CHAPTER 28
Management Transfers

The term "management transfer" refers to two different situations. A management buyout (MBO) occurs when an existing management team purchases all or part of the company in which they are employed. A management buy-in (MBI) occurs when a management team buys all or part of a business in which it is not currently involved.

Successful management transfers rely on the valuation and capital structure formation areas of the triangular body of knowledge. All parties must first value the company. These valuations may take place in several different value worlds and involve various capital access points, depending on who is valuing what. For instance, the seller may value the company in the world of owner value while the managers value the company in the world of investment value or the financial subworld of market value.

Secured lenders value the company in the world of collateral value. Ultimately a deal is structured with the seller, possibly using other transfer methods, such as employee stock ownership plan (ESOPs). Finally, the deal must be financed, which may require assembling several capital types, such as bank, mezzanine, or equity capital.

Management transfers generally occur under three different circumstances:

1. *Corporate divestitures*. A corporate parent decides a division is no longer core to its strategic direction.
2. *Private owner*. The controlling shareholders of a private company decide to sell the business.
3. *Failed business*. A bankruptcy court or liquidator sells a business.

This chapter focuses on management transfers in corporate divestitures and buyouts from private owners. However, the motives of all players are similar, in that each wishes to maximize returns and minimize risk. In other words, each desires to play and win in the value world where it has maximum control, to finance at the optimal capital access point, and to utilize the most advantageous transfer methods.

Exhibit 28.1 provides a snapshot of management buyouts and depicts their position relative to other transfer methods.

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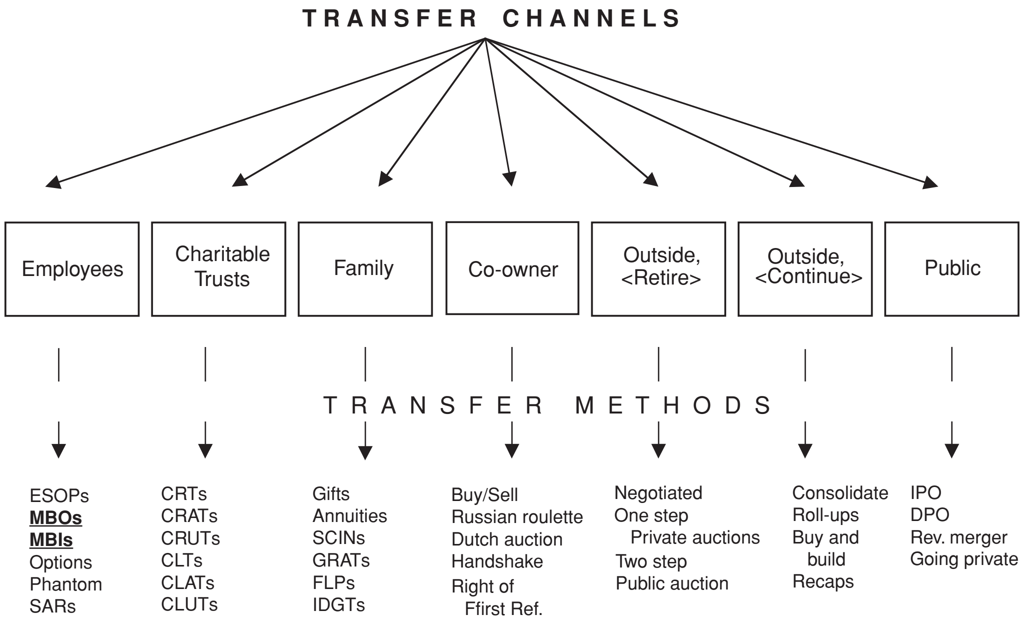
EXHIBIT 28.1 Transfer Matrix: Management Buyouts



Transfer Method	Management Buyouts
Definition	A buyout of a company by existing management
Owner motives	Some owners want the managers to own the business as a payback for years of service. Owners can engineer a deal that meets their needs. This may involve using tax-advantaged structures, seller notes, and earn-outs.
Means of transfer	An industry of investment bankers exists to support this transaction.
Authority	Owners, managers, and capital providers
Value world(s)	The choice of value world is dictated by the relevant authority: owners—owner value world, manager—investment value, and capital providers—either collateral value for lenders or market value for outside investors.
Capital access point(s)	Most capital access points are available to finance MBOs. However, the standard capital structure involves banks, mezzanine capital, and private equity groups.
Key points to consider	Managers of corporate divisions often have to be patient while the parent plans the divestiture, which might involve an open market selling process first. Managers of private companies also need patience, because many owners waffle on their desire to sell. Further, a good management team makes it more difficult for themselves to buy the business in two ways: (1) they enable the owner to disengage from the business while still enjoying the perquisites of ownership, and (2) they increase the value of the firm, making the eventual buyout more expensive. In any event, managers should engage a team of professionals to help structure and close the deal.

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DIFFERENCES BETWEEN MANAGEMENT BUYOUTS AND MANAGEMENT BUY-INS

The mechanics of acquiring a company are similar for an MBO and MBI. Differences between the two involve finding a deal, the perceived riskiness of the subject company, and the number of involved managers. Existing management teams have an advantage over outsiders for these reasons. Since they already manage the company, they can better assess its risk profile than outsiders. Outside management teams must search the marketplace for a company to buy. This search is usually more fruitful in the industry where they have experience. Most MBIs revolve around a single manager, who, if successful, may bring other managers into the deal. Many private equity groups will back an outside manager in the search and financing of a transaction. A number of industry roll-ups have occurred within this framework.

