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Legal and Regulatory Advisors

Management Buyouts: An opportunity for owners and management

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Background

In the wake of COVID-19, business owners looking to exit ownership, could in the right situation, benefit from a management buyout (**MBO**).

MBOs refer to the acquisition of a business by its management, often in coordination with a financial backer. They can be an appealing option for both the vendor and management as they present an effective way to transition ownership to executives already knowing, and working in, the business.

In recent years, MBOs have grown in popularity in New Zealand. This is partly attributable to the increasing accessibility of private equity. We expect to see the prevalence of MBOs continue to increase as businesses (and owners) mature, and as the impacts of COVID-19 become clearer.

This note will provide a high-level summary of the key aspects of MBOs.

Features of a good MBO opportunity

MBOs will not be an appropriate method of sale in all situations. A successful MBO requires a combination of several key factors including a willing vendor, viable stand-alone business, competent management team, and financial backing.

Vendor company willing to sell

An MBO opportunity requires a vendor willing (or needing) to sell its business. In addition, the vendor must be willing to sell at a price the management team can afford. MBOs may be an attractive sale method for vendors for a number of reasons including:

- the management team of a company will know the business well and may require fewer legal warranties and other protections than a trade buyer;
- the vendor may want a quick sale – as management knows the business already, it can act quickly in the process with limited due diligence;
- the vendor may not want to sell to a competitor; or
- the vendor may want to reward management for their role in building the business.

Provided the vendor is confident in the ability of management to take on and run the company post completion, there are strong reasons for the vendor to sell to management. These considerations are particularly important where the vendor is still owed money by the company or will stand behind obligations of the company (such as lease liability) post-exit.

Cash generative business

For a viable MBO, the business must be able to operate independently as a commercially viable entity. Here, it is necessary that the business generates sufficient revenue to repay loans as they fall due, and is able to support external investment in the business.

While businesses requiring significant investment can be financed by a third party and sold through an MBO, in such situations a higher shareholding will be taken by investors rather than management. This is a key reason why most MBOs happen in mature, stable, and cash generative businesses.

The business must also be in a readily saleable condition, from both a structural and documentary perspective.

Competent management team

A successful MBO requires a competent management team. Most financial backers will require that the business has a stable pre-existing management team in place. In addition to third party financiers being satisfied with the competence of management, where the acquisition involves vendor finance or deferred consideration, the vendor will also need to be confident in management's ability to successfully run the company post completion as this will impact the likelihood that they receive full consideration.

Acquisition finance options

It is the norm in MBOs that management will need financial assistance to front the acquisition. Examples such as the recent Stuff.co.nz acquisition for $1 are usually the exception. These rare cases reflect a situation where the future successes and liabilities of the business are considered to be evenly balanced. In such situations, external finance is not needed to fund the acquisition, and management can act alone. However these situations give rise to a number of additional considerations.

An exiting business owner who is required to underwrite liabilities of the company may prefer an MBO to a trade sale, on the basis that they will back their management team to ensure the business remains profitable and that they will not be called upon to satisfy business debts of the company.

External finance

As noted, management will commonly have external backers funding an acquisition. This can consist of any combination of debt funding, private equity and vendor finance. Vendor finance is usually in the form of a deferral of some, or all, of the purchase price or the vendor retaining a shareholding interest in the business to reduce the price for management.

Most commonly, additional finance will be raised in the form of equity or debt financing, or a combination of the two.

Bank loans and private equity

Banks provide loans and overdraft finance, whereas private equity investors ordinarily provide capital for the acquisition. As a result, private equity investors generally seek a larger return from their investment to compensate their additional assumption of risk.

In recent years, the private equity sector has become increasingly interested in MBOs. From management's perspective (and the vendor where they are retaining an interest in the business), the key is to ensuring that the private equity fund not only has the financial resources to finance the MBO and future growth of the company, but that it also brings advantages such as introducing further contacts, skills, and sector experience to grow the business.

Regardless of the source of external funding, management are usually required to take a personal stake in funding an MBO. This provides external funders with assurance that management are incentivised to maintain and grow the business.

Key issues

There are several moral considerations which should be addressed in considering whether an MBO is an appropriate method of sale. From the outset, ensuring that management and the current business owners have aligned objectives is important in ensuring a smooth transition.

In rare cases it may be that management is enticed to manipulate the financial performance of the business leading up to an MBO so that they can pay less for the business. Further, depending on the structure of the business, information held by management (but not by the owners) may offer an advantage relative to the current owners. These risks should be carefully managed through the warranties in the sale and purchase agreement.

A further consideration is how much information to share with staff, and when to share it. Effective communication between the vendor and management with staff about the potential transition of ownership is important. A failure to communicate effectively with staff about what is going on can result in rumours spreading, with a potential impact on employee engagement, productivity and retention.

Final thoughts

MBOs can be complex processes. This is a result of the competing interests between ownership and management. Exiting owners want to be fairly compensated for their hard work over the years in building the company. Management want to ensure they purchase the business at a fair price to generate future value. External funders, where engaged, will also expect to share in the company's future success. However, despite needing to effectively balance these competing interests, in the right situation, MBOs can offer unique benefits for both vendor companies and management.

Webb Henderson's New Zealand office specialises in strategic legal advice for corporate and commercial transactions, projects, and banking and finance transactions, with a particular emphasis in restructuring and insolvency transactions.

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