2024 – 1st Edition

A comprehensive guide to

Management Buyouts (MBO) for independent owner-managed businesses

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Why are we writing about this?

Management Buyouts (MBOs) present a very attractive route for shareholders to exit at fair value whilst also empowering the team they have supported and built to take the reins. For management teams it presents a potentially life changing opportunity to own and grow a business they understand, and realise the value themselves in the future.

This combination of present and future value creation is positive for the lives of the people directly connected and for the British economy. MBOs delay trade sales that would shift value creation to shareholders of, often, much larger organisations where flows of future tax revenue are spread beyond the UK.

Price Bailey advise on numerous MBO deals every year spanning multiple sectors, each with their own unique motivation for selling via MBO and each structured to suit each scenario.

We are often approached by new and existing clients seeking to understand MBOs and their suitability for their business, with common questions including:

1. How does a Management Buyout work in practice?
2. Can I approach my team about selling the business to them via a Management Buyout?
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4. Who funds a Management Buyout?
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The major challenges regarding an MBO tend to be centred around 1) valuation, 2) affordability, 3) the quality of the MBO team, 4) the market the business operates in, and 5) the business model and operations of the business.

Management buyouts are always relevant, but they become particularly relevant at times when alternatives to selling a business are less attractive, such as times of recession or times of negativity when trade acquirers sit on their hands and play the waiting game. However, that does not necessarily help somebody that needs to find a succession route for their business.

What is a Management Buyout (MBO)?

In its simplest form, an MBO is the name given to the sale of a business in which the existing owners of the business – who may or may not be existing shareholders and/or directors - combine resources in order to purchase the majority of the company they work in.

From a legal and tax perspective, selling a company via an MBO is very similar to selling a company via any other exit route. The main differences lie in the fact that the buyers are already known to, and working within, the business, and they typically do not have the cash to pay for all of the shares on completion. This, unsurprisingly, brings with it some unique practicalities that must be considered within the deal. Third-party finance is often used in an MBO to help pay the sellers more on completion, we will cover this in more detail later.

How does it differ from other buyouts?

An MBO is different from a Management Buy-In (MBI) as, in the latter, the acquiring team are not currently working in the business. MBIs are typically quite binary; they are either very difficult or very easy to put together.

MBIs where the buying team have meaningful amounts of their own cash to put into the deal (25%+ of deal value but ideally more) and they have secured the balance of funding are easier deals. MBIs where the target company is in distress also tend to be easier. However, MBIs become challenging to near impossible when the team does not have funding arranged and the business does not need to sell. In most cases, an MBO will be easier to structure and fund than an MBI.

Hybrid MBO-MBIs are also possible, often known as a buy-in management buyout (or "BIMBO") and involves a combination of the existing management team alongside external managers purchasing the business from its current owners. This hybrid model typically happens when there are gaps in expertise among the internal management team e.g., the existing team may have the skills, experience and knowhow to run the day-to-day operations but do not have sufficient leadership experience to drive strategic decision making and value creation. In the case of a hybrid model, the external members of the buyout team are also typically investors so will contribute to the purchase and acquire a stake in the company.

Is an MBO suitable for my business?

The key questions to determine this are:

1. **Is there a team who can be trained to be good enough?** In our experience, sellers rarely believe their potential MBO team are good enough, whereas the potential buyers typically have more confidence. This gap is fine and, if the team have the potential, bridgeable. The MBO team need to be close enough with potential.

   The MBO team need to have a breadth of skills. Typically, the most successful MBOs are a team of 3-5 people covering specific expertise in sales, operations, and finance. This may extend to technology, product development, supply chain or similar for larger teams. However, those three key roles are essential. In our experience, MBO teams fail to get a deal over the line, particularly when they need third party finance, when the skills, professional experience and credentials of the team are too similar to one another.

2. **Cash at risk** – the MBO team must put in what we call 'hurt money'. There are softer terms for this, but the reality is that for the team to demonstrate to HMRC that they should have capital treatment and avoid a punitive income tax charge, and to secure any potential funding, cash must be put in. This is typically around 1x annual salary though the number can vary – it is critical to take both tax and corporate finance advice on this to manage the MBO team's tax risk.

