ISC VENTURES

the MBO guide

What is a Management Buy-Out?

A Management Buy-Out (MBO) is the purchase of a company by its management team. Management typically acquire a controlling or significant equity stake for a relatively small personal investment. The remaining funds required are usually provided by external parties as a combination of debt and equity.

In the first few years of an MBO, the cashflows of the business are typically applied to servicing and repaying the debt taken on as part of the transaction. Over time, the management team has the opportunity to deliver a substantial increase in shareholder value both by paying down the debt and by increasing the underlying profitability of the business.

As an existing senior manager you may be in a good position to bid for ownership should the current owners be looking to divest all or part of their shareholding. Typically such a divestment occurs when an owner wishes to realise value in a retirement situation or when part of a business is deemed non-core.

As an existing business owner, you may already be thinking about an exit strategy and considering potential buyers for your business. A sale to management can provide a number of advantages over alternative exit routes and is usually worth including in the range of options for consideration.

If you are a manager with aspirations of owning your own business or an existing business owner looking to realise your investment an MBO could provide the answer you are looking for.

> "An MBO can provide a once in a lifetime opportunity to take ownership of the business you manage"

Key ingredients for success

There are four key ingredients for a successful MBO, namely:

1. Strong management team

The most important factor in an MBO is the management team. Financiers will need to be confident that the team that they are investing in have all of the attributes to make the business successful. The team should have the all round strength to manage the business independently and the drive and commitment to lead and grow the business after the transaction. Leadership is important, but a successful MBO is a joint effort by the right mix of managers. A typical MBO team would include the roles of Managing Director, Sales Director, Operations Director and Finance Director.

2. Clear Growth Plan

A commercially viable existing business with a well-developed growth plan is an essential part of a successful MBO. The business must be capable of operating commercially as a standalone entity with a clear vision and growth plan. The business will need to generate sufficient profit and cash to repay debt and sustain the business as it grows. Additionally, the growth of the business will ultimately drive future shareholder value.

3. Financiers/Exit Strategy

The management team will require the financial support of investors and banks in order to fund the transaction. Financiers will want a return on their investment and will often require a suitable exit strategy to achieve this. An early consideration of future exit options will enable management to choose financiers with a matching exit horizon.

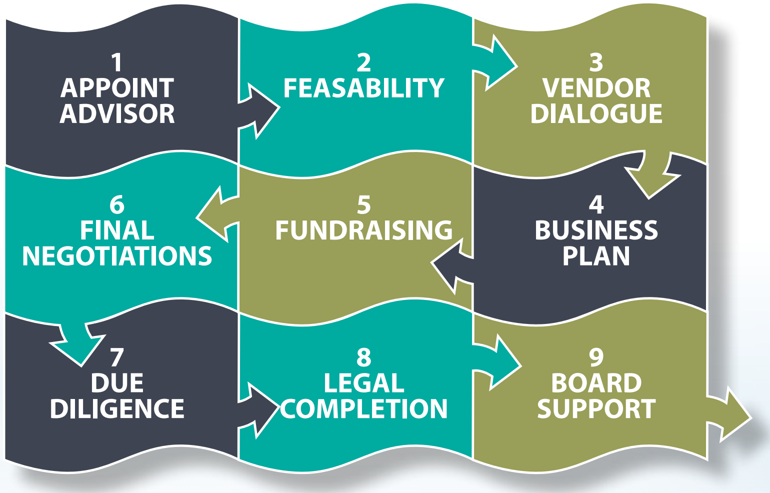
4. Willing Vendor

An existing owner will need to have thought about the possibility of a sale to management to enable an MBO to occur. However, many owners will not have considered a buy-out by management until it is suggested to them. It is therefore worthwhile understanding the advantages of an MBO for the owner, particularly when compared to a trade sale. These advantages include the following:

- **Confidentiality** - commercially sensitive information is not released in the wider marketplace;
- **Warranties & Indemnities** - given the management team's knowledge of the business the warranty obligations that a vendor will have to enter into are likely to be less onerous in an MBO;
- **Flexibility** - greater flexibility exists to deliver the owner's preferred consideration package, which may include an ongoing equity stake in the business;
- **Continuity** - continuity for all stakeholders within the business, including management, employees, customers and suppliers;
- **Deliverability** - the management team's knowledge of the business means that an MBO offer will often be seen by a vendor as more credible and deliverable proposition, being more likely to hold firm throughout any due diligence process; and
- **Speed** - MBO's can present a more timely completion process, particularly with the full cooperation of all parties.

