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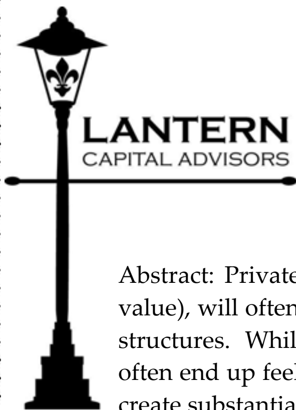

WHITE PAPER: Creative Management Buyout Strategies

Abstract: Private equity firms particularly those that focus on buying smaller companies (less than $100 million in value), will often structure the financing of a buyout utilizing limited amounts of their own equity and aggressive debt structures. While such an approach can create spectacular returns for their investors, management and the sellers can often end up feeling shortchanged. Thankfully, owners and managers can use their own creative buyout strategies to create substantially more value for both buyer (management) and seller (owner).

Typical Management Buyout Transaction

Most management buyouts are financed by an equity "sponsor". A sponsor is typically a private equity firm that offers to purchase a company from the seller and give management a percentage of the ownership. For a smaller, profitable business (i.e. less than $100 million valuation) most buyouts are usually priced at around 5 X (times) free cash flow (i.e. earnings before interest taxes depreciation and amortization (EBITDA) minus capital expenditures). Management is typically offered the opportunity to invest some amount of capital for an ownership stake typically equal to 5% to 10% of the company stock. Through longevity and performance the management team may get the opportunity to double their ownership stake with additional options or stock. Total ownership, assuming all performance hurdles are met, rarely exceeds 20% of the company stock on a fully diluted basis.

For companies that are worth above $100 million, a 5% to 20% stake in a business can be very significant to each key member of management participating in the transaction. However, for a business that's worth $25 million, the opportunity for three or four members of management to split 10% of the ownership is hardly a financial windfall.

In addition to their 80% ownership, buyout or private equity firms also collect significant fees at closing and charge additional advisory fees while operating a company they've acquired. They also typically take a share of the investment profits. The average annual management fee to do business with a private equity firm is about 1.5% to 2.5%. The average share of profits is about 20%.

Another Approach to Management Buyouts

For financially healthy businesses, there is another approach that utilizes the same financing and buyout techniques the pros use but management ends up gaining ownership and operating control. In fact, management can end up owning 85% to 100% of the company depending on the situation. These types of buyouts are called *Non-Sponsored Leveraged Buyouts.*

How they work

In a non-sponsored buyout, key members of management are asked to invest an amount of capital that is significant to them personally (this can range from $25,000 to over $1,000,000) depending on the collective personal wealth of the management team. What is most important to the financial partners is that management has some 'skin in the game.' The remaining amount of the initial proceeds to be paid to the owner comes from debt that is loaned to the company for the purchase of the business. Within the capital markets, companies that proactively shop aggressive funding sources should qualify for total debt financing of at least 4X cash flow.[1] The proceeds from that debt (less capital needed for future working capital and growth) are paid

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[1]One of the most common private equity buyout offers is to purchase 80% of a company at 5 X EBITDA. Their pitch to the seller is that by buying only 80% of the business, they can be assured the owner will stay involved and help them grow it. They will also explain that through this approach the owner will get a 'second bite at the apple', which means he can sell his remaining 20% at a higher valuation as the business grows. Interestingly, purchasing 80% of a business at 5 X EBITDA equates to giving the entrepreneur cash proceeds equal to 4X cash flow, the same (4X) multiple that companies are able to finance on their own in the capital markets. For equity firms buying 80% allows them to minimize their equity investment by either committing little capital at purchase or pulling their equity out later through a refinancing. Both strategies are routinely used to create spectacular returns for their fund.