3. **Realistic valuation expectations** – it is rare for MBOs to access premium valuation multiples without Private Equity (PE) involvement. In many cases, businesses sold to an MBO are those that are unlikely to command a significant market premium from trade or PE. Selling shareholders need to be aware of this and be realistic. A professional valuation is critical with adequate market data, accurate normalisation adjustments to profits and detailed balance sheet adjustments to connect enterprise value to equity value.

4. **Delayed payment** – it is common for at least half of the value being sold to be paid to the shareholders over a period of time this is called deferred consideration. This varies considerably from one deal to another and requires appropriate valuation guidance from a professional who can defend their view on fair value appropriately, and affordability modelling. Sellers typically benefit by locking in a tax rate and being able to realise an exit. We often advise that deferred consideration is structured as a vendor loan that also attracts a market rate income through interest.

   Funders will have their own view, and this will need to be negotiated too. However, the bottom line is that in most cases, though not all, the sellers are waiting for a meaningful amount of cash. Protections can be drafted around this but ultimately the sellers must believe that the MBO team can keep the business going. This also means that the market the business operates in, and the business model itself, must be robust enough to provide sufficient profits for the years ahead whilst payment is outstanding.

5. **Does the business generate predictable cash?** Cash flow generation is key to all MBOs – the bridge between profit and cash flow is what makes the financial wheels of a deal turn and in turn deliver success to all sides. Volatility, declining profits, poor balance sheet management and price or margin pressures can in some circumstances scupper a deal, particularly if third party funding is needed or if value / deal structure expectations are unrealistic. Alternatively, volatility in cash flow will simply impact valuation and the likelihood of third-party funding, which means the deal structures become more bespoke to the cash flow risks of the business.

6. **Do you want to avoid the outside world knowing you are selling?** In an MBO scenario, the outside world does not need to know anything about the transaction until it's done as there are no third-party conversations. All conversations are between the owner, the existing management team, and the funders of the deal, which will typically be a debt fund, who will not have any reason to disclose the possible transaction to any other party and are often subject to a non-disclosure agreement (NDA).

   Alternatively, if the seller is going to go out to trade buyers, they have got to advertise your business, even in the instance where the seller will only provide detail under a NDA. Inevitably, even if there is a desire to keep a sale confidential, at some point, it will become knowledge to the outside world. This is another reason for proactively using an MBO as the first route to market. If the seller can find an exit with the management team, then that takes away the risk of what the market reaction will be until the deal has happened.

For an MBO to be suitable, particularly if the sellers are expecting funding to be raised, items 1 to 6 all need sensible answers. In our experience deals fall over early because of one of these factors.

We are often asked how long someone needs to work for a business to be credible to a third-party funder as an MBO candidate who understands the business. Assuming they have the skills and experience, the answer is ideally at least two years but sometimes less if they are one of three or more members of a MBO team.

Incentive

It is necessary for the MBO team to be suitably incentivised in three primary ways.

Firstly, strategically: the MBO team should set the direction moving forward for the business and be able to explain and justify this to each other, the seller, financiers, and the team below them. They should articulate this with a business plan, backed by appropriate financial projections that cover a range of scenarios. This should be adopted as the basis of the plan moving forward that funds the business' transition in ownership.

Secondly, by income: the MBO team typically have the opportunity to access some form of bonus or dividend during the growth period of the business. This is normally quite modest whilst any loans are outstanding and then grows considerably thereafter.

Finally, by capital: the MBO team should be putting some 'skin in the game' and this is normally the hurt money which is around 1x salary. This capital invested is at risk. However, in return, if things go well their shares should go up in value and produce a meaningful return. In our experience it is appropriate for this to be estimated by the valuer – it is common for MBO team growth plans to show a growth in profitability. As profits grow, multiples can grow too, which means a future sale could be more lucrative than the deal the current owners are getting. This is a positive outcome and should be set out using good quality transactional information to show the MBO team a range of outcomes that could be transformational for them in the future. Of course, it is possible that the current shareholders might quite like the sound of this growth and decide to not sell 100% of their holding (this is known as 'rolling equity') and instead sell a smaller portion of the business so they can capture some of that future growth in value too.

