture capitalist, and the lending agreements with the bank. It is up to the corporate finance adviser and the legal team to handle these key negotiations.

The length of time taken up by these negotiations varies greatly. There have been examples of MBOs completing within three months, but these are the exceptions. Typically, the deal will take five to six months to come to fruition from the point the vendor is approached and agrees the broad principle of a transaction. It will prove to be a time-consuming and roller coaster experience for the management team.

END RESULTS

It is all likely to culminate in a nail-biting few weeks (and it is not unusual for there to be last-minute negotiations over amendments to the purchase price or conditions arising out of due diligence). But, as we all know, these deals do go through (eventually) and MBO teams embark on the road that should lead to demonstrable business success and personal wealth.

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