Opportunities for management buy-outs (MBOs) in the printing and packaging industries

Paul Holohan, Chief Executive, Richmond Capital Partners

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Management buy-outs (MBOs) have become commonplace in recent years, reflecting the enterprise culture that is growing internationally and the availability of funding from both private equity investors and financial institutions. Embarking on an MBO in the printing and packaging industries demands a closer look at the industry-specific issues, which can make or break the transaction.

Mature industries, like ours, contain certain characteristics that must be appreciated by vendors, management and investors. Our experience in this field enables us to share this knowledge with those interested in the subject – whether buying or selling.

The vendors' perspective

If approached by management, vendors should tread very carefully. The commitment of the management team and their willingness to commit personal finance must be established conclusively at the outset. Otherwise an unnecessary risk is being taken.

Certain owners can be upset by such an approach – and even seek to terminate the team leader. Dealing with the situation sensitively is vital to maintain management commitment to the business.

Of course, vendors can benefit in some ways from an MBO compared to a trade sale, for example:

- The transaction is an internal matter with less risks in terms of damaging leaks;
- Due diligence is simpler and less costly;
- Competitors are mostly unaware of the sale and therefore cannot use this to damage your business;
- Management, if driven by their ambitions, could leave and buy an alternative business. An MBO can prevent this;
- Customers are usually comfortable with the change of ownership, which provides continuity;
- Change of ownership clauses in contracts rarely become operative as a result of an MBO.

However, there are potential pitfalls too. These include:

- If the management has no clear strategy for the business going forward, problems can arise – jeopardising any deferred consideration;
- Trade buyers do not like competing with MBO teams;
- Potential conflicts of interest;
- Diverting focus and attention away from the business.

Either way once a decision to sell has been made – a decision in itself requiring careful consideration – the options of trade sale or MBO will need to be considered carefully.

Motivations of the management team

What drives managers to become owners of the businesses they have run under the control and direction of the owner?

A survey of MBO managers (Wright et al, 1991) reveals a number of reasons, of which the most important was the desire to run their own business.

In order of importance, managerial motivations were as follows:

- Opportunity to control own business;
- Long-term faith in the business;
- Better financial rewards;
- Opportunity to develop own talents;
- Absence of constraints;
- Fear of redundancy;
- Fear of new owner after the sale.

Understanding these motivations is key for the vendor because if they are 'blocked', a disaffected management team can result with consequences to the business. As a general guideline management should be prepared to invest around 10 per cent of the financial institutions 'exposure'.

Legal issues

As soon as a director decides to initiate an MBO, they should approach the board. If the board is prepared to contemplate an MBO, best practice suggests the following steps:

- A board committee (excluding any director involved in the MBO and including at least one non-executive director) should be formed to consider the buy-out;
- The committee should agree with the MBO director what company information the director is free to disclose to their advisers;
- Guidelines should be set as to the future conduct. The amount of time which can be spent on the MBO should be determined and any potential conflicts and issues should be addressed;
- The board may authorise the committee to negotiate the Heads of Agreement with the MBO team and their advisers.

As in any major business transaction, there are legal considerations. It is unlawful for a company to bear the costs of its management in a successful management buy-out. However in practice, if the MBO proceeds, fees are likely to be borne by the MBO vehicle – a new company formed specifically for the transaction.

Listed companies should not pay for abortive attempts but in reality, where goodwill exists between owner and MBO director, arrangements can often be made to cover these circumstances. However, good advisers will undertake the project on a contingent fee basis (i.e. no deal, no fee). This can alleviate this often difficult issue.

Structuring the deal

If an MBO is the chosen route for exit and agreed terms are reached, a period of exclusivity may be granted for the MBO team to raise finance with their advisers' support. This period would normally be for around 4–6 weeks and should result in comfort letters from financial institutions indicating their support for the deal. A further period of exclusivity can then be granted for due diligence.

The essential ingredients for a suitable company are:

- A positive cash flow;
- Adequate asset base;
- The prospects of the business itself;
- The management team.

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Cash flow is a vital issue. Unless it can be demonstrated that sufficient cash can be generated to pay the substantial amount of interest and debt finance, a deal is not possible. As a substantial amount of asset finance (refinancing of assets, invoice discounting, cash flow loan) is often used, it is helpful if the business has sufficient tangible assets to provide an acceptable level of security for the lenders. Service companies (e.g. print management firms) that are low on assets need to generate strong cash flows.

A suitable business must have a long-term future. The business may be making a modest profit, producing a loss or even be in receivership at present. However, this does not necessarily mean that the company is unsuitable. A clear and concise business plan will be needed, however, to show how sufficient profit can be achieved.

Management teamwork really is essential for an MBO to succeed. Members of the team need to be a close-knit group, totally committed to turning their shared vision into reality. Investors look for credibility, track record and willingness to invest.

The detail within each deal structure will vary, of course, driven by the maximum level of funding available. However, typical funding capabilities are:

- Refinancing of assets;
- Debtor finance;
- Commercial mortgages;
- MBO team investment;
- Cash flow loans;
- Equity shareholder (private or venture capitalist).

Appointing advisers

Choosing the best advisers can make a substantial difference to the success of the negotiations. Vendors recognise that they only sell their business once and the likelihood of the best possible deal is significantly enhanced by using experienced advisers with strong industry background. The principal function of any adviser should be to project manage the sale so that the vendor can remain focused on what they do best – managing the business for profit.

When choosing an adviser, the following should be considered:

- A track record of successful MBO transactions in the industry;
- A network of potential purchasers for the business should the MBO fail or an alternative exit method is chosen;
- The opportunity to obtain suitable references by telephoning clients for whom the firm has sold similar businesses in the industry;
- Industry knowledge;
- Reputation of the firm and its management.

Conducting a sale or purchase by any method is enough to test the nerve of the toughest management team. MBOs are extremely time-consuming and generate a lot of stress.

A good adviser can help by:

- Good project management;
- Devising timetables;
- Liaising with lawyers, accountants and other advisers;
- Negotiating on your behalf;
- Selecting and concluding the optimal deal;
- Having a good understanding of current market conditions in the industry.

However, all this is useless without 'chemistry'. You need to trust and respect your advisers. Their advice will often go beyond mere professional opinion. ■