OTHER BUYOUT/BUY-IN TYPES

Two other buyout types are

1. *BIMBO: buy-in/management buyout.* This unfortunately named transfer type involves a transaction where a business is bought by a management team consisting of both existing management and incoming management.
2. *BIO: institutional buyout.* These transactions involve an equity sponsor who then introduces a management team. The team may be the existing team, a buy-in team, or a combination of the two.

Unless otherwise stated, this chapter refers to management transfers without differentiating between buyouts and buy-ins.

Industry Characteristics

A number of industry characteristics influence the likelihood of success in a management transfer. Characteristics such as predictable cash flows and stable operating environments are particularly important.

- *Established, mature industries are more suitable.* Emerging industries often require large investments in capital expenditures and working capital, and are less likely to receive transaction financing.
- *Less cyclical, nonseasonal industries are appealing.* The more stable the industry's sales cycle, the better. Industries that depend on seasonal selling periods, such as a Christmas retailer or ornament manufacturer, are difficult transactions to finance and close in a management transfer.
- *Both a stable technology and customer base are important.* High-technology companies are less suitable for management transfers because of the possibility of technological obsolescence. Industries with shifting customer bases, such as certain kinds of retail, are also not good candidates.

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Of course, it is possible to effect management transfers in just about any industry. The issue raised here is the likelihood of closing the transfer and the ultimate long-term success of the acquisition. However, the individual company's characteristics are more important than industry characteristics.

Company Characteristics

The next company-specific attributes increase the likelihood of a successful transfer.

- Experienced management with a proven track record
- Management teams who invest substantial amounts of their own money
- Subjects with reliable cash flow streams
- Debts that can be serviced even during slow economic periods
- Predictable levels of capital expenditures and working capital investments
- Products or services that have some advantage in the marketplace

The best transfer candidates tend to have gross- and operating-profit margins above industry averages.

LIKELY DEAL STRUCTURES

There are two prevalent management transfer deal structures. The first is a leveraged buyout (LBO). The second is an equity-sponsored buyout. Both of these structures may involve tax-advantaged structures to the seller, such as the use of an ESOP or charitable remainder trust, the subject of Chapter 29. Both structures may also involve seller participation, either through seller notes or earn-outs.

> **EARN-OUTS**
>
> *Earn-outs* are a method for triggering changes in the purchase price based on future performance of the company. They are bridge tools to help buyers and sellers to reach a consensus on the purchase price.

Leveraged Buyouts

Leveraged buyouts use a relatively small amount of equity in the capital structure. For these purposes, LBOs rely on management's equity and nondilutive debt to pay for the acquisition. Exhibit 28.2 depicts capital contributions of the parties in a typical LBO capital structure.

The LBO capital structure is engineered to maximize the leverage of management's equity contribution. Management may contribute only 10% of the total capital needed. The team negotiates simultaneously with secured and unsecured

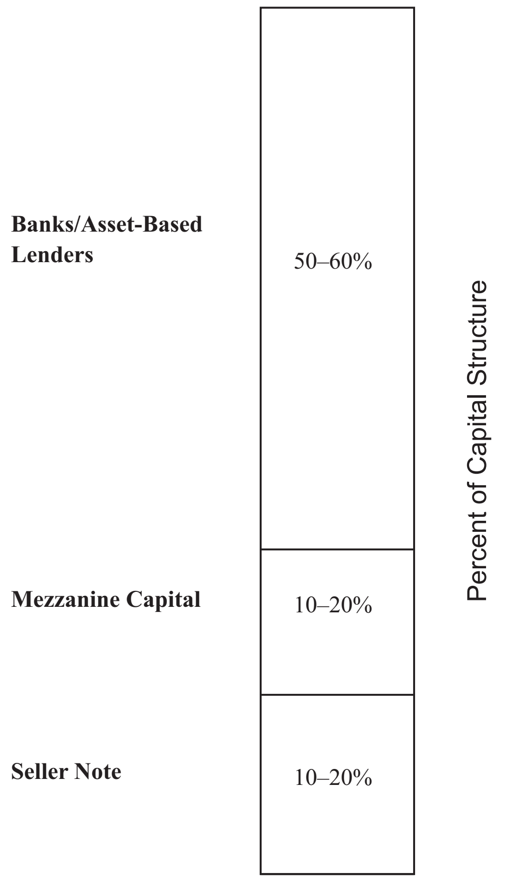

EXHIBIT 28.2 Leveraged Buyout Contributions to Capital Structure

lenders. The seller note is typically the last variable to be determined. Most sellers will not volunteer to finance a meaningful part of the structure because they are in a second or third lien position and basically incur equity-level risk while typically receiving only debt returns.

Sellers who finance a deal can protect themselves in a number of ways, such as:

- Finance less than 50% of the transaction.
- Require the buyer to obtain a life insurance policy naming the seller as beneficiary for the amount of the loan.
- Check the buyer's credit rating.
- Make sure the buyer has sufficient funds in the bank for operating costs.
- Receive a personal guarantee from the buyer.
- Limit the note to 60 months or less.
- Make sure the intercreditor agreements with the other lenders allow for continued payments of the seller note, unless a major covenant break occurs.

An LBO structure is so highly leveraged that a company may fail with unforeseen losses or costs. Management team performance after the transaction is

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crucial. Successful teams realize that cash generation is the key. These teams structure deal terms to defer payments by using devices such as interest-only loans for a period of time. They also negotiate preferred payment terms with vendors and probably also attempt to speed up payments from customers.

In an LBO, managers trade added deal risk for an increased equity interest. They may enhance their position by using various programs, such as the Small Business Association 7(a) or 504 loan programs. In many cases, the managers obtain control of the company with very little of their own money.

