10 BIGGEST MISTAKES OF MANAGEMENT BUYOUTS

For many managers, a Management Buyout (MBO) is their first venture as an entrepreneur. It takes courage to leave the relative security and comfort of a management position to face the challenges of ownership and independent accountability. However, on reflection, most managers find that the personal satisfaction of having more control over their own destinies is one of the biggest rewards from a Management Buyout.

Buying a company through a Management Buyout can be a shortcut to financial success. The risk is lower, the financing is easier to obtain, and the waiting period for a return on investment is shorter than starting a business from scratch.

There are risks in buying a company, even a well-managed and successful one, and the process can be stressful. Managers can reduce this stress, and mitigate some of the risks, by understanding the lessons learned by managers and advisors who have been through the process before them.

Some of the biggest mistakes we see during Management Buyouts include:

1. **Not having a leader and confusing "ownership" & "employment"**

   You and your MBO team might all invest the same amount of money, so some of you might think that you should all have the same say in running the business.

   This won't work. It's essential that you understand that you are an employee first, and a shareholder second. No organization can operate without a leader – someone has to have the final say and make the tough decisions. While MBO companies typically have better corporate cultures than non MBOs, they still require the presence a strong capable leader.

   Once you've completed your Management Buyout you will no doubt feel better about expressing your views on the business, but you'll still have a boss! And being a shareholder doesn't change this. Being a shareholder means you directly benefit from the success of your business and the efforts of you and your team – it doesn't mean that you now have an equal say on how the business is run.

2. **Getting greedy – the wrong mix of financing**

   There are various sources of financing that may be available to complete your deal – banks, term lenders, subordinated debt providers, private equity, vendor financing – all of which have different costs and attributes. Banks are your cheapest form of financing, but they have strict rules that you need to live with while private equity is very expensive but also very patient.

   You may be tempted to go for the cheapest financing and the one that allows you to keep the most equity for yourselves. This may not be the best approach. Why? Because the financing that you get to buy your company must also allow you to grow the company and weather the bumps along the road that you will inevitably experience.

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Once you've run some financial "what if" scenarios, you may decide that, for your long-term success and peace of mind, you would be better off having a smaller piece of a much more successful and stable pie. This means financing your MBO with more equity type money and less bank debt.

3. Not understanding your financial partners

Each of the sources of financing noted above has their unique rules of engagement and it's very important that you understand these rules.

Banks are not your equity partners and, if you bring on a private equity investor, you'll soon discover that private equity partners are very different from your banker.

Obviously, you need to treat all your financial partners with openness, honesty and full disclosure. But one of the keys to successfully growing your business, and to enjoying the process, is to understand what each of your financial partners will and won't do.

4. Not spending enough time on the Shareholders Agreement

There is probably not a more critical document for you and your managers in an MBO than the Shareholders Agreement and it can also be one of the most difficult to craft properly.

A well drafted Shareholders Agreement has to address all those difficult "what if" questions such as what happens if someone gets sick, dies, is fired (with or without cause) and what are the issues going forward that require a majority consent from the shareholders.

How a shareholder exits the business and how, and at what value, do they sell their shares back to the company is a key topic that needs to be spelled out in the Shareholders Agreement. Many of these topics can result in fairly emotional discussions, but getting these important issues on the table before you close the deal will allow you to avoid massive headaches and disruption down the road. Don't kid yourselves – these issues will arise, so take care of them now.

5. Not being candid and honest about key issues

The best candidate for a Management Buyout is a business (or business unit) that can assume debt and is stagnating because management is being prevented from unlocking upside revenue opportunities by the current owners.

In order to unlock the revenue potential, the MBO plan often calls for increased investment in product development, new equipment, staff training, marketing, and in the case of "carve outs" of non-strategic assets, a new accounting system. The management must operate as a team that can adapt to the new environment and unlock the upside revenue and accomplish other key objectives. If there are fault lines within management, they will be exposed. The sooner these issues are dealt with candidly and honestly, the greater the are chances of success of the Management Buyout.

