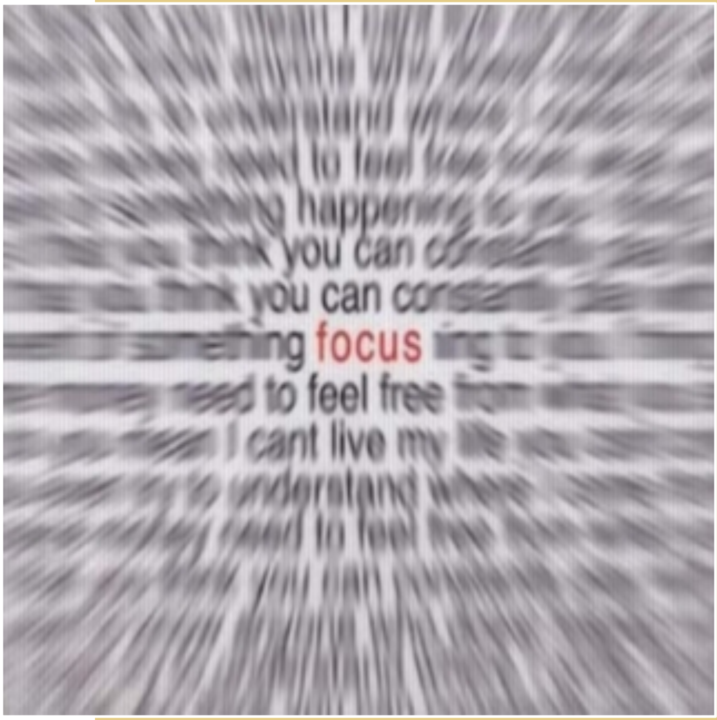
GUIDE TO MANAGEMENT BUY INS



M3 CORPORATE FINANCE

M3 Corporate Finance

M3 Corporate Finance is an independent corporate finance house focused exclusively on mid-market transactions.

M3 offers specialist corporate finance advice to shareholders and managers / directors of companies and private equity houses concerning:

- Exit strategy and company sales
- Management buy outs
- Management buy ins
- Corporate acquisitions
- Development & replacement capital
- Corporate divestments and restructuring
- Recapitalisation equity release ('cash out')
- Vendor roll-over

Our services are always led by an owner partner guaranteeing our commitment to your deal.

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Further information can be found at the back of this guide.

INTRODUCTION

This guide has been written for senior executives who are contemplating buying a business they currently do not work in.

Management buy ins ("MBIs") are considered by many to be risky transactions as the purchaser doesn't have the benefit of the inside track from being part of the incumbent management team whilst at the same time it is likely that the transaction will be at least partly funded by external finance (equity and/or debt) and hence the financial risks increase as well. Many funders will not provide funding to such transactions but others will. There are also ways of mitigating those risks by structuring the transaction in the right way and by carrying out thorough due diligence.

It should be noted that gone are the days whereby an executive can invest a nominal amount and expect banks and venture capitalists to do the rest. The executive needs to be able to invest a meaningful amount to show their commitment to the transaction and to taking a suitable level of risk for their future reward.

This guide is designed for executives who think they might like to take this route. We will cover:

- The basics
- How to find a company to buy
- Approaching a target
- Assessing the target
- Valuation
- Business plans
- Structuring and making an offer
- Due diligence
- Post deal

CONTENTS


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SOME TERMS EXPLAINED

Corporate financiers like to use acronyms. Certain common ones are as follows:

- MBO. A management buy out. This is where the existing management team buy the business they are currently working in. Please see our other guide to MBO's.

- MBI. A management buy in. This is where an individual or team buy a business that they are not currently working in.

- BIMBO. A buy in management buy out. This is a combination of the above two. The existing management team (or part of it) joins forces with an individual or team that is not currently in the business to acquire that business. This is seen as a lot less risky than a pure MBI and has become the more likely option than a pure MBI. We will cover BIMBO's as part of this guide.

Advantages and disadvantages of buying an existing business.

The alternatives open to an executive are:

- Taking an employed role in another business (with or without some equity upside);
- Start a new business; or
- Buy an existing business.

