Briefing Note

Whitehead Monckton
the Kent law firm

Management Buy Out (MBO)

If a business owner is looking to retire or exit their business then they need to develop an exit strategy. This will include looking at all the available options and considering which is the most appropriate in the circumstances. The exit options may include (1) selling the business to a competitor or third party or (2) selling the business to the current (or an external) management team or (3) letting your family take it over. This Briefing Note looks at the benefits and flexibility of an MBO and gives consideration to the advantages and disadvantages. This Briefing Note should be read in conjunction with our Guide to the Sale and Purchase of Shares and Assets.

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1. Initial Considerations

The first consideration is developing an exit strategy (see our Briefing Note on Selling Your Business). This will include assessing a timeframe, price, and options on succession. You will need to work closely with your accountant to assess the value and the most efficient tax structuring for you. You will also need to consider whether you want to sell the shares in your business to a competitor or third party or to the management team, or give it to your children. Selling to a competitor is often the preferred choice as there are a number of benefits for the buyer including increased market share, economies of scale etc, however, if you have an experienced management team capable of running the business then an MBO may be the preferred option.

2. Advantages and Disadvantages of an MBO

MBOs are generally considered to have a higher chance of success than many other types of acquisitions. This is because the current management team will have been successfully involved in the business for a number of years and they will be aligned with the long term success of the business. The flexibility of an MBO is often overlooked so I set out below a number of factors showing why an MBO may be the preferred option.

(a) **Sell all or part of your shares:** you may consider selling some of the shares in the business to existing management and keeping the remainder. There are a number of options you can look at in relation to deferred income and earn outs. If you keep a proportion of your shares you will need a Shareholders Agreement with a good dividends policy and information covenants to ensure an income stream from your remaining shares.

(b) **Hive off a part of the business:** you could sell a part of the existing business to the management team running it. This would allow you to realise some income whilst keeping core parts of the business.

(c) **No need to find a buyer**: if you sell the business to the current management team then there is no need to go through the sometimes lengthy process of finding a buyer. This may make the exit process quicker.

(d) **Limited due diligence:** as the management team will know the business there should be the need for only a limited due diligence process.

(e) **Limited warranties:** as the management team should be fully informed about the business they should not have to seek extensive warranties from the seller.

(f) **Financing:** the management team does not usually have the financial resources to completely buy the shares so they usually look for debt financing from a bank or other lender (or private equity) in addition to the capital contribution from the management team itself. The capital contribution required by the management team can often be significant such that they may need to mortgage their homes. In some circumstance the MBO can be financed by the seller getting paid through deferred payments over a number of years after completion, however, this means the seller is taking on the risk of performance of the business under the management team. The management team must be careful that they don't take on too much debt.

(g) **The management team will take a long term view:** one benefit of the management team taking over the business is that not only will they be financially invested into the business but they will also align their careers to the success of the business. The downside is that if the current shareholder is the owner/manager then she/he may play a vital role with, say, customer relations, and much of the goodwill may be directly attached to her/him. The transition to the new management team would need to be handled carefully so as not to lose the goodwill that was built up over time by the seller.

(h) **Family can be involved in the MBO:** if your children are involved in the business then you can either give the business to them (but with a loss of the sale price), sell it to them (but where will they get the funds), or include them in the management team under an MBO.

(i) **Human Resources:** one key element is how well the management team will operate without the owner/manager being involved in the business. In order to expedite the transition, the owner/manager can start to devolve responsibility early on in the MBO process and train their successor. However, if the management team is not capable of making the step to owning and running the business on their own then do not consider an MBO. The owner/manager is often the managing director and this can be a tough role to fill.

3. The Shareholders Agreement

I have singled out the Shareholders Agreement as one of the key documents in an MBO because it will deal with many of the key issues in the relationship between the management team going forward. It can deal with dividends, what happens to shares if someone leaves the business (voluntarily or involuntarily) or wants to sell them, control over key business decision making, composition of the Board, voting powers, roles and responsibilities.

4. Negotiating the MBO

So far my experience with all the MBOs on which I have advised has been positive as they have flowed smoothly to completion and this has been down to the management team being coordinated in its approach (and hopefully the good advice they have received). However, there are numerous potential pitfalls which can arise during a sometimes long winded and lengthy negotiation process. There are unforeseen issues which can test relationships such that honest and frank discussions may be needed about responsibility and abilities. Negotiating the MBO can be the first real test of the management team before they take over the business.

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