BOOM AHEAD IN BUY-OUTS

THE MANAGEMENT TRANSFORMATION

by PETER THOMAS and MICHAEL CUMMING

Although in their infancy in Australia, management buy-outs and employee buy-outs have caught the imagination of investors and financiers. But not every company is a suitable target for an MBO.

The combination of large corporates returning to their core activities, the growing desire of management to have an equity stake in their business, and the fiercely competitive lending environment, is giving prominence to management buy-outs (MBOs) in Australian financial circles.

The potential for MBOs in Australia has really been recognised only in the past 18 months with the launch of a number of new entities specialising in this form of financing, such as Byvest and the Pacific Buy-out Trust. Australia now is probably on the threshold of considerable growth in MBOs and is in a similar position to the US and UK in 1981. Since then the value of MBOs in these two countries has risen some 12 to 14-fold to $A55 billion and $A3 billion respectively. Last year in the UK MBOs accounted for 15 per cent of all takeovers by value. MBOs in Australia last financial year accounted for about $A200 million. However, given that the Australian economy is small in comparison with the US and UK, it is unlikely that the growth in MBOs in Australia will be at as high a level.

What then is an MBO? The essential ingredient of a management buy-out is that there is a change of ownership in a company in which the new owners include shareholders who are involved in the day-to-day running of the business. They are characterised by a higher-than-normal debt-to-equity ratio. MBOs include:

- Management buy-outs, in which a limited number of managers of a corporation, usually the top management, acquire a significant stake in the ownership of the corporation; because of wealth limitations, true management buy-outs are mostly confined to companies worth less than $5 million.
- Employee buy-outs, in which the new ownership is spread widely among many employees rather than simply the management; a particularly suitable type of buy-out for small "people" businesses where assets go up and down the lift-shaft every night.
- Institutional buy-outs, in which the impetus for the MBO has come from the primary funds provider and management acquires less than a controlling interest because of the large amount of finance needed for control. Managers work for new owners, the institutions, but with a significant minority equity position.
- Management buy-in, in which financiers back a management team with a strong track record to start a new company, or revitalise a company, in the same business in which the management team has its expertise.

It is expected that the next few years will see considerable growth in MBOs in Australia. The reasons for such growth are several and include:

- Corporations which are expanding by acquisition encouraging MBOs of their non-mainstream business.

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- The emergence of financiers who understand the market and its needs.
- Favourable press publicity, which is self-reinforcing and almost exclusively positive.
- A shift in political attitudes, one of the outcomes of which is the current privatisation debate.

Going by the UK experience, MBOs will begin in earnest in Australia when they become acknowledged as an ideal way for subsidiaries or divisions to be hived off from large groups. In the UK, industrial groups facing increasing economic pressures found that subsidiaries or divisions outside their mainstream activities were demanding a disproportionate amount of funding or senior management time, or were not performing well enough to justify their continued existence in the group. Whereas previously the most likely course of action would have been a straight sale to another company, or closure of the operation, MBOs have become a more attractive alternative.

If existing management takes control, continuity is ensured and personnel who best know the company are retained. Managers inevitably have a strong incentive to succeed if they lay themselves on the line financially.

Further, a buy-out of a company under threat is clearly more acceptable than closing it down and making more people unemployed.

While management has not, historically, been seen as the most obvious purchaser of a business, its intimate knowledge of an operation often puts it in the best position to make a bid, particularly if the company is a "people" business and not easily saleable to a trade buyer. Even if a company has failed financially there are instances where the management, which has not been involved in the faulty decision-making, has the potential to salvage something worthwhile from the wreckage.

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Large conglomerates are a potential source of MBOs because of the tendency for dynamic growth strategies involving shifting emphases in the conglomerate's portfolio of businesses. Thus smaller business activities can find themselves outside the main thrust of the group's strategy, particularly in the current environment where it is common to return to core activities, and dispose of activities in distant locations with limited growth potential.

Takeover activity often means the conglomerate ends up with smaller business activities which are not really understood by the board of directors. These peripheral businesses will also tend to be too small to be given adequate attention by group management. Failed corporate "marriages", too, are a likely source of MBOs.

Second and third-generation family companies are another source of MBOs (often known as "family hand-downs") as a certain commitment to a family's professional management tends to develop which can be adequately rewarded through an MBO, once family shareholdings become fragmented and widespread — it protects the jobs of professional managers (which would tend to be a casualty under the alternative strategy of selling the family company to a competitor) and at the same time grants them independence.

