MANAGEMENT

An opportunity for business owners

By Howard E. Johnson

Management buyouts have become increasingly popular in recent years due in large part to the abundance of available capital from financial investors throughout North America. Financial investors provide capital and work with the management team to grow the business. The payoffs from a buyout can be lucrative for the financial investor, management and the business owner. In most cases, the management team and the owner that retains a residual interest in the company can fare considerably better (in relative terms) than the financial buyer where the company exhibits strong operating performance following the transaction.

For business owners seeking to sell their company, buyouts can be an attractive option compared to selling to an industry buyer for several reasons.

- Financial buyers tend to react more quickly than industry buyers.
- Confidential information about the company is not exposed to competitors.
- Financial buyers generally offer cash deals, whereas industry buyers may seek less favourable structured payment terms.
- Management can feel like part of the process, rather than being concerned about what will happen to their jobs after the transaction.
- The business owner can enjoy upside potential by retaining a residual interest in the company.

In addition to an outright sale, buyouts can be a powerful vehicle for companies seeking capital to expand or for business owners who simply want to divest of a minority position in their company.

Adequate planning and preparation are critical for business owners to undertake prior to seeking out financial investors and in structuring a deal that meets their personal and financial objectives. Financial investors generally prefer companies that have a sustainable competitive advantage, good growth potential (including a well conceived business plan setting out the growth opportunities and risks involved) and a strong management team. Financial investors like to see management co-invest in the company in order to secure their commitment and be motivated by significant upside potential. They also prefer to see the owner retain a residual interest in the company, in order to ensure a smooth transition.

Strong cash flow generating capability, which in turn allows the financial investor to finance the transaction with some amount of debt, is also key. Finally, they want exit strategy opportunities. Financial investors generally have a three to seven year time horizon for liquidating their investments, either to another financial investor, an industry buyer or, in some cases, a public offering.

Importantly, a management buyout is not a one-way street. The management team (and the owner who retains a residual interest in the company) should expect to receive more from the financial investor than just a lump sum of cash on closing. There are other important considerations too.

- The ability of the financial investor to accommodate follow-on financing that may be needed to support growth or an unexpected shortfall in cash flow.
- Alignment of interests in terms of growth strategies, participation in upside potential and their level of tolerance for shortfalls from plan.
- Value-added service offerings. Financial investors should provide things such as business advice, customer contacts and other support to help the business grow and prosper.

Management buyouts can provide an attractive exit strategy alternative for business owners where the interests of all parties to a transaction can be aligned. The financial payoffs can be substantial for the financial investor, management and the business owner where expectations are realized.

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