



Anatomy of a Management Buyout

When appropriate, managers can become owners through an MBO.

by Michael T. Newsome

An alternative that frequently surfaces in discussions about the sale of a privately held business is a management buyout, or “MBO”. Simply put, an MBO is a buyout of a company, subsidiary, division, or even a business line, that is orchestrated by the management team to gain ownership and reap the rewards of the business’s future success. MBO transactions aren’t appropriate for every company sale situation and often don’t occur, even when they are.

MBO DEFINED

When the owners of a business contemplate its sale, their rational interest is to obtain its full value. Accordingly, for an MBO to be feasible, there must be a meeting of the minds between management and ownership on the following points:

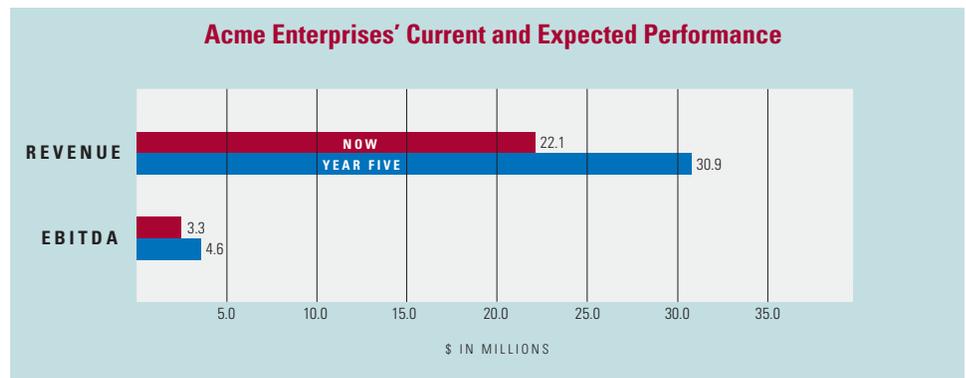
- There is limited potential for a strategic combination with another firm, where costs may be eliminated, revenues enhanced, or assets more efficiently used, because that type of opportunity implies value in excess of the business on a stand-alone basis.
- Management is capable of acting like owners and is reasonably among the best parties to lead the company into the next phase of its life.

In short, ownership has to want the management to buy the business.

MBO talk often outweighs action for two reasons—complexity and expectations. MBO transactions are difficult with multiple moving and inter-dependent variables. Success requires a reconciliation of value and price, and coordination of multiple capital components. For most private-company managers, this is unfamiliar ground that must be trod at the same time the day-to-day demands of the business are being juggled.

The second stumbling block is expectations, particularly with regard to value. For owners, unrealistic expectations are manifested in a belief that stand-alone value is much higher than what a dispassionate investor might pay. Management might agree to an owner’s vision of value, but then be unable to attract the capital to close the deal.

On the flip side, managers often labor un-



der the misimpression that an MBO will put them in control of the business, which is rarely the case, at least initially. An MBO might better be designated an MLBO, as in management-led buyout. Invariably, the total value of the business would, if valued fairly, exceed the amount that can be borrowed from a lender. Unless management has a sizeable amount of capital that can be invested in the buyout, the support of an outside investor is usually required, which almost always implies a controlling interest in the business. What management should expect is an opportunity, in fact a requirement, to make a personally significant investment in the business on the same terms as the financial partners. A mandatory cash investment by management is designed to insure that the economic interests of both investors and managers are aligned. In addition to the cash investment, management can expect to receive an incentive equity position that can be earned if superlative performance is achieved. It is not unusual for 10%-20% of equity to be allocated for incentive purposes, which will accrue value, once cash investors have recovered their investment.