Equity-Sponsored Buyouts

Many management teams partner with a private equity provider to complete a transfer. These buyouts tend to employ more conservative capital structures than LBOs. Equity sponsors provide expertise in financing the transaction as well as additional management if needed. The sponsor normally provides a carried interest to the key shareholders of the team. This stock interest comes in two forms. First, the management team is given a certain stock interest at the close, say, 10%, with additional stock granted based on achieving performance benchmarks. The second carried-interest possibility provides for the management team to purchase equity at attractive terms. This management preference is sometimes called an *envy ratio*. For instance, in a typical management transfer, the management team's investment may buy three times as much equity pro rata as the sponsor's money, for an envy ratio of 3. The management equity interest is negotiated up front with the sponsor, which means the team should shop around for the best sponsor.

The likely contributions in an equity-sponsored capital structure are shown in Exhibit 28.3. In this structure, the equity sponsor contributes 20% to 40% of the

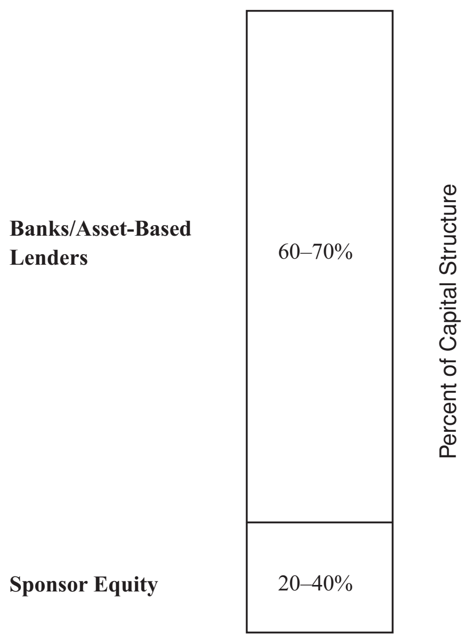

EXHIBIT 28.3 Equity-Sponsored Buyout Contributions to Capital Structure

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capital while the managers contribute little or nothing. A strong equity sponsor may attract a senior lender to a deal and may entice the lender to loan a greater percentage of the capital needed at more attractive rates than an LBO structure might garner. Lenders may participate in this way because a greater percentage of equity in the deal reduces risk, and it may come as a surprise to learn that deeper pockets tend to get better deals.

DEALS

The need to arrange a number of deals simultaneously is a key difficulty in completing management transfers. Negotiating a deal with the seller is only the starting point. Agreements with the financing sources must occur to support the acquisition price. A variety of ownership agreements, such as shareholder agreements, buy/sells, and employment agreements, are necessary between the management team and equity sponsor or between the management participants themselves. Exhibit 28.4 shows these deal possibilities.

Dealing with the Seller

The primary preclosing document between the management team and seller is called a letter of intent (LOI). An LOI is generally a legally nonbinding agreement that describes all of the important terms of the deal. Most LOIs contain these key provisions:

- Description of what is being purchased (assets, stock, details)
- Description of what is excluded (specific assets)
- Proposed purchase price with possible adjustments
- Delivery terms of purchase price (cash at close, payment over time, seller note)
- Earn-out provisions (stated with as much precision as possible)
- Due diligence period (scope of the diligence plus time required)
- Conditions to proposed transaction (financing contingencies, other)
- Consulting and noncompete agreements (precise terms)

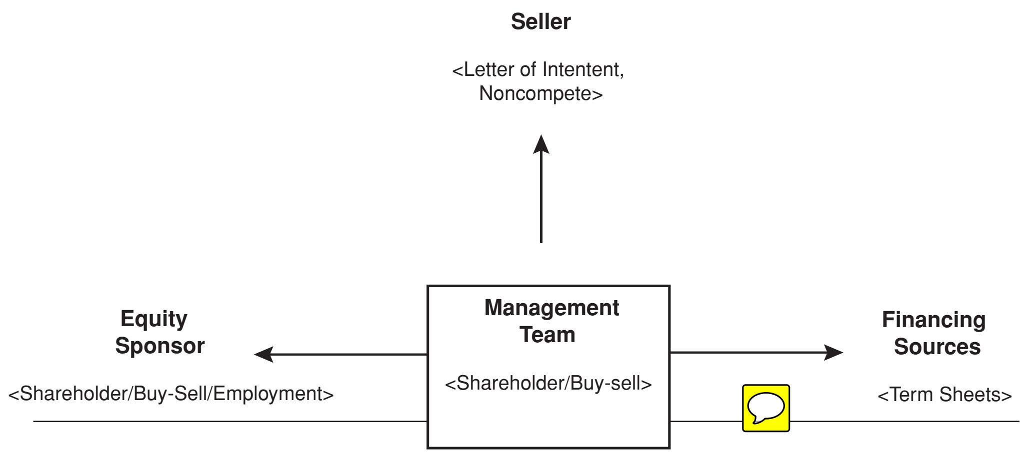

EXHIBIT 28.4 Simultaneous Deals Required

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- Various representations
- Conduct of business until the closing (no material changes)
- Disclosure statements (no public announcements)
- No-shop agreement (exclusive dealing clause)
- Governing law (which state or country governs)
- Closing date

A properly constructed LOI contains all deal-killer issues. Appendix G contains an example LOI. The deal closing lawyers use the LOI to draft the final purchase and sale documents.

Dealing with Financing Sources

Management negotiates a term sheet with each financing source. This may involve players in several capital types, such as banks, asset-based lenders, factors, lessors, mezzanine capital, and private equity providers. Like letters of intent, term sheets describe the financing in some detail. Part Two of this book, "Capital Structure," discusses each of the capital types and negotiating tips for each of the capital access points. The information in Part Two also helps interested parties structure and negotiate financing term sheets.

