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Management Buyouts with a Different Twist

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MBOs with a Different Twist

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Introduction

Even in the current poor dealmaking environment, investment bankers can adopt a strategy that creates wealth for themselves and their clients. This opportunity emanates from large company divestitures. Instead of taking a cash fee for arranging a management buyout, I-Bankers can convert ordinary income to capital gains by taking an equity position in the acquisition company. Isn't it the dream of every dealmaker to cast away the I-Banker's role in favor of a principal's position? The conversion to part-time merchant banker must be undertaken with care, however.

Poor economic conditions encourage large public companies to discard their orphans. Once the corporate decision to prune has been made, I-Bankers should team with management. Robertson & Foley has completed a number of MBOs over the past eighteen months in which their accomplishment fee was received in company stock. The typical deal has the following traits:

- Book value based pricing
- Subordinated seller notes at 30-50% of the purchase price
- Earn out: normally based on gross margin dollar improvements
- Investment ratio of 3:1 (management investment is

worth 3 times an outside equity source)

- Management/I-Bankers equity splits of 40-60% of the total equity

- Cash flow positive out of the gate, once the corporate charge is added back

The MBO transactions described herewith tend to result from busted auctions. Running an auction in the current market has about the same effect as running a stop sign in rural Wyoming. No one seems to notice or care. Big companies are most likely to make less-than-brilliant decisions once their "A" divestiture plan goes awry. To maximize this situation, bankers should do the following.

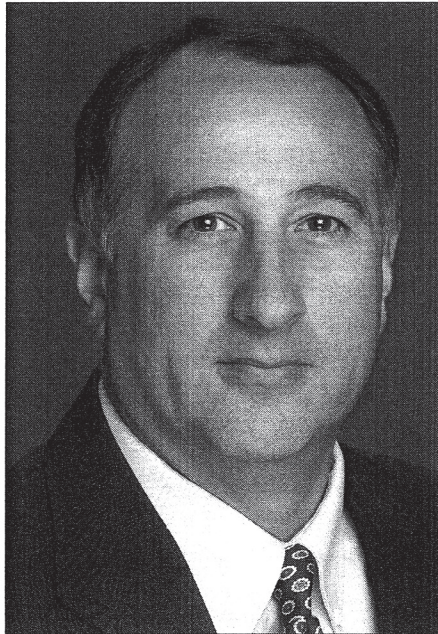
The Deal with Management

The mandate letter with management should have at least two parts. First, the I-Banker should have the option of either taking a cash fee or converting the fee into an equity position. This latter choice is typically in the range of 5-10% of the acquisition company's equity. The banker should also have a right to purchase additional equity, say another 5-20%, on the same terms as management. This arrangement enables the I-Banker to benefit from a favorable investment

ratio with equity sponsors.

Strength through weakness

At least initially, I-Bankers should avoid the temptation to peacock. They should stay in the back-



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ground during negotiations with the seller. The I-Banker writes the letter of intent and scripts the key manager in the negotiations. The seller suspects, of course, that the managers have little money. In fact, the managers have virtually no money. If management is challenged on this obvious lack of financial resources, the managers should convince the parent that they intend to hire an investment banker to ultimately raise the down payment and working capital. The parent is far more likely to offer a subsidized price and fully subordinated note

to the managers, as opposed to a fast talking I-Banker. This parental attitude is even more pronounced when it involves big-checkbook equity groups. The key factor is to negotiate a letter of intent without "a" committed equity source. If positioned correctly, the parent company will help the managers.

Control the Deal

Once the letter of intent is executed, the I-Banker creates an auction process for the debt and equity sources. With almost half the purchase price covered by a seller note, an asset based lender may be able to provide the down payment. In any event, the outside equity piece is limited and controlled. Since the I-Banker is perfectly aligned with management, he/she can drive a hard deal with the capital providers.

Deals, Deals, Deals

A difficulty with completing MBOs is the necessity to arrange a number of simultaneous deals at once. Negotiating a transaction 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. The schematic below shows these deal possibilities: The various term sheets contain provisions that are as important as the equity splits. The choice of the acquisition entity determines the type of the key agreement. We usually choose limited liability companies as the vehicle, so member agreement replaces shareholder agreement. Aside from the beneficial tax aspects and flexibility offered by an LLC structure, we like the lack of legal liability that confers to the LLC Board of Advisors.

The term sheets serve several purposes. First, the term sheets protect the I-Banker's position, especially regarding the Shareholder and Buy-Sell agreements. As we all know, short of a terminal event, minority

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interest positions in private companies only seem to have value in a fair market value appraisal. Second, the term sheets are the control documents that enable all parties to understand where they stand. Third, the drafts of some of the term sheets provide the tools that empower the I-Banker to run mini-auctions on key decision variables. Finally, once there is agreement on the term sheets, the various lawyers use them to close the deal.

It takes a hundred lawyers to close a management buy-

out. At least it seems so. The management team has its own lawyer, who helps negotiate the deal with the seller and equity sources. This attorney for management also helps work out the deal for management's equity splits and their employment agreements. Another attorney represents the seller. Yet another lawyer represents the company being acquired. Scores of lawyers represent the various other parties: equity source, financing sources, etc. A smart management team only incurs

an out-of-pocket legal expense for their particular lawyer. The other deal-related expenses are paid by the acquisition entity out of the closing proceeds.

Conclusion

In deal parlance, it's a good time to buy companies on the cheap. But taking equity positions in a variety of deals also solves an I-Banker's dilemma.

Retirement: A well thought out MBO investment strategy and good implementation can put an I-Banker in a coming-and-going position, i.e., as a broker/buyer coming in, and as a broker/seller going out.

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MANAGEMENT BUYOUTS Simultaneous Deals Required