Taking an employed role is the most risk averse but may well not satisfy the entrepreneurial hunger of the executive (as well as offering a more limited financial upside). Starting a new business or buying an existing one shouldn’t be seen as an alternative to getting an employed role because you can’t find a suitable job. You must want to run your own business and have the drive and ambition to make it succeed.

If the choice is either start a new business or buy an existing one, if you get it right, there can be many good reasons why buying an existing business could make good business sense for you. Remember though, that you will be taking on the legacy of the previous business owner, and need to be aware of every aspect of the business you're about to buy.

Advantages

- The business will be already up and running.
- Alternative funding sources will be available as the business will have a proven track record.
- A market for the product or service will have already been demonstrated.
- There will be established customers, a reliable income, a reputation to capitalise and build on and a useful network of contacts.
- Existing employees should have experience you can draw on.
- Many of the problems will have been discovered and solved already.

Disadvantages

- You often need to invest a large amount up front.
- If the business has been neglected you may need to invest quite a bit more on top of the purchase price to give it the best chance of success.
- You may need to honour or renegotiate any outstanding contracts the previous owner leaves in place.
- You also need to consider why the current owner is selling up and how this might impact the business and your taking it over.

Think about the feelings of current staff - it's possible they may not be happy with a new boss, or the business might have been run badly and staff morale may be low.

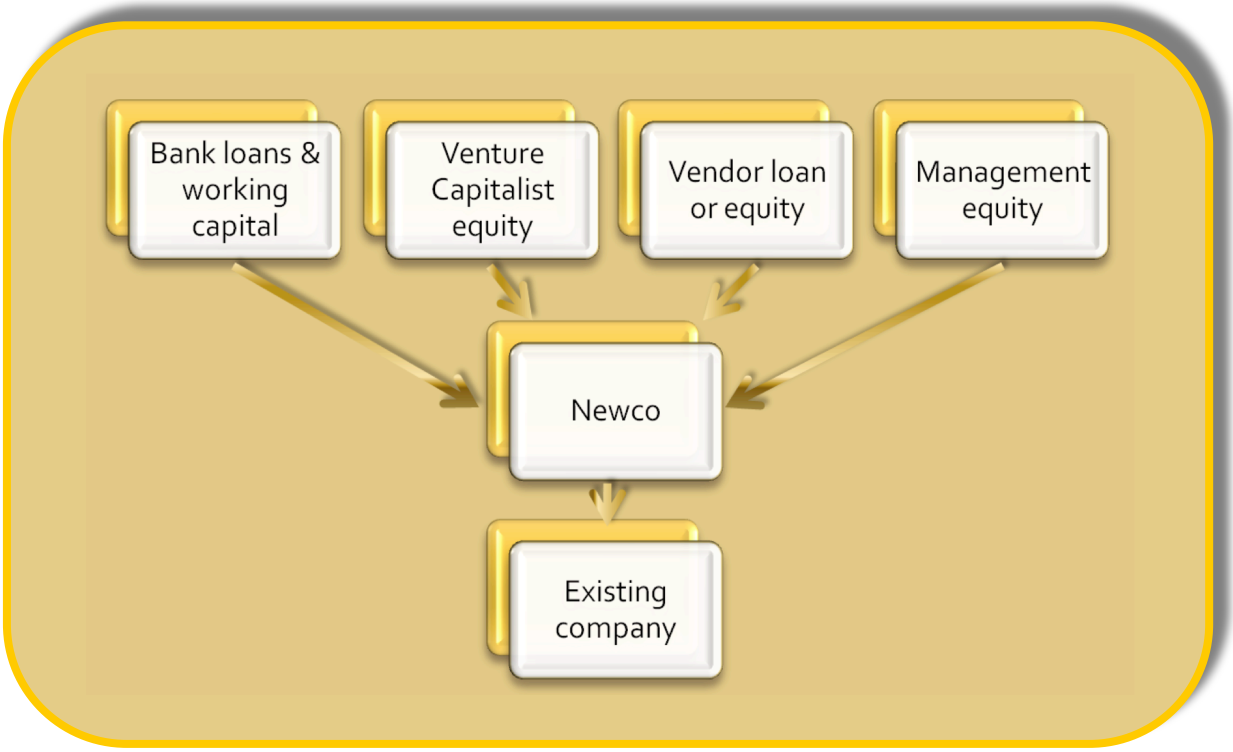
THE BASICS

How are MBIs structured and funded?

