Special report

"When we first entered discussions with ANZ regarding the possibility of a MBO, we were impressed by what ANZ Capital offered and with their philosophy ... as lead advisors and equity partners, ANZ Capital recognised the evolutionary opportunity for the company to move to the next stage of its development"

MIKE DONOVAN, MANAGING DIRECTOR,
MOTION INDUSTRIES LIMITED

Management buy-outs:

what businesses should know

Management buy-outs (MBOs) are becoming increasingly common in Australia and New Zealand as more and more people recognise the benefits such transactions can offer all parties involved.

If you've never thought about it, consider this: the chances are good that at least one of your competitors has either completed a MBO in recent times or is considering one.

What is a MBO?

A management buy-out is, at its simplest, a transaction in which a team of individuals purchase the business they intend to manage.

MBOs can offer a 'win-win' for two key stakeholder groups – owners and managers. Owners can obtain an exit from their investment at a fair price while managers get an opportunity to control their own destiny and share in the rewards they've helped create.

There's more than one kind

In a typical MBO, the business is sold to the existing management team, but there can be other structures. These include:

– Management buy-ins (MBIs) where a new, external management team purchases the business.
– A buy-in management buy-out, a combination of a MBO and MBI, and
– Partial MBOs, in which owners partially sell down their equity, retaining some ownership after the transaction.

In most cases, financial investors or a group like ANZ Capital gets involved in the buy-out. These investors can help to structure the process and finance the purchase, typically a complex deal that requires large amounts of capital.

Why are MBOs popular?

One reason for the recent surge in popularity of management buy-outs is the large amount of private equity capital available in Australasia.

Another is that MBOs can be particularly attractive as an exit strategy for owners of mid-sized businesses who find the trade-sale or IPO markets uninviting.

Larger firms, too, find that non-core business segments can be more valuable to others than themselves, while divestment allows the parent company to focus on core operations.

Finally there's widely available evidence that public capital markets can penalise the valuations of small- to medium-sized businesses. This creates potential buying opportunities for management of smaller listed companies.

Management Buy Out of
iTa Information Technologies Australia

Established provider of enterprise wide integrated voice solutions

Originated by: ***ANZ Capital,***

Private equity and debt provided by: ***ANZ Capital***

ANZ

Management Buy Out of
Netti Atom Pty Ltd

Netti CYCLING ESSENTIALS

Leading manufacturers and distributors of bicycles and relates clothing, part and accessories

Equity provided by: ***ANZ Capital, Investec Bank, LGL Capital Management***

Debt provided by: ***Investec Bank ANZ Corporate Bank***

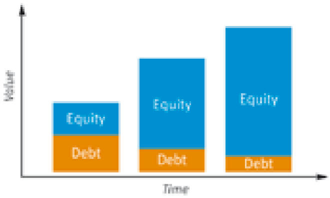
Led and arranged by: ***ANZ Capital***

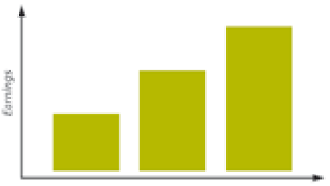
ANZ

MBOs can spark better performance

As part of a MBO team, you have the chance to own what you do and earn what you create. Statistics show that making managers owners drives better business performance.

To understand the potential for growth in the value of your shareholding in a MBO company, look at the following simplified example:





As earnings grow under the MBO team, value accrues in two ways:

- Improved profitability means the value of the core business grows, increasing the value of shares.
- Debt used to fund the initial buy-out is paid down by cash flows, compounding growth in equity value.

How can a MBO team *afford* to own the business they manage?

It takes a lot of money to buy a business, but typically only a small portion of the purchase price is actually provided by management, in return for a substantial portion of equity.

The purchase price is generally funded by a combination of management equity, outside equity, senior debt and mezzanine debt (if required).