Dealing with Equity Sponsors

Negotiating with equity providers is a major issue facing management teams. Many equity sponsors want to work out partnership agreements with the management after the seller signs the LOI. Management is better served by controlling the LOI process if possible. To accomplish this, management negotiates the deal with the seller and then cuts a deal with an equity sponsor. This enables management to obtain the best deal.

The deal with an investor is far from done once equity splits are negotiated. Equity splits represent how much of the equity each party owns in the acquired entity. But ownership agreements, such as shareholder, buy/sell agreements, and employment agreements are as important as the equity split. These agreements establish the working relationships between the parties and should be negotiated at the same time as the equity splits. The key ownership agreements used in a management transfer are summarized in the next sections.

Shareholder Agreement

A shareholder agreement sets the terms by which shareholders deal with each other (or members in the case of a limited liability company). The management team should draft the general terms of a shareholder agreement soon after the negotiations with the seller commences. Even if the transfer does not require an equity sponsor, the managers still should create this term sheet for use between themselves. The term sheet need not be much more detailed than the example provisions contained in Exhibit 28.5. The team is well served to hire a corporate

EXHIBIT 28.5 Example Tenets of a Shareholder (Member) Agreement Term Sheet

1. **Percentage Ownership Interest.** It is anticipated the equity will be split as follows:
   John Ambitious—10%
   Rick Underling—5%
   Dick Manager—5%
   PEGCo—80%
2. **Restrictions on Interest Transfer.** Interests cannot be freely transferred. The company has a right of first refusal to purchase the interest under terms no worse than those offered by a third party. If the company does not purchase the interests, the remaining shareholders may also purchase the interests under the same terms. If neither the company nor the shareholders purchase the interests, the interests may then be sold to a third party that is bound by this agreement.
3. **Tag Along.** The controlling shareholder cannot sell his interests unless the buyer agrees to purchase the minority interests at the same price and terms.
4. **Mandatory Buyout in Event of Death.** The company has an obligation to purchase the interests at death. The company will provide, if available, company-paid life insurance to cover this cost for the shareholders who are employees of the company. All valuation issues will be contained in the buy/sell agreement. In the event of a company purchase, the remaining shareholders will maintain their proportionate interest without dilution.
5. **Short-Term Disability.** Shareholders who are employed by the company will receive full salary for up to 12 months even if unable to work. If the disability extends beyond 6 months, then the disability will be classified as long term.
6. **Mandatory Buyout in the Event of Long-Term Disability.** The company has an obligation to purchase the interests in the event of a long-term disability by one of the employee-shareholders. For these purposes, disability will be determined by the definition in the disability insurance in force at that time. The parties will agree to a definition of disability in case no disability insurance is in force at the time of the disabling event.
7. **Optional Buyout in Certain Events.** A number of circumstances that *may* trigger the purchase of the interests include:
   - **a.** Bankruptcy of a shareholder.
   - **b.** Failure of a shareholder to perform duties as designated in an employment agreement or within the shareholder agreement.
   - **c.** Voluntary withdrawal from the business, either through retirement or quitting.
   - **d.** Divorce of the shareholder.

   In the event of a company purchase, the remaining shareholders will maintain their proportionate interest without dilution. Optional buyouts will require a supermajority of the shareholders voting interests to exercise the option.
8. **Dispute Resolution.** Disputes between the shareholders will be resolved by arbitration, with both sides paying equally for the services of the American Arbitration Association.
9. **Financing.** The primary source of borrowed funds for the company will be institutional lenders. A super majority of the board must agree to seek funds other than nondilutive debt.
10. **Distribution of profits and losses.** These will be divided per the original ownership percentages. Distributions for tax reasons will occur at the highest tax bracket.
11. **Managing the Business.** Issues that the management can decide without board inclusion:
    - **a.** Hire/terminate nonshareholders.
    - **b.** Spending less than $75,000 for capital projects.
    - **c.** Changing benefit plans as long as the net effect is less than $75,000.
    - **d.** Choosing and negotiating vendor and customer contracts.
    - **e.** Arranging consignment agreements with customers and suppliers.
    - **f.** Negotiating customer credits.
    - **g.** All other issues not specifically contrary to paragraph 10 of the shareholders agreement.

(*continued*)

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EXHIBIT 28.5 (*Continued*)

12. **Voting Rights.** Each shareholder will have voting rights based on ownership percentage of the entire entity on a pro rata basis.
13. **Duties.** The manager and other shareholders owe loyalty to the company. Specific job duties are described in the employment agreement term sheet.
14. **Corporate Governance.** The following decisions will require a supermajority (more than 66% of the outstanding shares) approval of the shareholders' voting interests:
    - **a.** Elections of directors
    - **b.** Issuance of new interests
    - **c.** Sale of entire business
    - **d.** Changes to share rights
    - **e.** Distributions or dividends, except for normal tax distributions
    - **f.** Incurring debts of more than $1 million
    - **g.** Acquisition of another business
    - **h.** Dissolution of the company
    - **i.** Major changes in employee benefit plans
    - **j.** Changes to the manager's compensation plan
    - **k.** Optional buyouts
    - **l.** Changes to the employment contracts, noncompete agreements, shareholder agreement, and buy/sell agreement

attorney to help construct terms appropriate to the circumstances. This lawyer also may represent the team in the negotiations with the equity sponsor.

Buy/Sell Agreement

This agreement controls the events that trigger a buyout, determines who can buy a shareholder's interest, and prices the interests that are purchased. Exhibit 28.6 presents some ideas management teams may wish to incorporate into their buy/sell term sheets.