For the sole purpose of buying the company and financing the purchase, management and the funders create a new company (Newco). In the most common structure, Newco acquires 100% of the shares in the target company and thus becomes the holding company. Newco then raises different types of financing from different sources.

Funding for a MBI will come from a variety of sources. The bulk of the funding will normally be provided by financial institutions, primarily from banks and venture capitalists / Private Equity Houses. Debt and working capital facilities (loans and overdrafts / invoice discounting) are typically provided by a bank. Equity investments are most frequently provided a Venture capitalist / Private Equity House. A venture capitalist and Private Equity House are similar in that they both provide third party equity to buy businesses – typically a venture capitalist looks at smaller deals and a Private Equity house at larger deals – so we will refer to them both as venture capitalists for the rest of this guide.

In addition, in certain circumstances, the vendor may be willing to defer some of the consideration for the business and, in the current marketplace, this has become a regular feature. The management team will also be expected to invest but in reality this investment is more to show their commitment rather than to be a major source of funding.



Bank
A bank typically provides up to 60% of the total funding need. The bank will have security over the assets of the business acquired and will require to be repaid in priority to the venture capitalist. Accordingly the bank profile is one of lower risk and therefore will command a lower return (via the interest charge). From time to time, if there are few actual assets but cash generation has been and will remain strong then the bank may also provide a “cash flow loan” as part of its proposal to increase the amount it lends over and above the amount it has security for.

Vendor
Vendor financing is usually a matter of negotiation. Vendor financing can be either in the form of deferred loans - after the bank is fully or partially out - or equity, generally in the same proportion of ordinary shares and loans as the venture capitalist. Vendor financing can be useful in bridging any price gap. However, some vendors may particularly appreciate the opportunity to reinvest part of their proceeds in the new entity and so provide them with an ongoing involvement and an upside potential. This continuation of emotional ties, and the possibility of a share in higher proceeds further down the line, can be a strong influence for vendors to choose a MBI over a trade sale.

Venture capitalist
The venture capitalist typically provides up to 50% of the funding required for the MBI although it can be up to 100% in special circumstances. It will “bridge the gap” between the other funding sources and the price. It will stand behind the bank and vendor and therefore require a greater level of return. It will achieve this by subscribing for a percentage of the ordinary share capital of the business alongside management with the rest of their funding typically being invested as loan stock.

Management
The management team is likely to invest the smallest amount but stand to make the greatest capital gain. As mentioned earlier, gone are the days whereby an executive can invest a nominal amount and expect banks and venture capitalists to do the rest. The executive needs to be able to invest a meaningful amount to show their commitment to the transaction and to taking a suitable level of risk for their future reward. As a rule of thumb, on a deal value greater than £500,000 we would normally expect the management team to invest £250,000 or more. However, this amount doesn’t need to increase significantly as the deal gets larger.

In a BIMBO it is typical for the MBI element to invest the largest share of the management equity but funders will still want to see a meaningful contribution from the incumbent team but the amount will vary depending on the deal and personal circumstances.

Do I need all of these sources of funding?

The simple answer to this is “no”. Some transactions do not lend themselves to large amounts of debt. Some vendors are unwilling to defer some of the proceeds in the form of a loan. Sometimes, the amount of debt and vendor funding that is available alongside the investment from management is sufficient to pay for the business and no Venture Capitalist is required. The best structure depends upon many things and your adviser will spend a lot of time working with you and the funders on the ideal structure for your deal.