Table 1: Example of Buyout Scenarios

		4X		5X		6X	
Enterprise Mulitple of EBITDA		4X		5X		6X	
Company Valuation		$ 20,000,000	100%	$ 25,000,000	100%	$ 30,000,000	100%
Transaction Overview							
Total Financing Commitment	$ 20,000,000						
Less: Reserve for Future Working Capital	(2,000,000)						
Cash Proceeds from Financing	$ 18,000,000						
Plus: Management Cash Contribution	250,000						
Less: Transaction Costs	(500,000)						
Cash Proceeds to Owner	$ 17,750,000	$ 17,750,000		$ 17,750,000		$ 17,750,000	
Value Retained by Owner & ownership %		$ 2,250,000	11%	$ 7,250,000	29%	$ 12,250,000	41%
Management's Equity Interest			**89%**		**71%**		**59%**

to the owner in a one-time cash distribution. The difference between the amount paid to the owner and the total value of the company is the value and/or ownership retained by the seller. That retained ownership can come in different forms including common stock, preferred stock or subordinated seller notes or some combination of each. Table 1 illustrates different buyout scenarios at different valuations for a company with an annual EBTIDA of $5 million.

Advantages of Non-Sponsored Buyout

As the table suggests the amount of initial proceeds paid to the owner is capped by the amount that can be financed plus management's own equity contribution. While that initial amount maybe less than a 100% sale, often the difference can be relatively small depending on the valuation of the Company. Further, the advantages for both management and owner can be very significant.

Higher Ownership Stake for Management - The primary benefit of a non-sponsored buyout for management is the opportunity to own significantly more of the stock than possible with a sponsored transaction. Even at higher multiples such as 6 X (times) or more, management is positioned to own more than 50% of the total common stock, which is far more than the total ownership in a typical sponsored buyout transaction (usually less than 20%).

Higher Company Valuation for Seller – As mentioned earlier most private equity firms value companies at around 5 X (times) cash flow (EBITDA) and many times less. When selling to management, owners can typically get a *higher* valuation even though their initial proceeds will be limited to the amount of financing available plus management's contribution.

Greater Control for Both Management and Seller – With a non-sponsored transaction, control of the business is maintained between management and the owner(s). Provisions can also be made for control to pass as the debt is paid down or paid off under any scenario acceptable to both buyer and seller.

Highly Vested Management Team and Continued Role for the Owner – Management teams that have significant ownership stakes are much more likely to perform at high levels than those that have less of stake. Conversely, many owners feel remorse after selling their business and would have desired to maintain a role in the company. A leveraged non-sponsored buyout accomplishes both.

Significant Liquidity to the Owner – Even though the owner hasn't sold 100% of the business, the liquidity can be significant and is 'true' liquidity because the debt should have no personal recourse to the seller (owner).

Requirements for Non-Sponsored Buyout

The process of completing a non-sponsored management buyout is similar to other kinds of business financing. The key requirements for a successful non-sponsored buyout include:

Quality Company and Team – An ideal situation is for the buyer (s) to already be running a profitable business. Common situations would be a CEO that buys a company from a passive owner or a limited partner buying out his or her majority partner (s). The key

is for would-be lenders or investors to have confidence in the management team once the owner walks out the door.

Proactive and Committed Management Team – Many prospective buyers never ask for the opportunity to buy their owner's business. They are unsure and worried about how to bring up the subject. The best way to start such discussions is to informally ask, either over lunch or at an impromptu meeting. I have heard managers use phrases like, "would you ever consider selling the business to key management."? Or even more simply, "if you ever decide you want to sell the business, we would be interested to try to put together financing to buy it." When phrased that way it's difficult for an owner to feel threatened by such a question. Many may even say they have waited years to hear such words.

Once management has permission to pursue a buyout, they need to remain committed to doing a non-sponsored buyout. *Most* of the financial industry from equity firms to advisors to banks will try to encourage management teams to do a sponsored deal because it's easier for them. Unfortunately, an easy transaction doesn't help management get a large ownership stake in their company. Thus, it is important to remain committed and find advisors and financial institutions with experience and a desire to do non-sponsored transactions. Also, if the owner is already going through a process to sell the business, management can hire their own advisor and go out and put together their own offer. We have found that if management can put together a total package that is somewhat competitive to an outside offer the owners will pick management.