6. Deal fever: taking your eyes off the ball

The Management Buyout process is seldom straight forward or smooth. Negotiations often get derailed. Managers often start to focus more on the deal than the business and if the business results start to deteriorate it can scare off financial backers or raise the suspicion of the business

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owner that management is deliberately driving down the results to help build the case to lower the price.

Provided that the management team is well advised, it is usually possible to ensure that management is not exposed, or "left holding the baby," if the deal fails to complete. One of the key benefits of hiring a good advisor is that they can take over a lot of the heavy lifting of pulling a deal together, allowing you to remain focused on your company's operations.

7. Not anticipating potential "deal breaker" issues

Some of the surprises that arise during a Management Buyout that threaten to derail the process include:

• Landlords who are not willing to let the seller off the hook on leases.

• Unexpected deal costs (including legal fees) that make it difficult to close the deal with the arranged financing.

• Financial backers changing the terms of their deal once they have completed their due diligence.

• An inability of your financial partners to agree on the terms of how they will deal with each other (covered in an Inter Lenders' Agreement).

• Managers getting cold feet and opting out of the MBO

An experienced advisor will have seen most of these issues before and will take steps to address them early in the process to minimize their risk to the deal.

8. Not taking the tough decisions

Once you've completed your MBO, your fate, to a large degree, rests in your hands. You may now be faced with difficult decisions that need to be made in order to successfully grow your business.

These decisions are made even more difficult if they involve managers who have participated in the MBO. Sometimes downsizing is required. Sometimes (more often than you would think) someone on your MBO team figures that, now that they are an owner, the rules don't apply to them anymore. Most leaders who are faced with these tough decisions and who delay making it land up regretting not acting sooner. And while it's hard to fire someone who helped you buy the company, you owe it to your other partners to make the right decisions and move on.

9. Not appreciating that you are in it for the long haul

Most MBO companies do better than their non MBO peers. It's not surprising to see companies' performance significantly increase post MBO (studies have tracked this phenomenon). And as owners, you and your team may be keen to start seeing a return on your invested capital.

Since your company has probably taken on a significant amount of debt to finance your Management Buyout, it's important that your "financial" focus be on paying down this debt as quickly as possible.

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You need to go into an MBO with your eyes open – most of your financial partners expect to be paid out before you see any money (and while most bankers will consider allowing dividends at year end, its best to assume that they will say no). A good rule of thumb is that you should consider that your money is locked in for at least 5 years, assuming that you remain with the company. Provisions obviously need to be made to allow you to get your money out should you land up leaving the company.

10. Not having a reputable advisor

Advisors can help make or break a deal. For a manager, a Management Buyout is a life-changing experience and so it is important to pick an advisor that your managers can really trust and who will take the time to "educate" you on the risks of what potentially awaits you and not just talk about the upside. An advisor with a strong reputation often provides the owner with the comfort that the management team is getting honest and realistic advice.

A Management Buyout advisor can help with selecting the right financial backers to get the MBO done while management can focus on running the business. There is no shortage of accountants, legal firms, bankers, and private equity firms that have an appetite for a good deal. However, it is important for the management team to feel very comfortable with their advisors and backers, as it is a bumpy ride and the managers may not be able to grasp all the ramifications as the process unfolds!

Conclusion

Management Buyouts present significant opportunities for business owners, financial sponsors and entrepreneurial management.

For the business owner it is often a chance to retire and unlock their wealth in the business. For corporate parents, these transactions provide an opportunity to divest non-core operations and raise cash.

From the perspective of management, Management Buyouts provide an opportunity to gain direct equity ownership of their business and create an entrepreneurial environment. And a Management Buyout is likely to be the best way that you and your team can build significant personal wealth.

A final thought… take time to enjoy the journey. When you look back it may be the most rewarding time of your business career.

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