An example

Let’s assume a management team is buying a company for £3 million (ignoring fees). The actual funding structure will depend upon many factors but it *could* look like the following:

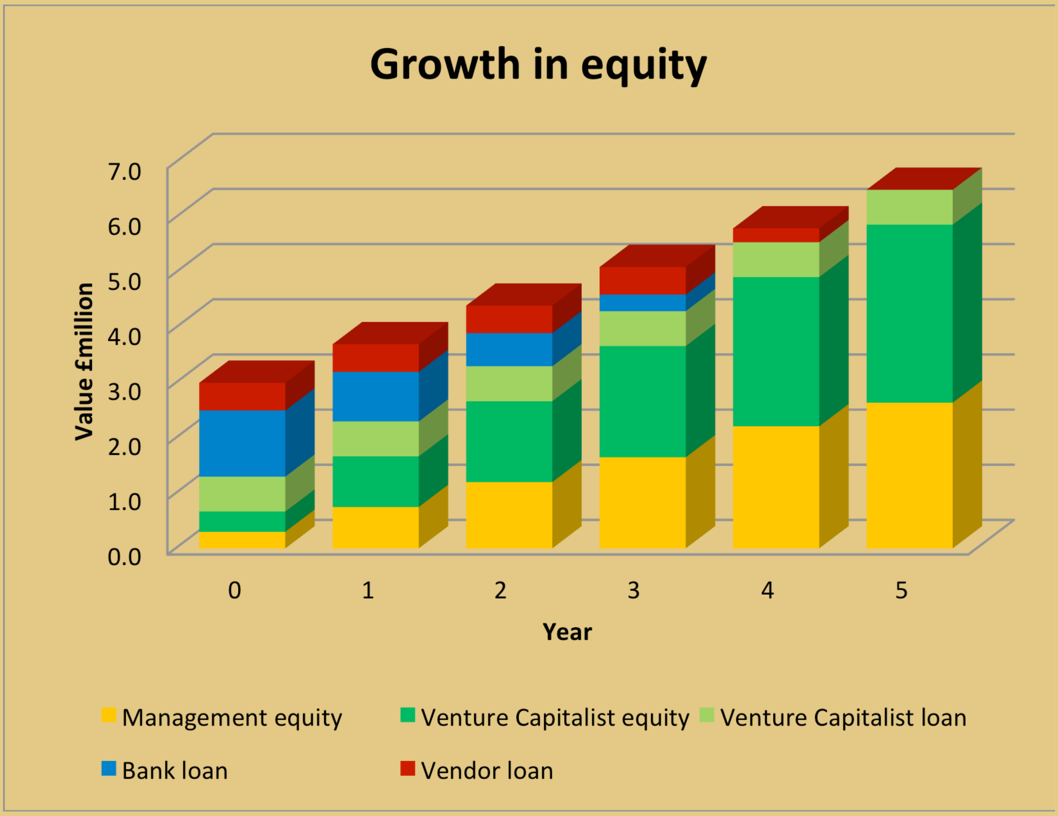
	£	
Bank loan	1,200,000	*plus working capital facilities*
Vendor loan	500,000	
Management ordinary shares	300,000	*45% of the shares*
Venture Capitalist ordinary shares	367,000	*55% of the shares*
Venture Capitalist loan	633,000	
Acquisition price	3,000,000	

Now, let’s move quickly forward and look at a possible future outcome. Imagine the company is sold for £6.5million including surplus cash with the loans repaid from cash generated from trading profits.

	£	
Valuation	6,500,000	*including surplus cash*
Less: Bank loan	0	*as it was repaid from cash generated by the business*
Less: Vendor loan	0	*as it was repaid from cash generated by the business*
	6,500,000	
Venture Capitalist loan	-633,000	
Available to shareholders	5,867,000	

