Management Buy Out White paper briefing

<u>Vfdnet Management Buy Out services</u>

Vfdnet regularly joins Management Teams on a part time basis to help MBOs happen. We follow this tried and tested process:

1) **Management Buy Out White paper briefing**
2) Preparation of business
3) Fundraising
4) Negotiation (Vendor & Funders)
5) Deal Completion

This white paper addresses the following key questions:

- **How to prepare** for a Buy Out?
- Have you got any **gaps in your Management Team**?
- How should you **Value your target business**?
- What types of **Funding sources** are available?

<u>How to prepare for the Buy Out?</u>

You need to prepare thoroughly for the fundraising because you need to convince lenders that their money will be repaid and persuade investors that they will achieve an appropriate equity return for their risk capital. Your Business plan needs to cover the **Narrative plan** and **Financial model**. The narrative business plan must cover:

Market: What is your current market - is it growing, stagnant or contracting; what market share do you have and are you planning to increase this? What are your plans for new market segments / new products / new sales strategies?

End Game: Determine your time horizon for when you wish to achieve your goal of either a complete exit or perhaps reducing your management to a non-executive basis. Are your fellow shareholders fully on board with the business goals?

Strengths: What are your businesses key core competences? Do you have a continuing and sustainable competitive advantage? How can you build on these strengths?

Weaknesses: What are your business constraints and how could you overcome them? Your management team could be a great strength but are you sure you have the right incentives in place to hold onto them through a critical period? Do you have any management gaps such as Finance?

Opportunities: What other markets opportunities are there? What is stopping you from evaluating these and taking your business forward?

Threats: What is your competition doing? How will they respond to your success? Are there any potential new entrants to your market which could disrupt your plan?

Financial modelling

The Financial Business Plan (figures) – you need to prepare the financial model based on your assumptions about the people required, space and marketing resource needed for your business. The financial model must be completely reconciled between the Profit & Loss Accounts, Cash Flow and Balance Sheet, and also include 'what if' analysis, which in turn helps define the total cash required.

Please remember that Lenders and Investors will be assessing your credibility based on the professionalism demonstrated in your Financial Business Plan, so it is essential that it includes:

- ✓ Full assumptions are stated and are completely in line with your narrative plan.
- ✓ Fully reconciled monthly Profit & Loss account, Cash Flow and Balance Sheet.
- ✓ Properly determined cash requirement, with funding structured in a realistic way, using realistic market interest rates.
- ✓ Sensitivity analysis (or 'what if' scenario) will reduce the perceived risk in the eyes of a bank
- ✓ Detailed calculation of expected bank covenants

Have you got the right Team?

Management Team - Bank Lenders and Investors will decide whether to back the business based on the quality, competence and experience of the key Management Team. They will be seeking re-assurance that the right leadership is in place, so looking to identify any perceived management 'gaps'. In addition, they will rate a sound Finance person as this individual is often a bridge builder between the operational management and the investors and lenders.

External team members – You also need to build the right teams of external advisors and even external backers. This means selecting credible Corporate Lawyers, as well as appropriate bank Lenders and sometimes the right Private Equity provider. It is very advisable to use an external project manager to manage the process, as otherwise it is very easy for operational managers to take their eye off the ball, so scuppering the MBO. Our Private Equity experience Virtual Finance Directors love joining a team (on a part time basis) to help make the MBO happen.

How to value your target business?

How are Businesses Valued? Our Virtual Finance Directors are regularly asked to help Value Businesses. Typical business valuation techniques include:

Profit Multiples

Often used method when a business is making good profits. However, be careful to watch which level of Profit is used eg. 5 times EBITDA is often higher than 7 times Post Tax Profit! In addition, watch whether the multiple is on historic profit (as favoured by Acquisitive companies) or on future profit (as a business would prefer to be sold on).

One of the most common business valuation techniques is the Profit Multiple or Multiple of Profit. Simply put it is the Profit of a business multiplied by the 'Multiple'. However, watch out for:

a) Which Profit level?