Cohesion

The MBO team have got to get on with one another, trust each other and want to own a business together. Whilst this sounds a rather obvious point, this is often assumed to be the case even in examples when the team are not cohesive.

The MBO team must be realistic about their own strengths and weaknesses. They should also work with an advisor to align on who is getting what in terms of equity, voting, rights to dividends, rights to capital, salary, and bonus. Matters such as 'what happens if one of us leaves' are also critical to align on early.

The MBO team also need to have, or be trained to have, appropriate levels of financial understanding so they fully understand the deal and the consequences and can manage the business appropriately moving forward. They must also understand the valuation mechanism and have a realistic view on price. It is not uncommon for the MBO team to be somewhat naïve in articulating and negotiating these matters with each other and with the seller; this is entirely normal and should not be a cause for concern in itself.

> Advisors are normally best placed to provide guidance on these topics and guide buyer, seller, and financiers through these discussions.

The MBO process

01. Business model and MBO team review

It is sensible to take advice early from peers, advisors, and other trusted professionals on whether both the business and the team are suitable for an MBO.

A seller may have in mind that an MBO is something to explore. Alternatively, a team of employees may approach a seller and ask to buy. Instead, a seller may be thinking about a sale to trade or PE but also want to evaluate an MBO route simultaneously.

All these scenarios should be discussed with a trusted professional early. The power dynamics, skills and potential of the team, and the strengths and weaknesses of each scenario and route, should be discussed and established before proceeding with an MBO.

MBOs have an inherent risk – if they fail and are mishandled (typically because this business model and MBO team review step is missed out), key employees, excited about a newfound belief that they can be a business owner, could become disgruntled that a deal has not succeeded and look to leave. Protecting against this through proper planning alongside someone who has been there and done it successfully and unsuccessfully multiple times is therefore a critical first step.

02. Valuing an MBO

Valuation and price in an MBO is subject to the same considerations, adjustments and complications as any market valuation calculations conducted for other 100% share deals. However, if we first approach the question of valuation from a philosophical standpoint, valuation in an MBO is driven by a combination of fairness and vulnerability.

Valuation is often the most contentious part of any deal, and that remains the case in MBO. In some instances, the contention is heightened on the basis that both parties know both one another and the business very well, which can lead to differing opinions on where goodwill and value is driven, and by who. We have seen numerous scenarios where valuation expectations have been wildly different, some examples include:

- The vendor has an informal conversation with a friend who tells them they sold their business for £4m, and the vendor should not sell theirs for anything less, despite the friend's business selling three years prior, in a different industry, and to trade, rather than to management.
- The buyout team cannot see why they should not get a cheap deal for the business because they have done all the work to create the value in the first place (which would of course lead to a significant tax problem for the buyers, we refer to this later in this publication).

This brings us to the first point of fairness. Ultimately, the valuation must be truly fair to both parties, which means both parties typically have to compromise on their value expectations.

When it comes to vulnerability, valuation needs to be weighed up against safeguarding the future growth of the business. The deal is typically funded through a combination of management contribution and debt (be that vendor loan or traditional bank finance), however, that debt will need repaying. In most MBO scenarios, there is only one source of repayment of the purchase price and that is from the profits of the business. Therefore, the deal needs to leave sufficient gateway between the actual profits generated by the company and the amount that the business can afford to pay out of those profits each year. It also needs to consider how long the vendor is going to be willing to wait for their money.

Valuation methodologies

In an MBO scenario, three of the five most common valuation methodologies are typically used:

1. Market (or multiple) based valuation,
2. Net Asset,
3. Discounted Cash Flow.

> For full details on each of the valuation methodologies, you can find the theory and worked examples in our e-book: Methods and approaches in valuing unquoted businesses.