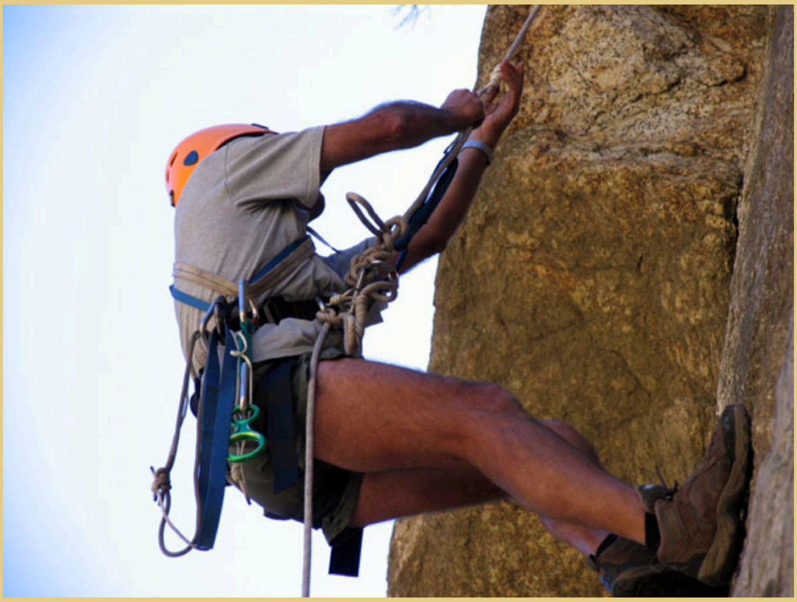
An example continued

Split:	£	
Management	2,640,150	*45% of the shares*
Venture Capitalist	3,226,850	*55% of the shares*
	5,867,000	



In this example management receives nearly nine times the original investment. The reason that management can make many times their original

MBIs can be ingeniously engineered, financially speaking, and the leverage effect of paying partly for the business using debt, may boost shareholders returns. However, an MBI is never purely a financial play because the most important prerequisite and driver of shareholder value is a growth in company value. Without growth the model struggles to work. Management is expected to grow the business, invest for the future and increase profits if it is to succeed in adding value over the long term.



HOW TO FIND A COMPANY TO BUY

Having decided that you are keen to progress with a MBI it is important to develop a profile of the sort of business that you want to acquire.

Ideally any business you buy needs to fit your own skills, lifestyle and aspirations. Before you start looking, think about what you can bring to a business and what you'd like to get back.

List what is important to you. Look at your motivations and what you ultimately want to achieve. It is useful to consider:

- Your **abilities** - can you achieve what you want to achieve? Do you need to add someone else to your team?
- Your **capital** - how much money do you have to invest?
- Your **expectations** in terms of earning and capital growth.
- Your **commitment** - are you prepared for all the hard work and money that you will need to put into the business to get it to succeed?
- Your **strengths** - what kind of business opportunity will give you the chance to put your skills and experience to good use?
- The **business sector** you're interested in – this is most likely to be a sector that you already have experience of – again a way of reducing the risk of the transaction.
- **Location** - don't restrict your search to your local area. Some businesses can be easily relocated or you may need to consider relocating yourself.

Gather and review as much relevant information as you can on the markets, companies, products and services you need. Once you have developed the target profile, you can:

- Consider firms you have previously sold to or bought from in your previous roles or who were competitors. Vendors rule out many potential buyers at an early stage, for a variety of reasons, and you should not rely on the grapevine to position your business for potential deals. On the contrary, you should use the close relationships that usually exist within sectors to your benefit by ensuring “the market” knows that you are a genuine and realistic potential purchaser.

- The business press can highlight opportunities either by allowing you to invite approaches by potential vendors, or by identifying companies for sale. This is an unsophisticated process, however, and the type of interested party it may give rise to should not therefore be a surprise! It can work, however, in a more focused manner. It will also highlight companies that are actually for sale that may fit your criteria.

- Circulating acquisition criteria to corporate finance houses and investment banks is a positive, but unfocused attempt to hear of opportunities. Whilst deal flow will improve, you are likely to receive details of companies with only a passing resemblance to your preferred profile, and you will not hear of them on an exclusive basis.

- Management research suggests that the most likely source of MBIs is when an executive has invested time and effort in a dedicated acquisition search exercise. Financial advisers will assist you with this research, and they should reduce the initial trawl to find businesses that most accurately fit your acquisition criteria.

THE ACQUISITION PROCESS

APPROACHING A TARGET

When you have identified a suitable target business to acquire you will need to register your interest in doing so with the owners of that business.