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An important source for employee buy-outs is government privatisation activity. Although buy-outs are not suited to enterprises the size of Telecom or the Commonwealth Bank, many smaller, less publicised activities are potential targets for employee buy-outs, which may bring the added advantage of answering many of the fears and reservations of the trade unions. Barclays' track record in the UK of employee buy-outs of public sector activities has been very successful. The most notable was the $A120 million employee buy-out of the National Freight Consortium in which more than 10,000 of the company's 25,000 employees subscribed for shares, the value of which has increased around 40 times since privatisation in 1982.

Another source of MBOs is receiverships. Generally receivers are an appropriate source only when the subsidiaries being considered for an MBO are not themselves the cause of the receivership. From the receiver's point of view, the need to act quickly is catered for by an MBO because the time-consuming initial assessment required by a third-party buyer is not necessary — the management is in a good position to act as it is familiar with the business, its suppliers and its markets. Receivers are a primary source of buy-ins.

The essential elements of a successful buy-out are:

- The business must be growing and profitable (or potentially profitable) and be capable of operating independently.

▒ The management team must be capable, cohesive and strongly motivated.

▒ The company must have a sufficiently strong cash-flow to finance its commitments.

A secondary but important requirement is that the company must be currently sufficiently healthy to cope with a sustained period in which management influence will be reduced, due to the diversion of management energies to the time-consuming implementation of the MBO.

Financiers participate in MBOs through a variety of instruments including straight debt, redeemable preference shares, convertible notes, convertible preference shares, ordinary shares and options. The more sophisticated development capitalists who invest in MBOs rely on their judgement of management and on their board representation to back their investments, although invariably there will be "crisis" controls in the shareholding structure, i.e. under certain conditions the development capitalist can take full control.

The primary benefit for the development capitalist normally comes from a listing of the company in the medium term. However, if the investor plans to have a short-term early recovery of investment through a profitable listing, there are, in the case of previously listed entities, implicit questions as to whether the management and the development capitalists have used insider information at the expense of the pre-MBO shareholders.

The development capitalist obviously gains considerable leverage by arranging to hold options exercisable at par on or near listing. However, the more sophisticated development capitalists, whose long-term view is one of continuing association with the business after listing (albeit reduced in percentage terms), avoid options: strains in the relationship with management can occur at listing when, after five years or so of grind, the management resents seeing the development capitalist take a quick profit on the listing premium by exercising his options at par. Similarly, the sophisticated development capitalist will avoid "hurt" money, e.g. there is little point in creating a situation where, in the event of a serious crisis when the interest of all parties will be best advanced by the manager being able to devote his maximum energy to the business, the manager is worried by the knowledge that his family home is on the line.

Below is an example from Barclays Development Capital Limited, London, of the structuring of an MBO and its history. The company, W.K.R. Limited, was purchased by management from Rockwell Corporation in December 1980. W.K.R. Limited designs, manufacturers and markets microprocessor-based electronic testing and measuring equipment. The table indicates that in 1982, profits were insufficient to service preference share dividends.

In April 1985 the company was floated on the UK Second Board (equivalent). The issue was eleven times oversubscribed and the market value on listing was 13.5 million pounds. The original 80,000 pounds subscribed by the management had a value of 5.4 million pounds, as did the 920,000 pounds subscribed by the development capitalists. A successful MBO! □

INITIAL CAPITAL STRUCTURE

Holder	Instrument	Cost		Equity	
		pounds '000	pounds '000	no conv. %	conv. %
Management	Ordinary shares	25.50		51.0	20.0
Barclays Dev't Cap.	Preferred ord. shares	12.25		24.5	9.6
I.C.P.C.	Preferred ord. shares	12.25		24.5	9.6
	TOTAL ORDINARY CAPITAL		50.0	100.0	
Barclays Dev't Cap.	Convert. pref. shares*	38.75			30.4
I.C.F.C.	Convert. pref. shares*	38.75			30.4
	TOTAL CONVERTIBLE CAPITAL		77.5		100.0
Management	Preference shares	54.50			
Barclays Dev't Cap.	Preference shares	409.00			
I.C.F.C.	Preference shares	409.00			
	TOTAL REDEEM. PREF. CAP.		872.5		
TOTAL EQUITY			1,000.0		
Barclays Merc. Bank	Secured loan	500.00			
I.C.F.C.	Secured loan	500.00			
TOTAL LOANS			1,000.0		
TOTAL PURCHASE CONSIDERATION			2,000.0		

* Convertible into ordinary shares if preference shares not redeemed on due dates commencing in December 1986.

TRADING RECORD

Year	Sales pounds '000	Pre-tax Profits pounds '000	
1979	3,387	(218)	
1980	4,833	292	Pre buy-out
1981	4,682	488	Post buy-out
1982	4,268	64	
1983	6,973	635	
1984	10,954	1,103	