"The quality of management is without exception the most important consideration in any MBO"

The MBO Process



1. Appoint Advisor

A corporate finance adviser should be appointed right at the start and will be fully involved in all aspects of the transaction until completion. The corporate finance adviser will work very closely with the management team throughout the whole MBO journey. It is therefore vital to select an adviser you feel you can work with and who will provide the necessary experience and support throughout. The key roles of the corporate finance advisor are to assess feasibility, lead negotiations, introduce financiers, manage the production of the business plan/financial projections, manage the due diligence and legal completion processes, deliver value for the management team, project manage the MBO process and ensure the transaction completes on a timely basis.

2. Feasibility

The corporate finance adviser will assess at the outset whether the business meets the criteria for a successful MBO. This feasibility would encompass a strategic review of the business, the growth opportunity, the management team, the standalone financials, any taxation implications and an early assessment of potential financiers. Although the financial structure will evolve throughout the process it is important to consider at an early stage a rough outline of the potential transaction structure to understand whether the proposed transaction and valuation will be both viable and fundable. It is crucial to understand whether an MBO is at least feasible before entering into detailed discussions with the vendor.

3. Vendor Dialogue

Without a willing vendor the transaction will not happen and so a suitable approach should be made early on in the process. It will depend on individual circumstances as to whether it is appropriate for the adviser or the management team to approach the vendor. It is important that these discussions are handled carefully and that a clear and effective dialogue is established with the vendor from the outset.

Heads of Terms are usually entered into between the vendor and the management team once broad agreement has been reached on the transaction parameters. Most of the terms set out are not legally binding. However they provide clarity and demonstrate commitment to enter into a legal agreement on specified terms and therefore should be considered and negotiated carefully. This document would also make reference to sensible period of exclusivity during which the MBO process can be completed.

4. Business Plan

The business plan is an important document and its main objective is to help raise finance. A well-presented business plan is also a key factor in securing funder confidence in the management team and the business. The business plan is thus primarily a sales document and should demonstrate the management team's commitment to the MBO. Management must take full ownership of the business plan and financial projections, but usually the adviser will give guidance and will critically evaluate the business plan before it is circulated.

The business plan is usually 15 to 20 pages, with sections covering an executive summary, business overview, market summary, management team, growth plan and financial projections. Detailed financial projections (usually appended to the business plan) need to be presented over a three to five year period, and incorporate a monthly profit and loss, balance sheet, cash flow and covenant analysis.

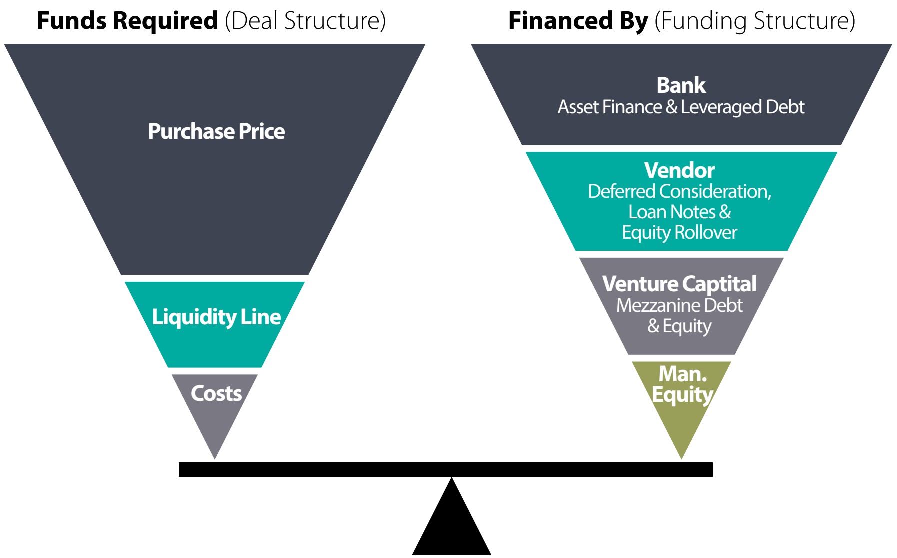
"A clear, concise and well-prepared business plan underpins all successful MBOs"

> Striking the right balance within the deal and funding structures is critical to the short, medium and long term prospects of the MBO

5. Fund Raising

Armed with a business plan the corporate finance advisers will identify and select a limited number of potential financiers that are well suited to invest in the transaction, based on the capital required, the financiers' prior track record and the financiers' appetite for such a transaction. It is critical to establish a working relationship and compatibility between the financiers and the management team.