As with the shareholder agreement example in Exhibit 28.5, the buy/sell example provisions are meant to provide ideas for managers to construct a suitable term sheet. Developing these term sheets is a test to determine if the managers can work together effectively. Once again, this term sheet is required for either LBOs or equity-sponsored buyouts. Working through these issues with prospective equity sponsors also sheds light on the viability of this future relationship.

Employment Agreements

As ownership term sheets are created, managers should construct terms for their continued employment after the closing. Exhibit 28.7 contains example tenets of an employment agreement term sheet. Although this step is vital with equity-sponsored transfers, it is also important in leveraged buyouts. The purpose of this term sheet is to define the duties and rights of the managers.

As with other agreements, managers should seek help from an employment contract lawyer when setting the employment terms.

The following example illustrates a management buyout.

EXHIBIT 28.6 Example Tenets of a Buy/Sell Agreement Term Sheet

1. **Triggering Event.** The following events involving a shareholder trigger the buy/sell agreement:
   - **a.** Death
   - **b.** Voluntary termination
   - **c.** Personal bankruptcy
   - **d.** Divorce
2. **Valuation of Interest.** The following process is used upon a triggering event. The value of 100% of the company is defined as the *greater* of the following values:
   - **a.** An agreed-upon price set by March 31 of each year by a consensus of the board. This annual agreement must be in writing, and the agreed-upon price will remain in effect until the following March 31, unless changed in writing by a consensus of the board. It can be amended within the one-year time frame by written unanimous consent of the board.
   - **b.** The insurance in force at the time of the triggering event.
   - **c.** The net book value is determined by using generally accepted accounting principles, on an accrual basis, as of the most recent quarter's end to the date in question.
   - **d.** The following formula will be used to value the company:
     i.100% value = (earnings before interest and taxes for the most recent year-end · 4) – Long-term liabilities for the most recent year-end. "Long-term liabilities" are defined as those corporate liabilities that come due in more than one year from the statement date.

     I. Death

     The value of a shareholder's interest involving death shall be determined by using the value determined in paragraph 2 above times the shareholder's percentage of interest. The net proceeds of any life insurance payable to the shareholders for the purpose of redeeming the deceased shareholder's interests shall be the cash payment to the deceased shareholder's estate, up to value determined in paragraph 2 above times the shareholder's percentage of interest. If the value determined in paragraph 2 above times the shareholder's percentage of interest is more than the net proceeds of the life insurance payable to the shareholders, then the difference will be paid to the estate of the deceased shareholder.

     II. Voluntary Withdrawal or Retirement of the Manager

     The value of a manager's interest involving voluntary withdrawal or retirement shall be determined by using the value determined in paragraph 2 above times the manager's percentage of interest less 20%.

     III. Right to Call Interests

     The company maintains the right or option to purchase any or all shareholder interests that are subject to a third-party action, such as a personal bankruptcy or divorce of a shareholder. A consensus of the uninvolved shareholders will need to vote in writing to exercise this option to purchase. If an interest is called, the value and terms of purchase will be the same as an voluntary withdrawal, as described in paragraph II immediately above.
3. **Payment Terms.** In cases of a shareholder's death, the deceased shareholder's estate shall be paid 100% of the life insurance proceeds, if such insurance was in force at the time of death. If the insurance in force is insufficient to cover the valuation, the underinsured portion shall be paid under the same terms as the other triggering events as follows: the ownership interest valuation amount as determined by paragraph II above, payable monthly for five years from the triggering event at an annual interest rate of 7%.

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EXHIBIT 28.7 Example Tenets of an Employment Agreement Term Sheet

1. **Term of Employment.** The following employees will be granted three-year employment agreements at the terms stated below.
2. **Salary.** The salary requirements for each manager is stated as follows:

   John Ambitious—$175,000 per year

   Rick Underling—$125,000 per year

   Dick Manager—$125,000 per year

   These salaries will increase each year by 3%.
3. **Bonus Plan.** In addition to the base salary, the key managers will participate in an "Annual Incentive Plan," which is described on a separate sheet.
4. **Employee Responsibilities.** A separate sheet is included on "Employee Responsibilities."
5. **Devotion of full attention and energy.** Yes.
6. **Confidentiality.** Yes, executive will sign a C/A.
7. **Reimbursement of Business Expenses.** Yes.
8. **Reimbursement of Expenses.** Normal reasonable expenses furthering the company business will be reimbursed via itemized expense reports.
9. **Benefits.** The executives shall enjoy standard benefits in the following areas:
   - **a.** Vacation days. Vested in same way as before the transaction.
   - **b.** Health insurance.
   - **c.** Disability coverage; short term versus long term.
   - **d.** Life insurance.
   - **e.** 401(k) plan.
10. **Termination of Agreement.**
    - **a.** Without cause:
      Company may terminate with 18 months' notice.
      Employee may terminate with reasonable written notice for transition, but no less than 30 days.
    - **b.** Termination as a result of business condition changes:
      Sales of assets or share of the company or material change in duties, remuneration, or benefits would be considered termination by company under clause (a) above.
    - **c.** Disability: If unable to perform duties for more than 26 weeks, company may terminate agreement and company obligations cease without prejudice to employee rights under company disability programs or shareholder rights.
    - **d.** Death: Agreement terminates and obligations cease.
    - **e.** With cause: Company may terminate without notice for causes to be defined.
    - **f.** In the event of termination without cause, employee shall be considered to have been given notice specified in (a) above and shall not be required to perform any duties during the notice period but shall receive all salary, prorated incentives, and fringe benefits as if the employee were a continuing employee.
11. **Settle Disputes.** By arbitration.
12. **Right to Work Product.** No.
13. **Noncompete Agreement.** For a period of 24 months after termination.
14. **Governing Law.** New York.