There are three common ownership structures for unquoted companies in the UK – the owner-managers, the venture capitalist / management team combination, and the parent company (be it a public company or a larger private company).

The important issue is who to approach so that you get to the key decision-maker as soon as possible. A limited amount of research should allow the right person to be identified, whether it is the controlling shareholder, the venture capitalist or the group managing director.

As an individual you may have reservations about making a cold approach to a target - a professional corporate finance adviser will have no such reservations and can add significant credibility to your approach by demonstrating that you are approaching this in a professional manner.

The "buffer" of an adviser between parties is a recurring theme throughout the whole process. There are no formal rules as to the most effective way to approach a target company. A letter then following up with a telephone call can be productive. The ability to interact with the decision maker and explain the rationale for the approach is unmatched, and is to be recommended. Again the most appropriate party to make that call is often the corporate finance adviser.

Being able to demonstrate that you have the financial resources to acquire the business is important to your credibility. Therefore becoming acquainted with funders at an early stage is positive. Your adviser will assist with these introductions. If a vendor then requires some indication of your ability to fund the transaction then that should be forthcoming.

ASSESSING THE TARGET

An initial information request should focus on those areas most relevant to valuation and compatibility with the strategy for the acquisition. These will include:

- Key drivers to target's success;
- Target's products and services;
- Target's management and culture;
- Recent and future financial performance;
- Future prospects;
- Markets, customers and suppliers.

It will be important to compare and contrast all information received from the target, with that available from independent third parties. This is most relevant in respect of market conditions and future prospects, and will be revisited later.

In addition you should attempt to work out the vendor's objectives. For example:

- Does the vendor have to sell? If the answer is yes, what time pressures are they under?
- Does the vendor wish to sell assets or a company which holds assets?
- Is money the prime motivation for selling?
- Does the existing management aim to stay involved in the business?
- Expose areas of the business which need to be changed.

As well as having to have demonstrated your credibility as a buyer it is likely that the target will require you to sign a "Confidentiality Letter" or "Non-disclosure Agreement". As you are likely to divulge information about your own plans it is usually worthwhile to have this work in both directions. Typically certain highly sensitive information will not be shared until later stages of a deal, for example, customer names, margins by product etc. This information will become available once the trust between the two parties and the likelihood of a deal increase.

You must be sure that the business has no major problems. Preliminary 'due diligence' is completed before you make a firm offer for the business. The vendor's Sales Memorandum usually glosses over the weak areas.

VALUATION

Unlike public companies, private companies do not (usually) have price tags on them. You can spend many hours understanding business valuation methodologies for formally valuing a target company. However, the value of any company is that which a purchaser is willing and able to pay.

In determining the value that should be paid, a purchaser should have a view of the long-term addition to shareholder value that the transaction will bring, and the costs of the MBI itself (transaction costs, financing costs and integration costs).

Your proposed funders as well as your adviser will have views on valuation. In the current markets the amount of available funding is often the limiting factor on valuation but differences between value and the level of funding may be bridged by the vendor leaving in some loans or by retaining an equity stake.

Any valuation based on future earnings should be sensitised to reflect the uncertainties of financial forecasts, particularly in the longer term.

Good versus cheap

If your intentions are to find a cheap business you must be prepared to never find one or to deal with one that may never turn into what you had hoped that it would. It's akin to buying a cheap used car versus a good used car that you have checked over extensively. Yes, there is a chance that you will get lucky and get one that runs relatively trouble free for as long time, but the odds are that you will get one that requires ongoing maintenance. If you want to dramatically improve your chances for business success then look for a good business that can become great.

BUSINESS PLAN

The actual mechanics of funding a MBI have been discussed earlier in this guide. Often this stage will run at the same time as the deal is being negotiated with the vendor.

To be able to raise the funding management need to prepare their business plan.

What do we include in the business plan?
The business plan is a very important document and its main objective is to help raise finance. A clear, concise, well presented business plan is also an important factor in securing funder confidence in the management team and the business. The business plan is thus primarily a sales document and should demonstrate management's commitment to the MBI. Management must take full ownership of the plan but usually the adviser will give guidance and will critically and constructively assess the business plan before it is finalised.