There are three key advantages of debt for the MBO team. It:

- Reduces the amount of equity required from individuals' pockets.
- Increases returns on equity
- Provides equity holders with a call option on the value of business growth. This option is exercised as the debt is retired by the business.

But there's a balance to be struck here. Too much debt, on the other hand, may not be good for business. Overly aggressive gearing structures can act as a drag on entrepreneurial talents and energy as well as the business' ability to grow.

That's why in many MBOs the role of a private equity investor like ANZ Capital is fundamental.

In addition to giving the MBO team important structuring and negotiation advice, a private investor can provide the additional equity required to meet the transaction price and maintain a balanced capital structure.

What's the recipe for a successful MBO?

In ANZ's experience, the most important ingredient is a high-quality management team of committed individuals who have a strong leader and a clear strategy to build the business. He or she should be someone with vision, energy and a passionate commitment to succeed.

Are there conflicts?

Yes, often. Management should work to help owners maximise value on a sale, but if the management team is the intended purchaser this role can become blurred. A good financial supporter can play an important role in managing such conflicts.

Managers can protect themselves by involving a private equity group to act as instigator and lead sponsor of the proposed deal. The private equity team can negotiate directly with the vendor on behalf of the management team.

Also, consent must be received from the board or owners as a prerequisite to management involvement in a MBO.

Why would vendors consider a MBO rather than a trade sale or IPO?

There are a number of clear advantages to a MBO.

Selling a business to an existing or incoming stand-alone management team helps ensure confidential information about the business doesn't end up in the hands of competitors.

A MBO can offer vendors a relatively quick and clean exit compared with other methods. For example, financial investors in the MBO may require less onerous warranties. And they can complete their analysis of the business quicker knowing that management, with their extensive knowledge of the business, supports the offer.

As well, there are usually no escrow provisions on vendors' residual equity as is often the case in an IPO.

With management's special knowledge of the business, a MBO can help unlock "hidden" value for vendors.

MBOs are relatively flexible processes. That means a vendor can maintain a reduced stake, if desired, after the transaction. A partial MBO allows vendors to realise a good proportion of their investment while sharing in any future increased performance.

What's involved in setting up a MBO and how long does it take?

The key steps in structuring and securing financing for a MBO are profiled here:

Confirm management interest & strategy for MBO ⇨ Gain Board approval for management to bid ⇨ Review financial case & value business ⇨ Submit indicative offer

Maintain Integrity ⇩

Submit final offer & conclude transaction ⇦ Confirm debt & other equity financing ⇦ Conduct due diligence & confirm ANZ equity interest ⇦ Negotiable offer

Given management's privileged position with respect to information about the business and control over day-to-day operations, many vendors prefer to negotiate directly with a private equity group representing management. The vendor can then maintain control over the release of information and the sale process.

Depending on the complexity of the business being sold and transaction structure, this process can take two to three months.

That's generally enough time for due diligence to be conducted by the private equity investor on the commercial, accounting and legal aspects of the business; for the investor to seek approval from their investment committee; for agreement on price and structure to be reached; drafts of the legal documentation to be drawn up and – on completion – funds to be transferred.

What information would be required by a private equity investor in a MBO?

To start the process, a private equity group will usually review three years of historical financials, near-term sales and earnings forecasts and a detailed business plan.

Being prepared with this information is a good way to fast-track initial enquiries.

ANZ Capital completed the Management Buy Out of

norfruss BUILDERS SUPPLIES

Northern Territory Leading Builders Supplies

Company Originated by: ***ANZ Corporate Banking***

Private Equity provided by: ***ANZ Corporate Banking***

Private Equity provided by: ***ANZ Capital***

ANZ Capital completed the Management Buy Out of

Michel's PATISSERIE

Leading franchised patisserie system

Originated by: ***ANZ Corporate Banking***

Private Equity provided by: ***ANZ Corporate Banking***

Private Equity provided by: ***ANZ Capital***

For more information, talk to an ANZ Capital specialist today.

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