Market based approach

The market or 'multiples' approach to valuation involves assessing a business's worth based on its normalised, repeatable profit, which is then multiplied by a factor to determine its enterprise value. This method is widely used in the UK and relies on applying appropriate multiples (e.g., EBITDA or revenue multiples) to relevant performance metrics. The selection of a suitable multiple requires consideration of factors such as deal comparability, sector specificity, transaction timing, and legal structure. Notably, caution is advised when using headline multiples, as they can mask underlying deal complexities, particularly in funding or minority buyout scenarios. Valuation databases play a crucial role in providing accurate and comprehensive multiples data for informed decision-making, especially for smaller businesses where professional advisors subscribe to such services. It's essential to understand the limitations of quoted multiples, which may not reflect adjustments for timing, performance-based payments, deferred payments, equity components, or non-financial terms in transactions. Real transaction data and thorough due diligence are recommended to mitigate potential misinterpretations associated with market multiples.

Net asset approach

The asset-based approach to valuation involves determining a business's value by assessing the net worth of its assets, adjusted for factors like depreciation and changes in market values that are not reflected in the balance sheet. This method is particularly suited to businesses with significant fixed assets relative to earnings, those without a strong profit history, entities focused on capital growth rather than immediate profits (e.g., investment firms), or businesses facing insolvency, provided asset values are adjusted to reflect sale conditions. Adjustments to the balance sheet are crucial to reflect current market values, especially for assets not essential to generating current earnings. For example, there may be properties within the company and a decision needs to be made on if they are sold with the trade or not. The valuation process typically involves adjustments to the balance sheet, considering market values, cash levels, loan accounts, and tax liabilities, with additional adjustments as needed based on the business's circumstances.

Discounted Cash Flow

The Discounted Cash Flow (DCF) approach to valuation involves estimating a business's present value based on its projected future cash flows, which are discounted to reflect both the inherent risk and the time value of money. In the UK, for most small, and medium, sized businesses this method is employed cautiously, typically as a supplementary analysis rather than a primary valuation tool.

DCF relies on detailed financial forecasts over a specific period, typically 1-5 years, and allows for flexibility by considering various scenarios. Despite its complexity and academic nature, DCF can serve as a useful cross-check alongside other valuation techniques.

03. Affordability analysis

With the valuation complete it makes sense for a professional to next appraise how the business could afford to pay the value to the seller in different scenarios including early consideration of:

1. HMRC's perspective on ERS risks
2. Cash paid on completion
3. Cash paid overtime
4. Interest rates on deferred payment
5. Carving out non-operating assets (e.g. property)
6. The triggering of any existing options
7. Debt funding
8. Equity funding
9. Hurt money
10. Company performance scenarios

All of the above should be put through a variety of scenario plans to determine different probable outcomes and both seller and buyer should consider these to better understand their appetite to undertake the deal.

This modelling is key and is best delivered using a dynamic financial forecast. You can hear more on our thoughts on this in our financial modelling podcast.

04. Deal structuring and Heads of Terms

With the above defined and agreed, a clear deal structure can be agreed and both buyer and seller can agree to a set of Heads of Terms.

This document is often known as 'a deal to do a deal' – in other words it sets out a largely non-legally binding understanding between both sides which gives licence to the MBO team to go and explore fundraising and undertake due diligence to complete the transaction.

An important part of the Heads of Terms is to establish the basis of the valuation and the completion mechanism which, for a share purchase, will typically be either 'completion accounts' or a 'locked box' – you can read more about both in our article.

It is worth noting that the typical structure for the MBO team is to form a New Company, often called Newco, and for that Company to acquire the shares in the target operating company. Newco is capitalised with hurt money, any vendor loans and any third-party equity funding. Third-party lending can sit in either Newco or the target company and this varies depending on the type of funding and the lender. There are a variety of legal, tax and commercial benefits to structuring a MBO in this way and the advisors will normally help guide on this topic. Setting out the intended structure for the acquisition is an important part of Heads of Terms.