A typical business plan will include the following:

- Executive summary covering a brief overview of the business and the rationale for the transaction together with the key strengths of the business
- A short history of the business
- Overview of the products or services
- Profile of the management team
- Analysis of the business's top customers and its key suppliers
- Analysis of the market and key competitors
- The company's operations – its premises, systems and employees
- Strategy for growth
- Historic financial analysis (normally the last three years)
- Analysis of the projections (typically for the next five years and at least two years on a monthly basis) and their assumptions. The projections

To raise the required funding you will need to meet and present the business case to a number of banks and venture capitalists that the adviser considers suitable and will arrange. If, following the initial meeting a funder is interested, they will provide an indicative offer of what they are prepared to provide and on what basis they will provide it. It is likely that the funders will want to meet again with further follow up questions before they convert their indicative offer into one that has the outline support of the credit or investment committees. It is a key part of the adviser's role to assess each funding offer and to negotiate the best terms for the MBI. Best terms will include price but also take into account many other factors such as amount and equity requirements, repayment terms, positions of default, exit expectations, ongoing monitoring / governance requirements, personal chemistry, etc, etc.

STRUCTURING AND MAKING AN OFFER

In deriving your offer for a business you need to form a view on the future profits and cash flows of the business:

- Make your own profit projections. Do not rely on the vendor's figures.
- Identify where savings can be made, and where there is scope to increase profits.
- Identify what you can "afford" to pay in terms of available funding.

Consider your level of risk. Risk is higher if the target business:

- Has low net assets.
- Relies on one or two major customers (or contracts, or suppliers, or key employees).
- Is currently unprofitable, or has a chequered history.

Writing an offer

When formalising your offer, always put in writing but head it "Subject to Contract". The vendor may have laid out the matters they want you to cover but even if not cover areas such as:

- Your price.
- When the consideration is to be paid and in what form (cash, loans etc).
- Your key assumptions both in terms of what you are expecting for the consideration and any assumptions you have made over profitability etc. Are you buying assets or shares?
- What further work you need to do and what approvals you need.
- Reasons why this offer should be attractive to the vendor (cash at completion, short handover period, retention of management, keeping the business as a separate entity, etc – i.e. make the offer sound attractive and highlight the softer issues that are likely to be important to the vendor).
- Next stages and timescales for a response.

Your adviser will have experience of writing such offers.

If an offer can be agreed (often after much negotiation) then it is worthwhile detailing what has been agreed in “Heads of Agreement”. It is useful to get your adviser to draft these to ensure all key matters are covered. Experience says that thorough Heads of Agreement will make the rest of the transaction more straightforward as what has already been agreed is laid out in the Heads. The Heads will typically cover a period of exclusivity as well to enable the transaction to be completed.

Negotiating a deal

Many business people have made long and successful careers from being good negotiators. It is surprising therefore, as to how poor those same people can be when negotiating their own transaction. It is an almost inevitable truth that a transaction in which you have a significant personal stake becomes a personal transaction. An adviser – whilst motivated to complete a successful transaction for his client – should be able to bring a degree of dispassion to negotiations that allows for clarity of thought and a level-headed approach.


FINANCE

DUE DILIGENCE AND CONCLUDING THE DEAL

Due diligence

Due diligence has become an ever more important phase of a transaction. Due diligence investigations are now covering the following areas:

- Financial
- Commercial
- Technical / operational
- Legal
- Taxation
- Environmental
- Pensions
- Insurance

Not every deal requires every aspect, and some elements can be carried out by the purchaser themselves. Other areas can be carried out by external advisers as required. If external funding is required then the funders are more likely to want more of the work carried out by external advisers to give them a "third party" view.

Funding

Funders, whether they are debt providers or equity providers, are by nature risk-averse, and they will not short-circuit procedures to meet deadlines imposed on them by transactions introduced to them at the eleventh hour.

The importance of project managing the fund-raising exercise alongside the acquisition itself cannot be overstated.

Concluding the deal

If issues arise from the due diligence then make the vendor aware as soon as possible. Be firm over the issues that have arisen and evaluate the impact they have on your previously agreed deal. Do you still want to progress? Does the price need adjusting? Does what you are buying need amending?