The management team is usually expected to contribute a relatively small amount, with the majority of funding coming from a bank and/or a venture capitalist. The owner may also provide part of the funding by leaving money in either as a loan note and/or as a reduced equity stake going forwards. Funds raised will be used to pay the purchase price of the business, provide working capital to the business post-completion and cover the professional costs of the transaction.



6. Final Terms

Following the presentation of the business plan and financial projections the lead adviser will typically seek to negotiate and agree final terms on behalf of the management team with the selected bank and venture capitalist. This will also usually coincide with a reaffirmation and agreement of final terms with the vendor. The key objective of this stage is to agree all material terms with all parties, subject only to due diligence and legal completion

7. Due Diligence

MBO due diligence is typically more straightforward given the management team's existing first hand knowledge of the business. However, it remains necessary as the financiers will require a level of independent scrutiny to ensure that there is nothing that contradicts their understanding of the current state and potential of the business. The individual elements of the due diligence process may include commercial due diligence, financial due diligence and legal due diligence.

8. Legal Completion

It is common for each of the parties (bank, venture capitalist, management team and vendor) to have separate legal representation. The are a number of legal agreements between all these parties, all of which need careful attention.

Competent and experienced lawyers will maximise and protect value for the management team and contribute towards a timely completion process. There is a considerable amount of legal documention involved and when all is finally signed it's usually time for a well-deserved glass of champagne!

9. Board Support

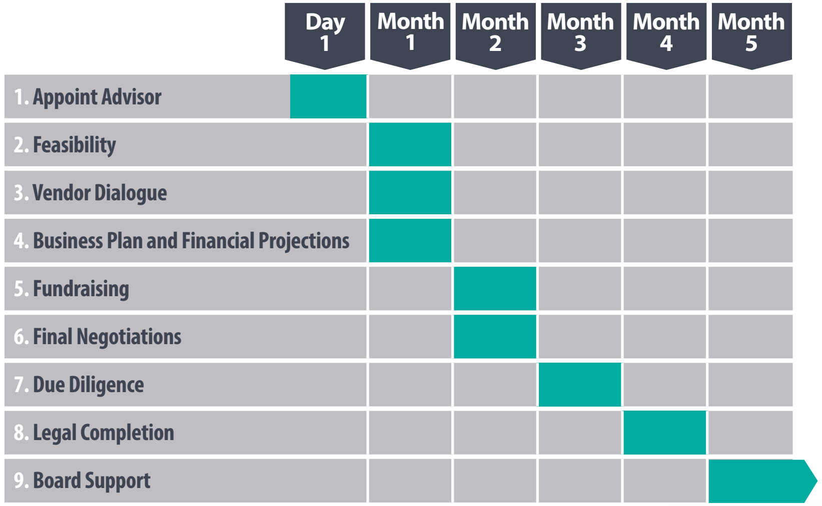
Managing the business effectively must become the top priority immediately after legal completion, typically with an initial focus on a '100-day plan'.

The venture capital investor will probably want to appoint a representative to the Board of Directors, together with a suitably experienced independent Chairman. The selection of the Chairman will usually be a joint process between the management team and venture capital investor, typically occurring within the first couple of months after completion.

The focus for the management team and all shareholders is then the delivery of their business plan - when the real work begins.

Timetable & Transaction Costs

An MBO usually takes between three to five months to complete, depending on the complexity of the transaction and the position taken by the various parties within the transaction. An illustrative timetable is outlined below:



The new company established to undertake the MBO will settle all transaction costs on the legal completion of the transaction from the finance raised. Additionally, most transaction costs will be on a contingent basis (being dependent upon a transaction successfully competing) thereby ensuring the exposure of the management team is minimised should a transaction not occur.

> "An MBO typically takes three to five months to complete"

Potential Investor Returns

It is worth remembering that all the parties enter into a buy-out because they expect to gain something from the process. The main reason management teams undertake MBOs is to gain independence and autonomy, a chance to influence the future direction of the company and to make a significant capital gain from a relatively modest personal investment.

The realisation of value for the management team and financiers will largely depend on the exit of the business. An exit will usually be achieved through a sale of the company to a trade acquirer, the flotation of the business, the sale of the business to an institutional investor or the management may buy-out the venture capital investors through a secondary buy-out.