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PrivateCo's president, John Ambitious, approaches Joe Mainstreet, PrivateCo's sole shareholder, about buying the business. Ambitious has managed PrivateCo for five years and believes he is now experienced enough to take this important step. Joe has no real desire to sell the company but cannot ignore the solicitation. Given the miserly approach to salaries at PrivateCo, Joe suspects Ambitious does not have money to buy the company. Ambitious says he will raise the money through a combination of debt and outside equity. Joe says he will not finance any part of the purchase price but will entertain a 100% buyout if the price is right.

The first step is to agree on this price. Joe is slow to talk about what he thinks PrivateCo is worth but eventually compiles the next valuation. (This is taken from the owner value world found in Chapter 13.)

PrivateCo Owner Value as Prepared by Joe Mainstreet

	$000
Total compensation to owner, including bonuses	450
+ Pretax earnings of the business	1,800
+ Personal expenses passed through to the business[a]	75
+ Effect of close business contracts[b]	9
+ Covered expenses such as insurances, business vacations, etc.	25
+ Any other items that personally benefit the owner[c]	90
Benefit stream to owner	2,449

[a]Personal expenses equal vacations and conferences charged to company.
[b]Excess rent charged to PrivateCo by a company controlled by Joe Mainstreet.
[c]These equal donations ($74), legal ($9.9), and accounting ($6.5).

The benefit stream to Joe Mainstreet is $2,449,000. This is the amount that he expects to receive or control each year for the foreseeable future. Joe capitalizes this benefit stream at a low rate because he believes the risk of achieving this stream is low. In this case, Joe uses a 15% capitalization rate. This creates an owner value on a total capital basis of $16.3 million ($2.449 million by 15%). By deducting PrivateCo's long-term debt of $500,000 from the enterprise value, the value of Joe's equity in the owner value world is $15.8 million. This equates to about 6.5 times the benefit stream.

Joe tells Ambitious he will sell 100% of PrivateCo for $16 million *cash*. (Rounding up makes sense to Joe.) Ambitious is delighted that Joe has agreed to sell. He is uncertain, however, if $16 million is a fair price. When in doubt, hire an expert, thinks Ambitious. After hearing from an acquaintance that Dan Dealmaker is a fine fellow, Ambitious hires Dan to raise the money and close the deal. Ambitious tells Dan that he and two other managers can invest about $500,000 combined.

Dan believes this may be a record high amount for managers to invest in an MBO.

As a starting point, Dan reviews PrivateCo's balance sheet. After some study and calculations, Dan calculates PrivateCo's collateral value (also taken from Chapter 13). Dan's presentation is presented next.

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PrivateCo Collateral Value ($000)

Asset Class	Stated Value	Loanable Value/Fair Market Value	Advance Rate	Collateral Value
Accounts receivable	$722	$686	80%	$549
Inventory	450	250	50%	125
Land/Building	442	2,200	70%	1,540
Machinery and equipment	866	450	65%	293
Total				$2,500

The "stated value" for each of the asset classes has been taken from PrivateCo's balance sheet (as shown in Chapter 5). The loanable value/fair market value column shows the amounts eligible for secured lending. Accounts receivable have been reduced from the stated value to reflect ineligible receivables, such as past due invoices or those generated from related companies. Inventory has been reduced to account for work-in-progress inventory, which is not eligible for lending. Land and building and machinery and equipment have been adjusted to fair market values.

Advance rates reflect the percentage of each asset class that a lender will actually loan against. For example, a lender may advance 80% against eligible receivables, 50% against eligible inventory, and so on. Eligibility can vary from lender to lender, and is explained in detail in Chapter 20. Finally, collateral value is the sum of the various asset class margined collateral. For PrivateCo, collateral value equals about $2.5 million (as rounded). With a $16 million need and only $2.5 million in traditional borrowing power, Dan Dealmaker quietly thanks his lucky stars that he took this assignment on an hourly plus success fee basis.

Considering management's investment of $500,000 and a $2.5 million borrowing capacity, Dan still needs $13 million to close the deal. The next step is to tap the mezzanine capital market. Dan contacts his golfing buddy, Tim, at MezzanineCo. Dan gives Tim these numbers on PrivateCo:

PrivateCo Summary Financials

Book value (Chapter 5)	$1.0 million
Net asset value (Chapter 5)	2.4 million
Benefit stream	
Pretax earnings	$1.8 million
Prior owner compensation	.45 million
Prior owner discretionary expenses	.10 million
Depreciation	.4 million
Normalized capital expenditures	(.3) million
Adjusted EBITDA	$2.45 million
Expected stream growth in next 5 years: 15%	$5.0 million in year 5
Projected cash at end of year 5	$10.0 million

Tim reviews this information, along with the reams of backup information on PrivateCo that Ambitious created but Dan now claims as his own.

P1: a/b P2: c/d QC: e/f T1: g
JWBT486-c28 JWBT486-Slee February 24, 2011 4:4 Printer Name: Yet to Come

Somewhere deep in the bowels of MezzanineCo prowls an algorithm that determines how much mezzanine capital can be applied to the PrivateCo buyout. This simplified illustration assumes that MezzanineCo will not lend more than three times PrivateCo's adjusted earnings before interest, taxes, depreciation, and amortization (EBITDA), or about $7 million. The detailed pro formas show that the company can afford the $1 million per year in interest, and cash builds to $10 million by the end of the fifth year, more than enough to pay off the mezzanine loan.

MezzanineCo provides a term sheet to Dan that would choke a whale. Beyond the 14% current coupon payable quarterly, the warrant play amounts to 5% of PrivateCo's stock exercisable beginning in year 4. The warrants are valued using a formula that increases over time, thereby enticing Ambitious to buy them back as soon as possible. Dan expects PrivateCo will be worth at least $25 million in year 5 ($5 million EBITDA times a selling multiple of 5), so the warrants should be worth at least $1.25 million at that time. If the pro formas are correct, PrivateCo will be debt and cash free at the end of year 5 and will enjoy a strong earnings base.

