

# UK MBO

LawNet, a national association of independent law firms, was founded in 1989. It rapidly grew to become the largest legal network in the UK and Ireland, with solicitors quickly realising the benefits of pooling resources, collectively purchasing and sharing knowledge and expertise, in a non-competitive environment.

Corporate International spoke to four LawNet member firms, as well as two other expert advisers in the UK SME market, to get a clear picture of current UK management buyout activity.

## The financial crisis

The financial crisis has had a significant impact on the MBO sector in the UK, with MBO activity falling by 72% in 2009 compared to 2008, while M&A activity also showed a decline despite high profile government bail-outs.

Richard Somerville, director at Rice Associates, explained that the main factor contributing to this reduction of activity is the lack of available funding. He commented:

"Prior to the credit crunch, funding for M&A activity was much more readily available for the many investors and companies willing to purchase a business, whether by outright share purchase or by way of an asset purchase. With the emergence of the credit crisis lenders became much more critical in their appraisal of deals, looking for more security and higher returns from the deals they were willing to fund."

As well as the reduction in the amount of MBO activity, the financial crisis also affected the size of deals and the amount that failed to complete. Steven Treharne, partner at Mogers Solicitors, explained:

"Transaction sizes have generally been smaller with more private equity funding as private investors and VC's try and fill the gap left by the banks.

"Of those that have got funding approved in principle, a higher number than usual have failed to complete. Due to the wider eco-

nomie position, all stakeholders are far more risk adverse when reviewing a proposition and margins are tighter. Therefore even small issues that arise during the due diligence process have the potential to derail the transaction."

As a result of the lack of funding and the higher scrutiny given to deals, many management teams are looking to raise the required finance themselves, as Andrew Heeler, partner at Hegarty LLP noted:

"MBO activity has continued, but it's been at a smaller level and it tends to be the management team themselves raising the finances they need, not necessarily by leveraging against the assets of the business. There may be some element of security there, but not necessarily to the extent previously seen."

There has also been a change in the types of transactions. Richard James, who leads the corporate practice at Dyne Drewett LLP, explained that they have generally been more strategic in nature, with businesses looking to consolidate and focus more heavily on their core activities. He commented:

"A disposal of a non-core subsidiary or business division to the incumbent management team will almost always be more attractive than a sale to a competitor. And indeed, from the management's perspective, has there ever been a cheaper time to consider a buy-out? Until confidence in the marketplace comes back strongly, which may not be for a few years yet, I can see this trend continuing."

Recently there has been a lot of interest from management teams of poorly performing companies to consider the MBO route, as they believe that it will be possible to turn around these businesses with some additional investment and full management control. Mr Somerville explained:

"Often these deals need to be completed quickly to ensure that the investment can be made before the cash flow position of the target deteriorates and the company goes beyond saving which can be difficult when there are several stakeholders in the transaction to get comfortable."

## The Comprehensive Spending Review

In October 2010 the UK's coalition government announced the results of its Comprehensive Spending Review (CSR), and how the government will carry

out the reduction of the deficit.

Phillip Hoskins, partner at Andrew & Co LLP, believes that there is a real prospect that the CSR will have an adverse impact on the UK economy, at least in the short term. This impact may be particularly felt in the retail sector and the housing market, which will inevitably cause a ripple effect through other sectors of the economy.

If this is the case, Mr Hoskins believes there will be "a lowering of confidence, less funding and managers will be less willing to 'take the plunge' by becoming part of an MBO team." He explained:

"Becoming part of an MBO team involves both investing money and entering a highly geared environment. This is not a step for the faint hearted, particularly if economic conditions are less than favourable."

However, Mr Hoskins also believes that there may be opportunities for MBO teams. Vendors may sell parts of their businesses to keep other parts afloat, and functions previously carried out by government/quasi-government organisations may be devolved into the private sector.

"That will give private sector organisations an opportunity to build values within their businesses and in due course owner managers may seek to realise that value," Mr Hoskins added.

Measures such as greater access to finance, loan guarantees and the creation of more adult apprenticeships have been welcomed by small businesses. However, Mr James noted that organisations that represent SMEs, such as the Federation of Small Business and Enterprise UK, are calling for more. He explained:

"As the lifeblood of the British economy, some say that a more radical package designed to stimulate entrepreneurship and business growth is what is needed and we'd be inclined to agree. For SMEs that have managed to survive during the last couple of years, and which are now perhaps leaner and fitter as a result, there will be new opportunities but these will be stifled if the financial support is simply not there."

Rodger Price, partner at Symes Bains Broomer Solicitors, believes that many firms will hunker down, seeking to ride out the impact of the cuts, get leaner and position themselves for the upturn. Costs and revenue streams will continue to be the focus of attention.

"Others will act now," he added, "perhaps confident that the double dip will be avoided as predicted, and these firms will undertake restructuring now in order to steal a march on competitors."