Target Purchase Price – Developing a purchase price can be complicated or easy depending primarily on whether the owner has a price in mind. Within the financial community a company's sales price is analyzed as a multiple of EBITDA. As shown earlier any purchase price between 4 X and 6 X (times) is likely to give management a much greater stake in the business than they would working with a private equity sponsor. Simply put, if the seller's desired purchase price is anywhere in this range, management should seek to pay it, especially since the owner is giving management a once in a lifetime opportunity. [2]

Maintain Flexibility with Owners - Books and guides to management buyouts suggest that management formalize their buyout terms similar to an acquisition through a Letter of Intent (LOI). This approach can be difficult because owners are always moving targets. They typically do not know really what they want until they are presented with options and feedback on financing terms. We suggest the management team get the owners to disclose the target purchase price and expected initial cash proceeds from the buyout. Once you receive initial financing terms, owners may continue to change what they want. Some owners even decide to provide some of the financing themselves once they see the rates certain lenders will receive. Regardless, owners typically stay moving targets right up until the end of the transaction so it's important to keep them in the loop, have them committed to a process, and let them adjust as the process unfolds.

Strong Business Plan – The basis for the buyout and its potential should be spelled out in a very high quality business plan. The better and more thorough the business plan and projections, the greater the interest from prospective financing sources and the better the financing terms and cost. A high quality plan is typically 40-60 pages in length with a concise well written explanation of the business, industry, history, competition and management. The business plan should also include historical financials and detailed projections including income statements, balance sheets and cash flows. Ideally, projections should be done for a 5 year period with the first two to three years projected on a monthly or quarterly basis. Those projections then outline how much capital the company will need both now and in the future. The projections should be optimistic yet achievable. Creating a quality business plan is often the most tedious part of the financing process, however advisors (such as our firm) will typically take on the role of drafting and distributing the business plan which allows the plan to get out to the appropriate financing institutions faster and with less fatigue for management.

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[2] It is also possible to pay higher multiples too. Some businesses that are in industries that are acquired by well known consolidators often sell for higher EBITDA multiples because the acquirer can cut costs and raise the company's cash flow after purchase. In those instances, management can still look to do a buyout at a higher multiple, however, the initial cash payment to the owner is limited by the company's current EBITDA multiple. Thus, there may be a big difference between the upfront cash the owner receives by selling to management rather than a strategic acquirer.

Understanding of Financing Options – Financing for non-sponsored buyouts can be comprised of various forms of debt instruments. Most CFOs have a good understanding of working capital and term debt that are collateralized by assets such as accounts receivable, inventory, and/or property plant and equipment. However, many leveraged buyouts require debt financing beyond traditional bank financing. A common debt product used to increase borrowing amounts is *mezzanine* or *subordinated debt financing*. These products are offered by insurance companies, corporate development companies, hedge funds and other specialty finance firms. Many entrepreneurs and CFOs will shy away from such instruments because they have a higher cost and often include some amount of equity participation through warrants.[3] A big positive however is that these instruments allow management to borrow far more than they could with only bank or senior debt, thus making the transaction appealing to both buyer and seller. Table 2 illustrates the point.

The composition of debt (senior vs. subordinated debt) will be based on the underlying collateral, market conditions and aggressiveness of the lenders. The intent of subordinated debt instrument is to provide a flexible source of financing that increases the amount a company can borrow while minimizing dilution without increasing the *risk to the borrower*. (Most subordinated debt instruments have no personal guarantees). The loan, while expensive relative to other forms of debt, is expected to be paid off with future cash flows or a refinancing with cheaper sources of capital, such as lines of credit and senior term debt, as the company grows larger. A future refinancing is also a time to consider buying out the owner's remaining interest in the business. The more the company has grown the higher the future purchase price but the cheaper the capital is to buy it.

Competition for Financing – Equally important to how much a company can borrow is the cost of the capital. Bankers do not like to compete but competition can *dramatically* reduce the overall cost of capital. Traditional banks tout the value of relationships yet relationships rarely drive pricing or creativity as much as competition. Private equity firms know this and they will often use competition extensively. It is not uncommon for a private equity firm to solicit as many as 50 institutions to find financing partners that will give them the best terms. Management teams should do the same in order to have more competition. Competition

[3] *How Subordinated Debt and Mezzanine Financing Work*– Most of these debt products are structured as 5 to 7 year term loans with interest only payments for the first 3 to 5 years. Funds that offer these instruments seek a total return of between 15% and 25% per year. To get that return they typically charge 12-14% interest and then make up the difference with added compensation through detachable warrants. Detachable warrants give the lender the right to acquire a certain percentage of the company's stock either after the maturity of the note or upon a liquidity event such as a sale of the company or initial public offering. In practice, most warrants are repaid through a 'put' option where the lender proactively requests ("puts") to be paid out based on their percentage of warrants and the value of the company at the time of the put. Companies can be valued any number of ways, but most are valued based on a multiple of cash flow (often 5 or 6 times) at the time the 'put' is exercised. Once the warrant price is paid, the fund loses its ability to purchase the company stock thus eliminating any ownership dilution for the company's shareholders (management or seller).

