Management Buyout and Leadership Succession – Financing Case Study

Management buyout (MBO) and leadership succession transactions are options for owners that seek to exit. In earlier blogs I overviewed these transactions, pointed out common features, considered valuation, and wrote on motivations. In this blog I will take a quick look at financing with a case study.

Debt and Equity

Lets consider in the context of a 100% management buyout. We all know that financing is a mixture of debt and equity.

Equity can be management equity, or private equity. When we consider management equity we differentiate what is genuine management equity from debt raised privately by management (such as additional debt on private real estate). This distinction is important as a senior lender into the transaction will take a perspective on the total leverage in the transaction including that which may be raised separately outside the business by management. Private equity refers to either organised equity (such as a private equity fund) or a non management equity party introduced to the transaction. If private equity is a part of a transaction it is important that more is brought to the table than money. Private equity must come with shareholder attributes that add to the business, at a governance level or strategic relationship level.

Debt can be senior debt or mezzanine debt. Such debt is a mixture of term loans, plant finance, real estate finance, overdraft, debtor financing and the like. Mezzanine debt is the bridge between senior debt plus equity where it falls short of the vendor price. Finally we have a component we call vendor deferred (illustrated in the case study).

For most transactions in New Zealand (so under $15m) there is very little appetite from private equity funds (as distinct from private equity). Equally, mezzanine finance is scarce, and its providers tend to have an appetite for equity rather than solely interest. Be mindful of the fundament principle that debt structure must match the underlying assets used as security and their depletion or income generating capacity. Therefore anticipate principal and interest on each tranche of senior debt matched to its underlying security. The days of large interest only facilities are behind us.

Case Study

So here was a infrastructure business where the intention was a generational succession in a single transaction. The price was arms length and roughly $9m, based on an EBITDA of roughly $2.3m. The business was well established and had minimal debt. A couple of sizable near term jobs that were likely but not committed has resulted in acquisition of considerable inventory and other consumables. The incoming owner has minimal personal (management) equity. A bank was willing to lend around $5m on acceptable principal and interest terms. Their absolute sweet spot was a little under $5m and they were willing to extend to a bit under $6m but would be on far less attractive terms and with acute covenant oversight. The vendors were always going to be willing to provide the equity component (as vendor deferred) however in what form? We proposed two tranches of convertible preference shares. One required redemption within four years the second within six years. The coupon rate was a base with share of upside based on profit, which left a strong purchaser motivation to complete the redemption but vendor assurance that the opportunity to convert was acceptable security. There were various rigorous covenants in the issue terms, notably around distributions. Each tranche was around $1.5m.

This still left a gap. There is always a gap. Ultimately the solution was to finalise senior debt at just over $5m and then a $750k mezzanine finance facility was provided by the vendors. Why? Whilst on very robust lending terms, it reflected banking belief where it was best suited. The two near terms jobs and build up of inventory preceding them was a risk the vendor had instinctive comfort with and which the senior lender, while willing to lend into it, caused a colouring of their approach to all the senior debt. So the acute period of risk for the purchaser was the duration of risk in those two pieces of work. As it transpired the work was won, the value delivered and mezzanine finance paid off in seven months – comfortably ahead of the drop dead loan terms date of 10 months. Incidentally this negotiation of financing spanned six months, it took time to get everyone comfortable with their roles.

What does this tell us? Well, as I said, there is always a gap and the art is often how you deal with the gap, to understand peak risk and de risking. It also tells us that financing means the right financing, not just any financing, and that it will take time. It is one of the joys in advising on these transactions. They have as their essence a positive transaction for both the vendor and purchaser (see my last blog on motivations) and for advisors will require both creativity and wisdom.

Now, as I do, to ***words.*** Lets consider **debt**. In English first used in the late 13th century, but comes from ***dette***, from Old French ***dete***, from Latin ***debitum*** "thing owed". Now **mortgage**. From old French "***gage***" is a pledge so mort "dead" turns into "dead pledge" or "debt until death". Proverbs (one of the Biblical wisdom books) says "Death and life are in the power of the tongue" (Prov 18:21), so our words can speak life or our words can speak death. Maybe you would like to retire the word mortgage in your thinking and use home loan.

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