Mr Price advised clients to look beyond their own market. With £83 billion to be saved and a sharp contraction of public services, there will be an impact of every aspect of business. He commented:

"Clients also need to keep a weather eye on what's happening in the USA, the Eurozone, and the emerging markets. They need to be quick

on their feet, anticipating and reacting to the prevailing conditions."

## The benefits of an MBO

There are many advantages to an MBO, particularly in the current economic climate. One such advantage is the management team's knowledge of the business.

Mr Heeler explained that the management team will "know the pitfalls, outside perhaps some of the accounting and financial issues. They will generally know the nature and resilience of the business, so they can be much more certain when they're entering into the transaction what they're letting themselves in for."

This knowledge is particularly advantageous in terms of financing a transaction, as Mr Somerville noted:

"This offers security to customers and suppliers and by extension the seller and the provider of finance. As a result it is much more likely that the deferred consideration and finance will be paid."

According to Mr Treharne, understanding the business "warts and all" is more important than ever as it limits the risk of an issue arising out of due diligence that catches the management, or more importantly its funders, by surprise, which might derail the transaction. He explained:

"The management team are often best placed to explain any issues that do arise to external funders to help get them comfortable and may also be prepared to offer the funder some form of comfort in the funding documentation."

There is also an advantage for those who are exiting the business, Mr Heeler added.

"They have the comfort level that they know who they're dealing with and who they're selling to. That can make getting the deal done easier, in some circumstances anyway."

For management teams and funders, the current economic climate has reset the expectations of many sellers when it comes to price. This is especially true where the sale is by a seller who is not prepared or able to wait it out to achieve better deal value. Mr Treharne explained:

"Due to the effect on the company's balance sheet of property prices being at a low, a lack of trade buyers, and below average results for the last few years for example having an impact on earnings multiples, there are some bargains to be had if funding can be obtained."

"Sellers have also had their expectations lowered as to when they can expect to receive the purchase price with more of the purchase price inevitably being deferred or linked to the future success of the business going forward in order to ease the cash flow pressure and ensure that the business can meet its debt servicing obligations."

Selling to management also avoids the potentially damaging disclosure of sensitive business

information to trade competitors, which is more important than ever in tough times. Mr Treharne continued:

"This is especially true if the business is being sold due to poor performance as trade buyers may use this information to their advantage. Selling to management will also help to reassure a seller who is concerned about a transaction with a trade buyer collapsing due to the current funding issues at an advanced stage after that buyer has had access to sensitive information relating to the business."

The rise of secondary buyouts

Over the past twenty years, prior to the credit crunch, the UK has seen a significant rise in the MBO market place in terms of buyout value to GDP. As more and more transactions were taking place there was an increased impetus for the secondary buyout market to develop along with an increase in the range of financial products available to fund buyouts. Mr Somerville commented:

"We have seen a move away from senior debt and mezzanine finance in larger deals to subordinated debt as the number of debt providers has reduced. In many cases this has meant that there were fewer parties concerned which assisted with the exit strategies of many private equity firms, particularly when the exit strategy may have been aligned to an IPO which then became difficult to achieve due to the volatility of the markets."

"As a result many private equity firms instead found alternative methods of exiting the deal including the secondary buyout market. This trend has seen a sharp rise and with the impact of the credit crunch is likely to continue for the foreseeable future."

This rise in secondary buyout activity has been particularly noteworthy in 2010, with strategy group Dealogic stating that it accounts for around 35% of all private equity deals this year - the highest level in at least a decade.

Mr Treharne explained that trade buyers are not readily available and IPOs might not be possible for niche or undersized businesses, especially with the current volatility in the markets. He commented:

"There is still pressure on investors to maintain their internal rate of return. In the current climate, secondary buyouts may also generate liquidity more quickly than other routes (i.e. IPOs).

"Many secondary buyouts have also been acquisitions of distressed assets, suggesting that as private equity firms reorganise their portfolios, private equity firms are selling these assets on rather than allowing these firms to go into administration."

Mr Treharne believes that this trend will continue in the short term as the economy picks up and more businesses are forced to address their



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funding needs in an upward market, rather than simply cutting costs in a downward market.

#### The dangers of overleveraging

Over the last decade there has been a marked increase in leveraged transactions, as the booming economy saw asset prices rising above inflation leading to higher and higher leveraging ratios, sometimes in excess of 30-1.

"However," Mr Rice noted, "as the recession has progressed and asset prices remain stubbornly low, there are serious consequences for any transaction particularly where there is a high ratio and asset values do not support restructuring of high debt levels."

Mr Heeler explained that this increase in leveraging has been the pitfall of a number of MBOs.

"We've seen it in relation to transactions that we've been involved in, certainly transactions that were set up ahead of the financial crisis. When they were overleveraged, particularly with the parties having a very strong grip on the finances, it's a very short road to their downfall."