Table 2: Buyout Illustration With and Without Subordinated Debt

	With Subordinated Debt		With out Subordinated Debt	
Enterprise Mulitple of EBITDA	5X		5X	
Company Valuation /Sale Price	25,000,000	100%	$ 25,000,000	100%
<u>Transaction Overview</u>				
Senior Debt	$ 10,000,000		$ 10,000,000	
Less: Working Capital	(2,000,000)		(2,000,000)	
Subordinated Debt	10,000,000		-	
Management Equity Contribution	250,000		250,000	
Transaction Costs	(500,000)		(500,000)	
Initial Proceeds to Owner	**$ 17,750,000**		**$ 7,750,000**	
Value Retained by Owner & ownership %	7,250,000	29%	17,250,000	69%
Management's Equity Interest		**71%**		**31%**

means that senior lenders (the least expensive form of financing) will stretch to maximize their loan amounts while subordinated debt lenders will have to carefully monitor the amount of warrants or total return they seek. As such, financial institutions will often significantly discount their fees when competition is involved. We have seen firms resubmit proposals and cut their pricing in *half* after learning their first proposal was not competitive with other offers. For management the cost of financing can also impact their resulting ownership.[4] Table 3 shows a range of pricing on different financing proposals.

Table 3: Pricing Examples

	Low End	High End
1	$12 Million 13% Interest Rate 15% Warrants	$12 Million $13% Interest Rate 35% Warrants
2	$19 Million 12% Interest 5% Warrants	$19 Million 13% Interest Rate 15% Warrants
3	$22 Million 13% Interest No warrants or equity	$22 Million 9.5% Interest Plus 51% Equity Ownership

Know about ESOPs and Other Special Tax Elections – Business owners looking to sell their business and retire focus not only on the sales price but the after tax proceeds from the sale. As such they look for elections, approaches or incentives that will limit their tax burden. Most well known of those elections is an Employee Stock Option Plan (ESOP). An ESOP, whether leveraged or not, enables sellers to defer the tax liability on the proceeds from the sale of a company if the proceeds are reinvested into specific assets. ESOPs also allow management to deduct all or part of the debt repayment as an expense, creating significantly more free cash flow to pay down debt. While these benefits are widely known, what is less understood to acquiring managers is that ESOPs also impose limitations on the amount of stock any one employee can own. Ownership between management is based on relative salaries and everyone in the company is allowed to participate. This means the CEO and key management, really running and responsible for the business, may end up owning a small share (i.e. less than 20%) of the company stock. Thus, the end result is an ownership interest for key management that would be similar to doing a buyout with a private equity firm, but where *all* the employees own stock rather than an outside investor that funds the buyout.

If businesses are looking at alternatives such as an ESOP, key management should look for ways to provide the owner the same after tax proceeds. Thus, one approach is to increase the value of a company to an extent whereby the value of the after tax proceeds from the sale would be the same as from an ESOP.

Another approach is to look for other special elections. A key election for S-corporation doing buyouts is a *338 (h) 10 election.* This election allows owners of an existing S-corporation to sell the company stock (as opposed to assets) but the acquiring entity is able to write up the assets and record goodwill and amortize it as an expense which significantly increases the available cash flow for debt service. This election for S-corporations enables managers and financing sources to pay a higher price and/or reduce the time for debt repayment by a year or more.

"If businesses are looking at alternatives such as an ESOP, key management should look for ways to provide the owner the same after tax proceeds."

[4]As discussed earlier warrants are a financial instrument that give the lender the option to acquire a certain percentage of a company's stock in the future (typically after maturity of the note or upon the event of liquidity such as an IPO or sale. Often times warrants are not redeemed to stock but are paid off by a company through a future refinancing which eliminates any equity dilution to the shareholders. Either way warrants do not impact operating control like equity does, but the amount of warrants can have a substantial impact on the total cost of capital. As such, companies almost always choose the institution offering the lowest warrants and cost of capital.