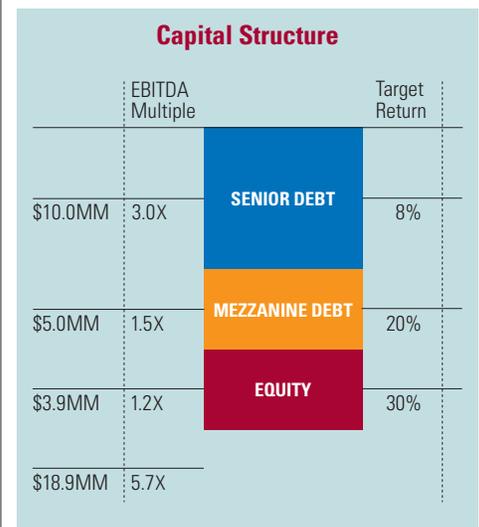
HOW DOES AN MBO WORK?

As an example of how an MBO might come together, consider Acme Enterprises, a hypothetical company having \$22 million of revenue and earning EBITDA of \$3.3 million. A reasonable, perhaps even a bit conservative, enterprise value (outstanding debt + value of equity) would be \$18.2 million, which represents a 5.5X multiple of EBITDA.

After accounting for transaction expenses, a total of \$18.9 million would be required to fund the Acme Enterprises buyout.

In today’s aggressive credit markets, it should be possible to borrow senior debt equal to 3.0X EBITDA and another 1.5X of mezzanine debt. Equity of \$3.9 million is required to fill out the capital structure. In this example, the financial investor (private equity firm) kicks in \$3.3 million and management pulls together \$600,000 of equity. These elements fit together in a capital structure along the lines illustrated in the chart below.

In order to fully compensate the mezzanine lender, it would be granted a 16% equity position (typically nominal-cost warrants),



leaving 84% of the equity value for the owners. Assuming that 10% of the equity is carved out for management as an incentive after the cash investors' capital is returned, the financial investors and management would split the incremental value created on an 84.6% and 15.4% basis, respectively.

If management's vision of Acme Enterprises' future performance (7% compound annual growth and 15% EBITDA margin) comes to fruition, at the end of five years, Acme would be generating EBITDA of \$4.6 million on revenue of \$30.9 million. Assuming that there is a liquidity event at that point, and the business is valued on the same multiple (5.5X) as it was purchased, the company would be worth \$25.5 million. As shown in the table in the next column, total enterprise value grew by \$6.6 million over five years. More importantly, the equity share of the value pie expanded from \$3.6 million to \$17.6 million as the company's cash flow was allocated to paying down the senior debt. Results are pretty attractive—the mezzanine lender earns a 20% return based on the 12% coupon and the implied value of the warrants; the cash investors triple their investment to earn a 29% annual return, and management earns an additional \$1.1 million from the incentive shares for an all-in return of almost 40%. This

ACME ENTERPRISES MBO	ORIGINAL INVESTMENT			EQUITY RETURNS	
	\$ in Millions	\$	EBITDA Multiple	Fully Diluted Share	5.5 X IRR
Enterprise Value	18.9		5.7		25.5
Senior Debt	(10.0)		3.0		(2.9)
Mezzanine Debt	(5.0)		1.5		(5.0)
Total Equity Value		\$ 3.9	1.2	100.0%	\$ 17.6
Mezzanine Warrants	-			16.0%	2.8
PE Investors	3.3			65.8%	11.6
Management:					
Cash Investment	0.6			12.0%	2.1
Incentive	-			6.2%	1.1
Total Management		\$ 0.6		18.2%	\$ 3.2

was a successful deal because the key elements—purchase price, performance expectations, and capital structure—were aligned, all having been considered in the design of the transaction from the outset. Interestingly, this outcome creates an opportunity for managers to now own a controlling interest in the company by rolling their gains and re-leveraging the company to take out the investors.

Apart from basic economic feasibility, there are a number of design complexities associated with structuring an MBO, including the appropriate level of financial leverage

relative to ongoing capital investment needs, and/or sustainability and cyclicity of the cash flow. Finally, managers should bear in mind that an MBO entails the formation of a long-term business relationship with a financial partner, where all of the attendant issues of personality and compatibility, control and governance, investment horizon, and exit strategy will come into play. The prospects for a successful buyout are much stronger when there is a good philosophical fit between management and equity investors. ♦



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