Dan acts the part of an insulted broker for receiving such harsh terms. In reality, he is just one stop, and $6 million, away from raising the money needed to close the deal ($16 million purchase price less $500,000 management investment less $2.5 million asset-based loan less $7 million mezzanine loan). The last stop is private equity.

Ambitious watches Dan's progress and suddenly realizes he and the other two managers have a math problem. With a management investment of $500,000 and an equity need of $6 million, Ambitious and his team are staring at a 7.7% equity split ($500,000 divided by $6.5 million). It occurs to Ambitious, for the first time, that he might be better off working for Joe Mainstreet going forward and owning no stock than investing all of his money and owning about 4% of the company. (Ambitious has two management partners.) But wait! Dan Dealmaker is finally about to earn his money.

Dan knows a private equity group that specializes in backing management teams. PEGCo gives extra credit to the management team's investment. In other words, the management team's money is worth more than a pro rata share. After several meetings and two rounds of golf, PEGCo offers to cut the management team in for 20% of the equity. If management hits its financial targets, PEGCo will allow the management to *earn-in* another 2% per year over five years. Of course, PEGCo's senior partner says paying 6.5 times PrivateCo's adjusted EBITDA is too rich. This will necessitate a lengthy due diligence about PrivateCo and its industry.

There is a fairly disciplined approach relative to PEGCo's investment position. Assuming PEGCo is a typical private equity provider, it desires a 30% compounded rate of return on its investments. PEGCo believes PrivateCo will be debt free in year 5 and will earn about $5 million per year at that time. PEGCo is betting that it can sell PrivateCo for 6.5 times EBITDA in year 5, or $32.5 million. But PEGCo may only own 70% of the stock at that time, assuming management fully hits its bogeys. This 70% position is worth $22.8 million in year 5 ($32.5 million times 70%). Is this enough money to warrant a $6 million investment today? A financial calculator determines this compounded return is 31%. PEGCo is good to go.

In real life, PEGCo may have six to eight different deals under a letter of intent at the same time. The one deal that actually gets done is the one that shows the best potential during due diligence. This is disconcerting to members of a management team because they cannot hedge their bet. If the equity player decides not to close the transaction, management has to start over. It may take six months to arrange a complicated financing. Many owners are not patient enough to go through the capital-raising process again.

During due diligence, a PEGCo partner finds a problem. It looks like PrivateCo's industry is cyclical. Every 15 years or so the participants apparently lose their minds and begin a price war. PEGCo believes this might happen again in the next five to seven years. In an attempt to get Joe Mainstreet to accept less money because of this unforeseen risk, PEGCo decides it cannot move forward with the deal. Of course, Ambitious and the other managers are crushed. But they still have their old jobs.

What lessons can be learned from this hypothetical buyout?

1. Managers need to manage and leave the heavy deal making to a professional. A major backdrop issue with management transfers is that the managers *work for* the owner. It is imprudent for them to go nose to nose with their employer in negotiations. By hiring an investment banker, even if the deal fails, both sides can blame the dealmaker, and the relationship between employer and employee may continue as before.
2. The dealmaker should engineer a funding solution that simultaneously attacks the capital structure. All capital access points have credit boxes. This knowledge enables dealmakers to plan capital access. Next, each capital provider issues a term sheet for their proposed financing. The battle is won or lost at this point. A good dealmaker conducts this symphony of conflicted interests with a careful wand. Also, dealmakers need to incorporate the layered capital structure into the detailed projections. Doing this requires a thorough understanding of the effective returns for each capital access point.
3. The management team should sign the letter of intent with the owner, then shop the deal with a number of equity sources. Once again, the equity split and ownership term sheets are negotiated together.

POINTS TO CONSIDER

Management transfers are multivariable problems and require a structured approach to achieve success. There are many points to consider when approaching this task.

P1: a/b P2: c/d QC: e/f T1: g
JWBT486-c28 JWBT486-Slee February 24, 2011 4:4 Printer Name: Yet to Come

Number of Managers

The fewer managers involved in the transfer, the better. Many managers cannot make the transition from corporate minion to owner-manager. All managers think they work hard while in the big company. Owning a business, however, means a doubling of the workload and a tripling of the pressure. The key manager should bring on board only those players who have core competency skills. Another way to look at this is to invite only the managers whose skills cannot be readily purchased in the marketplace. In most cases, this limits the invitation list to less than five participants.

Fiduciary Responsibility

A primary difference between an MBO and MBI is the level of fiduciary responsibility required of the managers. For management buyouts, the key managers have a fiduciary duty to their employers. They must act honestly and respect the interests of the employer. The MBI team does not have this level of responsibility because its members cannot be fired for acting unprofessionally. Many sellers set ground rules for the managers at the beginning to head off these potential conflicts. For instance, they may set up front the terms of the deal, when the deal must close, and who may know about the situation. Sellers also may not allow the managers to bid on the business if the selling process is open because sellers do not want to scare away potential bidders. In some cases, managers have to be patient and let the auction process break down before putting their own deal together.

Earn-outs

An earn-out is a method for triggering changes in the purchase price based on future performance of the subject company. It is useful in helping buyers and sellers reach a consensus regarding the purchase price. It is especially useful for management transfers, since a full down payment may not always be achievable. Earn-outs are fertile ground for downstream lawsuits, so great care must be used in their construction. A few of the more important points to consider when structuring an earn-out are listed next.