Company Example: Putting it all together

Two years ago the owner of well respected service business hired an investment banking firm to sell his company. The owner and management team after holding numerous meetings received a proposal from a private equity firm. The offer was to purchase the 100% of the business for approximately $20 million equating to a valuation of 4.7X (times) EBITDA.

After reflecting on the offer, neither management nor the owner was excited. Management didn't like their rapport with the equity firm while the owner had second thoughts about completely walking away from the business he had spent 25 years building. In the end he wanted to continue down the same path, working about 20 hours a week and participating in the direction of the Company. But still wanting personal liquidity, a significant stake for management and a meaningful role going forward, the owner decided to let management identify a financing and buyout strategy that would work well for everyone.

Striking a Deal

While trying to figure out how to proceed, the business continued to grow reaching an annual EBITDA of $5 million. The owner realizing that he was enabling management to purchase the company, offered to sell 80% of the business to four members of management at 6X (times) trailing EBITDA equating to total company valuation of approximately $30 million. With the help of Lantern Capital Advisors, management developed a comprehensive business plan and then met with numerous funding sources including banks, specialty lenders, hedge funds and other finance companies. Through that process management received financing proposals with initial proceeds ranging from $17 million to $24.5 million. The owner seeking maximum liquidity chose one of the proposals offering $24.5 million. Of this amount $23.5 million was used to finance management's portion of the buyout. The remaining $1 million was offered to provide working capital for the business after the close of the transaction. The difference between the amount received by the owner and the value of his 80% interest in the business was captured in a seller's note (about $1 million) to the owner.

For the four key players in management this buyout transaction was a life changing event. Instead of collectively owning 10%-20% and working for someone else, management owned 80%, controlled their own destiny and created meaningful wealth for themselves. The owner was at peace since he sold at a higher valuation, is still active in the business and was able to reward the key members of management that had helped build the company over many years.

Summary

With some knowledge of the management buyout process and financing alternatives, management teams and owners that want work with each other can create customized solutions that create tremendous value for all parties involved.

"Instead of collectively owning 10%-20% and working for someone else, management owned 80%, controlled their own destiny and created meaningful wealth for themselves."

About the Author:
Chris Risey

Chris Risey is the founder and President of Lantern Capital Advisors, an Atlanta-based financial consulting firm that specializes in helping successful entrepreneurial companies finance growth, acquisitions and buyouts. Since its formation, Lantern Capital Advisors has helped clients develop strategies and fund their Company in a way that best suits their unique needs and growth potential.

Prior to founding Lantern Capital Advisors, Mr. Risey served as a Managing Director for niche consulting firm that provided corporate financial consulting and helped companies raise capital from a variety of institutions including banks, specialty and mezzanine lenders, venture capital firms and underwriters. After nine years, Mr. Risey left to launch his own financial consulting firm to provide cost effective services, guaranteed results and high client satisfaction. Chris started his professional career as a CPA in the audit and advisory services group for Arthur Andersen in New Orleans, Louisiana.

Active within the business and civic community, Mr. Risey has served for many years in a variety of leadership roles within Rotary International, Financial Executives International and The Association for Corporate Growth. Mr. Risey is also a frequent writer and speaker to financial executives and entrepreneurs throughout the country interested to learn more about today's financing and planning strategies that have created significant value for a variety of companies.

Mr. Risey is a magna cum laude graduate of the University of South Florida with a degree in Finance. He was twice named Academic All-American (Men's Basketball) and is a former Rotary International Ambassadorial Scholar and studied at the Australian Graduate School of Management at the University of New South Wales in Sydney, Australia.

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Many clients have limited prior experience in the capital markets and want to gain the benefit of an experienced advisor to source funding alternatives and give advice that is in their best interest. Lantern Capital Advisors hourly based approach uniquely positions us to do just that. Our professionals have been engaged in a broad array of large and small assignments across various industries across the United States. Common client engagements and activities include one or more of the following:

- Evaluate growth and valuation alternatives
- Secure capital for growth or liquidity
- Coordinate mergers/acquisitions
- Coordinate management buyouts
- Prepare quality business plans
- Replace current lenders or investors
- Remove personal debt guarantees
- Solicit underwriters for securities offerings