An illustrative transaction structure:

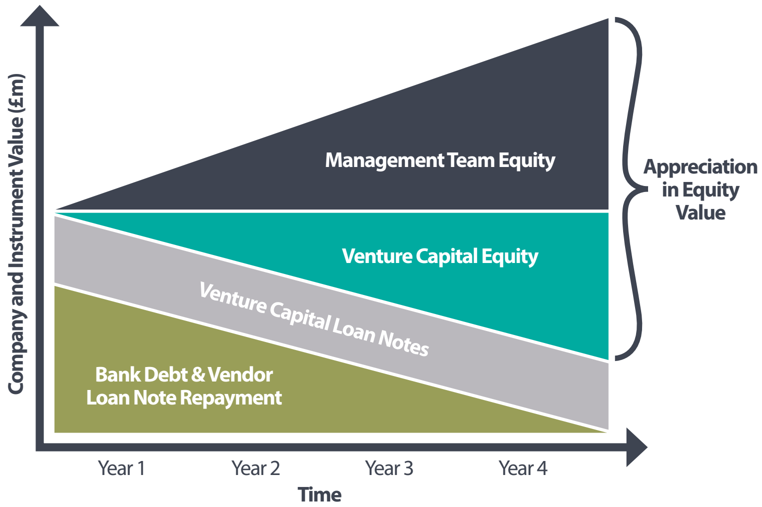
This analysis assumes the business is acquired for an overall enterprise value/ consideration of £20.0m, being financed by bank debt of £10.0m, vendor loan notes of £3.0m, venture capital investment £7.5m and a management investment of £0.3m. For their investment, the venture capital investor receives a 40% equity stake in the company, with the management team receiving a 60% equity stake.

	Completion Date	During the Transaction	Year Four
Funds Required:			
Enterprise Valuation / Consideration	£20.0m		£40.0m
Transaction Costs	£0.8m		-
	£20.8m		£40.0m
Financed By:			
- Bank Debt	£10.0m	£(8.0m)	£2.0m
- Vendor Loan Note	£3.0m	£(2.4m)	£0.6m
- Investor Loan Note	£7.3m		£7.3m
- Investor Equity (40%)	£0.2m		£12.0m
- Management Equity (60%)	£0.3m		£18.1m
	£20.8m		£40.0m

Note: The above example does not include any vendor equity participation which could also provide a source of funding

Within this analysis it has been assumed that after four years the business has doubled its earnings, resulting in an enterprise valuation/consideration of £40.0m. Over this four-year period the business has also repaid a substantial amount of the bank and vendor loans from the operational cashflow generated. After the assumed exit at the end of year four, these proceeds would first be used to settle any debt the business holds: being bank debt of £2.0m, vendor loan notes of £0.6m and venture capital loan notes of £7.3m. The remaining consideration would then be split between the equity holders: being £12.0m for the venture capitalist and £18.1m for the management team.

Under this scenario the proceeds received by the venture capital investor would be above 2.5 times their original investment and the management team's initial investment of £0.3m would be worth £18.1m. This appreciation in equity value is highlighted in the graph below.



> “MBOs can provide the opportunity to significantly increase shareholder returns in a short period of time”

Role of Isca Ventures

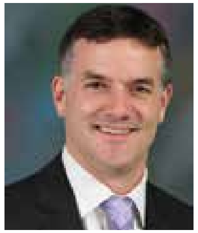
Isca Ventures are experienced in all aspects of delivering successful MBOs.

When choosing your corporate finance adviser we recommend you consider the following key attributes of Isca Ventures:

- Unique blend of corporate finance and Board Director experience, within numerous successfully completed MBOs;
- Independence ensures no conflict of interest with our clients or the vendor;
- Impressive track record of transactional success provides our clients with an early endorsement for their business, growth and financial plans;
- Partner-led advice throughout the transaction will maximise the prospect of a successful completion;
- Long-standing relationships with a range of potential financiers will ensure you attract the right partners; and
- Success orientated transaction costs assures you that we are willing to be judged by our results.

This guide provides a generic overview of an MBO.

For additional advice relating to your business, we would be delighted to meet on a no-obligation basis to discuss your circumstances in a more personal manner. Please don't hesitate to contact our Partner team.



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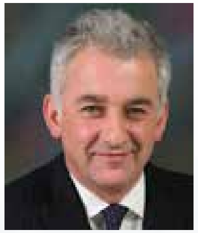

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"We understand the steps required to complete a successful MBO and our approach is built around being in for the journey"

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