- Base the earn-out on services/products that exist at the closing, for some determined period of time, using terminology that exists in a third-party context, such as according to generally accepted accounting principles. A dealmaker or lawyer experienced with crafting earn-outs is needed at this point.
- Sellers typically want an earn-out to be based on net revenue rather than profits because the owner cannot control expenses post-closing. Buyers prefer a profit-based method earn-out because it better reflects whether the company can afford to pay the contingency. Because there are more variables in determining earnings than revenues, there is a greater likelihood that disputes may develop with the latter approach.

P1: a/b P2: c/d QC: e/f T1: g
JWBT486-c28 JWBT486-Slee February 24, 2011 4:4 Printer Name: Yet to Come

- When disputes inevitably appear, private arbitration is preferable, using an arbitrator mutually agreeable to the parties. Using arbitration is usually faster and cheaper than settling a dispute in court, and the parties can choose an arbitrator with specific knowledge and expertise.

Much like seller financing, earn-outs should be used only by sellers in situations where they can live with the purchase price paid at closing, and any monies received postclosing are considered gravy.

Bridging the Purchase Price

Assuming the seller reads the prior paragraphs and refuses to provide seller financing or an earn-out, management still may be able to bridge a difference in purchase price. Managers are in a unique position to work with the seller to implement a tax-advantaged deal to the seller. Two choices exist. Managers can implement an ESOP–MBO structure, which may save the seller millions in taxes. Or managers can purchase the sellers shares from a charitable trust (the subject of Chapter 29), which may also save the seller a bundle. Chapters 27 and 29, on trusts, will give managers plenty to think about along these lines.

Who Has the Power

Managers who partner with an equity source should not cede operating control of the company, even if they are minority holders. Managers can negotiate certain rights with the equity sponsor so they do not get run over. Assume that PrivateCo will have a five-person board of directors post-buyout. PEGCo appoints three of the directors, and the management team appoints two. The next clause can be negotiated into the shareholder's agreement to block the majority from taking actions that might be detrimental to the managers.

> ***Corporate Governance***
> *The Board will have five members: PEGCo will appoint three; the Management team, two. PEGCo will appoint the chairman and CFO of the company. The following decisions will require a supermajority (at least four board votes) approval of the board:*
>
> *Elections of directors*
> *Issuance of new interests*
> *Dilution of current interests*
> *Sale of entire business*
> *Changes to share rights*
> *Distributions or dividends, except for normal tax distributions*
> *Incurring debts of more than $1 million*
> *Acquisition of another business*
> *Dissolution of the company*

P1: a/b P2: c/d QC: e/f T1: g
JWBT486-c28 JWBT486-Slee February 24, 2011 4:4 Printer Name: Yet to Come

Key employee hires
Major changes in employee benefits
Optional buyouts
Changes to the employment contracts, noncompete agreements, operating agreement, shareholder agreement, and buy/sell agreement
Job termination of a shareholder

With this structure, managers cannot be forced to dilute their ownership interest or be terminated *unless* one of the management board members votes with the equity sponsor.

Legal Counsel

It takes a million lawyers to close a management transfer—at least it seems so. The management team has its own lawyer, who helps negotiate the deal with the seller and equity source. This lawyer also helps work out the deal between the managers, such as equity splits and employment agreements. Another lawyer represents the seller. Yet another lawyer represents the company being acquired. Scores of lawyers represent the various other parties: equity sources, financing sources, and so on. A smart management team incurs only out-of-pocket legal expenses for its particular lawyer. Other deal-related expenses are paid by the acquisition entity out of the closing proceeds.

Perhaps more than any other transfer method, management transfers contain a multitude of deal variables. The only thing standing between managers and complete chaos are term sheets. Well-constructed term sheets provide all interested parties with necessary information. Term sheets perhaps can be likened to a set of blueprints. Of course, the deal can be constructed without them, but chances are good that the foundation will sag and the structure ultimately will fail. The best advice is for managers and sellers to be represented by knowledgeable professionals. This is yet another time when good advice pays off handsomely.

TRIANGULATION

The ability to transfer a business interest is conditioned by its access to capital and the value world in which the transfer takes place. No other transfer method has as many capital options and possible value world combinations as management transfers. This variety of alternatives causes these transfers to be volatile and uncertain—and potentially rewarding.

Management transfers take place in several different value worlds simultaneously, depending on the perspective of the participants. Owners view the transaction through the world of owner value. They are the supreme authority in this world, so owners choose to transact in this world whenever possible. Although managers may view the deal in the world of investment value, they can get it

P1: a/b P2: c/d QC: e/f T1: g
JWBT486-c28 JWBT486-Slee February 24, 2011 4:4 Printer Name: Yet to Come

financed only in the world of collateral value or, in the case of outside investors, the world of market value.

Too many perspectives in a deal can be dangerous. Value world collisions invariably result. One recent management buyout of a metal-stamping company exemplifies this dilemma. Although the owner believed the business was worth \$20 million, the managers valued the company at \$15 million. Secured lenders would lend only \$10 million. This situation had the makings of a time-and-energy black hole. Yet the owner is the ultimate authority in management transfers. The owner decided to lend the managers, through a subordinated note, \$10 million to complete the deal. Although the managers paid \$5 million more than they thought the company was worth, the terms of the seller note were quite favorable, effectively causing the deal to consummate in the world of owner value.

Casual observers might blame the owner for taking such a large risk in the preceding example. To stay in the world of owner value, this particular owner decided to exert deal-making authority. The same observer might think less of the managers for overpaying and overleveraging the company. Are the players at risk here? Yes, but risk is better understood in management transfer than any other transfer method. Both owner and managers should understand and be able to measure and manage risk better than anyone else. Who better to judge the merits of the deal than the people who have shaped the company?