The obvious examples, according to Mr Treharne, are those deals that were completed in the boom period running up to 2007, which looked sensible at the time and are now struggling. He commented:

"Current deals tend to involve less debt as well as deferred consideration and earn out provisions which eases pressure on the company in the initial trading period following completion which is often vital so as to maintain cash flow and enable the company to meet its debt servicing obligations."

#### The role of advisers

The role of the adviser is crucial in any MBO. Generally, the adviser will assist in the preparation of the sale document including business plans and financial models for the vendor, which will be reviewed by the MBO's advisers as part of their due diligence procedures. Mr Somerville explained:

"The advisers for both sides will aim to optimise the structure of the business from both a commercial and tax perspective although inevitably there may be compromises in the commercial negotiations as what is best for the vendor may not suit the MBO team and vice versa."

Mr Somerville noted that the advisers will consider as part of their due diligence work whether the transaction may require a specific vehicle such as a NEWCO to acquire the trade. Alternatively the vendor may have already formed a new company which then acquires the trade of an existing business and the MBO team acquires shares in the entirety. He added:

"In all of these stages the adviser is critical in both assessing the risks and optimising the structure of the MBO. If the longer term plan and the exit strategy for the investor was linked an IPO then the role of the reporting accountant along with other advisers would be to produce a long format accountant's report for the purposes of listing along with tax advice and informing the team of their reporting requirements in accordance with the rules of the stock market or the AIM rules. This could extend to either preparing a prospectus or introducing the nominated adviser who will become responsible for the placement.

"Also of critical importance in any of the above deals, would be a full assessment of the future cash flows of the business as finding alternative sources of finance once the MBO has taken place may constitute a breach of a financial covenant."

According to Mr Heeler, management teams will be used to doing their day-to-day job, but not necessarily used to running a business. He explained:

"They often need to make that leap from being senior executives within their business to being business owners whom the fundamental future of the business is dependent on. Sometimes making that leap is something that people will struggle with; the advisers need to be there on hand to help them make that adjustment."

The advisers on any MBO require a number of key skills in order to ensure that the transaction goes ahead smoothly and efficiently.

Mr Treharne believes that the fundamental requirement for advisers is experience in advising through the process and acting for management, funders and vendors. This experience gives the adviser a better understanding of the key issues each party will have, the ability to advise all parties in advance of potential pit falls, and the ability to solve potential problems before they arise. He added:

"For a management team that has not been through the process before it is also vital in preparing them for anything from three to six months of being pulled in numerous directions, juggling their conflicting interests all whilst trying to run the business and maintain its value.

Mr James agrees:

"The management team's continuing role as senior executives in the business should not be overlooked; although they will obviously want to devote a lot of their time to progress the buy-out, this must not be to the detriment of the business itself, or their responsibilities as executives; if they do, both sides suffer and might put the deal in jeopardy. An experienced set of advisors will often add real value to the process, helping all parties overcome these issues."

Mr Treharne continued:

"Another key skill would be communication in order to effectively project manage the process and keep all parties involved up to date on progress."

#### The future of the MBO

The most important factor affecting MBO activity for the foreseeable future is the availability of finance, and if the market will return to more traditional funding from banks and financial institutions. Mr James explained:

"Private equity has always played a major role in MBO transactions but, for some, the need to relinquish an element of control to an investor, once an MBO is complete, goes too far; particularly for those who see a management buyout as the right first step into the world of being their own boss!"

Mr Price agrees that the lack of bank lending will continue to be the most significant issue, as commercial activity is inextricably linked to the availability of finance. He commented:

"My clients continue to say that is a problem – despite what the bankers themselves are saying. I am aware that the banks' own borrowings are coming up for renewal in 2011, how that is negotiated will be crucial to the freeing up of lending to businesses across the board."

However, despite the problems in financing, MBO activity will still continue, as Mr Heller explained:

"MBOs have always been a part of corporate life and will continue to be a part of it. The local banks are not interested at all in that activity in the moment, so until the banks are willing to join in and support MBO teams, it's down to how much management teams can raise personally."

With more and larger organisations optimising shareholder values, Mr Somerville noted that the role of the UK MBO market place is a great stimulus for enhancing values and providing business geared with the right staff and resources to continue innovating. He added:

"For this reason along with the recent downturn as the result of the credit crisis there is likely to be more emphasis on the MBO market place than outright M&A. Provided the private equity and venture capitalists can continue to gain or secure access to funding the MBO marketplace is likely to continue unabated and innovate."

Mr Hoskins added that restructuring is likely to continue to present MBO opportunities, noting that "whatever the economic circumstances, restructuring of businesses will continue to occur for a variety of reasons."

Mr Treharne concluded:

"It's not going anywhere! Deal values will continue to be lower in the short term but will pick up as confidence returns to the market, trade buyers return and funding becomes more readily available."