When you can see the finish line emotions will be running high so the assistance of your adviser should help maintain a level headed perspective on the transaction. If things aren't right, don't be afraid to walk away even if you have incurred fees.

Why will we need tax advice?

Expert advice is needed before the acquisition is legally completed in order to ensure the maximum financial benefit for the shareholders after paying income and capital gains tax and also to ensure the company has the necessary protection in respect of any tax irregularities that subsequently come to light. Issues that need to be addressed are:

- The structure of the transaction and the requirements for any tax clearances;
- VAT registration for the new company and advice on the recoverability in relation to deal costs;
- Opportunities to minimise capital gains tax and inheritance tax liabilities on future gains;
- Tax indemnities from the vendor; and
- Payment of stamp duty.

Why do we need to appoint a corporate finance adviser?

A corporate finance adviser should be appointed right at the start and will be fully involved in all aspects of the transaction until completion including helping you find appropriate targets. The corporate finance adviser will work very closely with you throughout the whole rollercoaster ride. It is therefore vital to select an adviser you feel you can work with and who will provide the necessary experience and support when times get difficult – because they invariably will!

Key areas where a corporate finance adviser will be involved are:

- Finding and approaching targets;
- Assessing the feasibility of the acquisition;
- Valuing the business;
- Introducing appropriate funders;
- Deciding on the nature of the approach and negotiating the best deal with the vendor;
- Negotiating the funding package;
- Introducing the management team to other advisers such as lawyers and tax advisers etc;
- Monitoring deal costs; and
- Project managing the entire transaction through to completion.

AFTER THE DEAL

Congratulations, the transaction is completed and you have acquired your target.

There is a lot do over the next few weeks. Many managers put together (as part of the business plan or separately) a “100 day plan” to cover the detailed aspects that need to be done.

Communicating to your staff, customers and suppliers is a key early task. It is important for you to communicate to all of the key groups your vision so as to carefully instil the necessary confidence in the new ownership. It is likely that you will need to give the some comfort about your future plans and the impact it will have on each key group as well as the robustness of your funding support.

It may also be necessary to install new independent systems for financial reporting, etc. if the target was previously part of a larger group. Even if the business was independent the systems may need to be strengthened to ensure that they provide necessary and timely information to you.

Finally positioning the business appropriately and planning for a fruitful exit cannot start soon enough. Further information on this can be found in our guide to “Grooming for Exit”.

WHY USE M3?

Your adviser needs to be an experienced corporate finance adviser with wide experience in advising corporates on buying businesses with a proven record.

M3 differentiators	*So what...?*
Owner managed business	Its more personal We understand deals as Principal & Adviser Entrepreneurial in outlook
Our people	Senior partner – led advice throughout the deal Experienced team who know how to acquire & sell businesses & understand the dynamics of transactions Mix of backgrounds from accountancy, banking, private equity & industry
Track record	Regular contact with funders Activity creates experience Vast pool of accessible knowledge
Creative & innovative	Creative deal structures that work for our clients We get the job done
Independent & focused	This is all we do – no conflicts of interest Team hungry to deliver We focus on our deals
Excellence & commitment	We strive for excellence in our work Strong research capabilities Committed to client satisfaction, standards & performance

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Gary Hyem

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- Gary originally trained as a Chartered Accountant with two periods working in industry.
- Having spent the last 16 years in Lead Advisory and Venture Capital markets, including five years as a Venture Capitalist, Gary has valuable experience in raising finance for businesses, working with management teams on MBO's and MBI's, as well as buying and selling companies from £1m to £100m+ and in numerous sectors both as an advisor and a principal.

Matt Oliver

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- Matt provides lead advisory support to corporate clients & management teams on the complete range of corporate finance activities.
- He has developed particular expertise advising management on both buy out and buy in transactions. In previous roles he has advised on larger international transactions & helped secure growth equity finance, both as advisor and as part of a management team.
- In addition, Matt held a number of senior financial positions globally.
- Matt qualified as a chartered accountant with Arthur Andersen.