The Advisor – Spring 2010

Management or Shareholder Buyouts

In our last newsletter, we discussed mezzanine and sub-debt financing. One use of this type of financing is for a buyout of existing shareholders by other shareholders or by the company's management team. This could be due to a dispute between shareholders or a shareholder deciding to sell and giving management an opportunity to purchase the company before other third parties.

A sub-debt lender or private equity firm can assist purchasers in financing an acquisition in these circumstances. These firms are also known as "sponsors" since they facilitate or sponsor the transaction.

Sponsors will look for the following criteria before considering a loan or investment in a buyout of existing shareholders:

1. A stable and experienced management team. This is probably the most important pre-requisite. Without this, it is unlikely that the deal will get financed.
2. "Skin in the game" from managers who are retained. Sponsors will expect managers to invest some of their own money in the transaction. One rule of thumb is a minimum of one year's salary for each manager but that amount may be greater depending on the net worth of the individual.
3. The ability to add debt to the company's balance sheet in order to finance the transaction. Debt is cheaper than equity and the interest paid on debt is tax deductible. Sponsors generate greater returns on investments that have a higher mix of debt versus equity so they'll want to maximize the debt portion without risking the failure of the business due to high debt repayment obligations.
4. A history of profitability and stable cash flows. The business model should be sound. And consistent cash flows will be required in order to repay the debt used to finance the transaction.
5. The ability to cut costs and reduce headcount. This is where a significant portion of buyout gains occur. Once the managers are owners and their interests are aligned with the sponsor's, it is expected that they will be more aggressive in cutting costs than they were prior to the acquisition.
6. The ability to break up the target and sell non core assets. The proceeds from the sale of redundant assets can be used to reduce the amount of financing required for the purchase of the business.

Assuming these criteria are met, the next requirement would be for the buyers to prepare a business plan outlining how they intend to operate the business after the acquisition. The plan (which has been discussed in previous newsletters) should include details on the strategy to be employed, a discussion on where costs can be streamlined or eliminated and financial forecasts for the next three years.

Purchasers in a buyout situation should be prepared to engage in two sets of negotiations:

1. Negotiation of the investment terms and conditions with the sponsor; and
2. Negotiation of the purchase price and payment terms with the vendor.

Items to negotiate with the sponsor include: the amount of the investment, the type of investment (debt, equity, warrants), the sponsor's fees, representations and warranties and conditions precedent prior to the investment being made.

Negotiation of the purchase price with the vendor can be a challenge in a buyout situation. When one shareholder is buying out another, the shareholders' agreement may dictate the formula for determining the price and no negotiation is required. But in a management buyout, this is rarely the case. Management will attempt to negotiate the lowest price possible for a company they know intimately and from owners they still work for. In these circumstances, it is imperative that management retain an advisor to assist them in the negotiating process to negate the inherent conflicts and ensure an appropriate price is paid.

Aries Advisory Group can act as your advisor throughout the entire buyout process. We can assist you in generating the business plan, in sourcing and negotiating with sponsors to finance the transaction and in negotiating the purchase price with the vendor. Please contact us at info@ariesag.com or at (416) 467-7878 to see how we can help.