Profit multiples can be calculated at many different levels such as:

Pre Tax Profit
Earnings before Interest Tax Depreciation Amortisation (EBITDA)
Post Tax profit
Gross Profit

When a multiple is quoted check which Profit level it is being applied to as this will normally have a big effect.

b) Sustainable Profit

Many buyers are seeking to determine the 'Sustainable Profit' which is the element of current Profit which is likely to recur in the future. In arriving at this figure, it is normal to adjust the stated Profit, removing any unusual items of income or expenditure to identify the sustainable or maintainable Profit.

c) Historic or Future?

Multiples can be applied to either the historic sustainable profit or the forecast future sustainable profit. Buyers of businesses will almost always seek to purchase based on a historic profit multiple, however the FD of the Buyer will also have to justify the valuation being paid by reference to the forecasted future performance, as the FD will be putting the investment case to the Board or Shareholders or Funders. Business Sellers will seek to apply the multiple to future profits. The sellers case will be strengthened if the business owner can point to a good track record in forecasting future profit and regularly achieving these forecasts.

Which Multiple to use?

Buyers typically seek to apply lower multiples whereas Sellers favour higher multiples. Our Virtual Finance Directors often are asked to review the multiples of deals done to provide objective advice.

Net Asset Value

Net Asset Value is typically used when a business is either breaking even or perhaps marginally loss making. Use of this method without any Profit multiple implies that the business cannot be valued for its ability to generate profit (the business making a Profit is too uncertain). The Net Asset Value is essentially the realistic Balance Sheet value at a point in time; care needs to be taken over the valuation of each main asset type to ensure the correct Net Asset Value is derived. This method is also sometimes used in conjunction with the Profit Multiple discussed above, particularly where the business has a Balance Sheet which is stronger than you might expect for the type and size of business.

Pay Back Method

This method is simplistic; however, it can provide a useful way for a Finance Director to explain the business valuation to non-financial Board member colleagues. The Pay Back method is calculated by forecasting the future Profits of the target business and determining how many months or years of such profits are required to pay back the original investment. Please note that the original investment value should also include the costs of acquiring the business. The actual payback period so calculated is subjective as it does depend on the forward forecast for the target business, in turn driven by the expected Cost and Sales synergies from the new group.

Discounted Cash Flow

This method may be applied by specialist buyers. Essentially the potential acquirer will forecast the future cash generation of the business and then apply a discount factor to future years' cash generated to give a Net Present Value for that future cash flow. This is on the premise that £1m in a years' time is worth less than £1m today.

Other Methods

In specific situations, other methods may well be used. For example, if a target business is close to insolvency a liquidation basis may be applied. This typically involves reviewing each asset category and assessing how much the asset could realise in a 'fire sale' situation.

Where can you find the right Funding?

Funding sources available include:

Debtors Confidential - Bank funding against your customer Debtor security - Confidential Invoice Discounting has the advantage that your Customers are not made aware.

Debtors Factoring - Bank funding against your customer Debtor security but this form is disclosed to Customers so less attractive. Banks see this form as more secure.

Assets - New assets could be funded by either Finance Lease (HP) or Operating Lease (contract hire). Could be used for Assets already purchased for cash.

Bank Overdraft - Flexible but typically unsecured so could be withdrawn with no notice. Banks typically seek security for overdrafts such as Personal Guarantees. Banks tend to be reluctant to provide overdraft facilities.

Bank Loan - so called Cash Flow loans are becoming available once more for the right business, although the lending criteria is much tighter than pre Credit Crunch

EFG Loan - the Enterprise Finance Guarantee loan replaced the Small Firms Loan Guarantee Scheme, and provides Loans secured 75% by the BERR (was DTI) where business owners lack their own security.

Mezzanine Loans - Unsecured loans are available, usually up to £100k, which charge higher interest rates than high street banks but don't normally require equity. These sources include some of the development agencies as well as new organisations aggregating private individual's loans.

Private Equity - Private Equity funds are looking for good quality growth businesses to invest into. To succeed businesses needs to be carefully prepared to be ready for the rigorous 3 - 6 month process. (See our website article on Raising Private Equity)

Business Angels - Angel investors will negotiate their equity stake so again this is funding suitable for high growth businesses. Angels can often open doors to new business opportunities. Business Angel Pros & Cons link.

Vendor Finance - As a business owner you may chose to leave funds in the business you are selling. It is more attractive to receive cash later than reduce the business Valuation!