We regularly draft Heads of Terms in MBOs and it is often a real moment of excitement for all involved as both parties quite literally finish this step 'on the same page.'

05. Funding an MBO

Financing

Buyouts are typically funded through a mix of debt and equity, with other hybrid sources like mezzanine also considered, as discussed later. Although these sources have distinct characteristics, the general strategy for management is to seek capital from the most cost-effective source first (senior debt) and then explore relatively more expensive options (equity). Striking a sustainable balance involves securing funding at a fair price, allowing management to gain upside while providing room for business growth, plan execution, and navigating challenges.

Management team contributions - affordability

Starting with the buyout team, the general rule of thumb with an MBO is that a manager must have skin in the game in order to be given the opportunity to successfully lead a management buyout. The question is, what does skin in the game mean?

When we talk about 'skin in the game', what we are really talking about is the concept of hurt money; the contribution from management needs to be significant enough to the individual to reflect a true commitment. At the same time, it needs to not be so significant that it would financially cripple the individual and put such stress onto them that it becomes counterproductive to both them and their effectiveness within the business. The typical starting place is a number that is equivalent to a year's salary, however, when it comes to 'rule of thumb' in this situation, there is no rule of thumb, as it comes down to each individual scenario.

For example, a young manager with a new mortgage might find a year's salary too much, but a smaller amount, such as, £1,000 may still be meaningful. Conversely, a more financially secure manager with a longer tenure may need to invest more than a year's salary to show true commitment.

Management's financial contribution usually covers only about 25% of the purchase price, with the rest funded through debt or vendor loans. Thus, while the ability to finance their part is important, it's only a fraction of the total deal. In the case that there are different degrees of affordability among the individuals in your management team, it is important to understand this at the outset. It is not a dealbreaker as there is a lot of flexibility around MBO structures. What is probably the more important conversation is: what is going to work best for that management team to jointly achieve the end goal? It is not uncommon to see a management team that all want to have an equal share going forward in the equity even if they cannot put in an equal share of the cash contribution. In those circumstances, certain managers may provide funds in the form of loans rather than shares and having a priority on those loans being repaid before the equity investors.

Disagreements over contributions and equity shares is an area that can cause an MBO to derail. Therefore, the sooner difficult conversations around money and shareholdings happen, the better, so that when management are coming to the vendor, they come as a unified group.

The management team's ability to finance their part of the deal is important. However, in combination, this contribution typically amounts to only a small fraction of the total purchase price and total valuation of the business. The remainder of the deal is then typically funded through a combination of debt and/or vendor loans.

Debt:

Alongside management contributions, the buyout team will also typically source debt funding. Often the question we are asked is how much a business can borrow from the proceeds of an MBO? Typically, a business may be able to borrow up to half of the valuation, subject to other debt already in the business and the other security available in the business.

It is also common in these circumstances not to put new funding into a business. Sometimes it might be that the business can use finance that has not been necessary to fund the working capital of the business up to now and unlock some cash to help fund the deal.

Senior debt, often the most economical capital source (aside from family and friend contributions), includes bank loans, overdrafts, or lease financing. Debt can be short or long-term, secured or unsecured. Lenders receive interest at an agreed rate, and in case of non-payment, they may have rights over certain company assets. Importantly, lenders usually do not have ownership in the business but are inclined towards buyouts due to the presence of a capable management team. The lender may secure assets and may also require personal guarantees from the management team. In addition, typical lending terms for cash flow loans might also include covenants that within which the business must operate in, such as the following:

- **Total debt to EBITDA:** This is the total debt as a proportion of EBITDA. At the time of writing (2024), 2.5x appears to be the maximum for most lenders, though this varies according to the context of the borrower and lender. During periods of low interest rates, challenger lenders can sometimes stretch to 4.0x EBITDA.
- **Interest coverage:** This is typically a measure of EBIT and expected gross interest expense on borrowings. As a rule of thumb, EBIT should be at least 1.5x the interest expense, and ideally 2x to 3x.
- **Cash Flow Available for Debt Servicing (CFADS):** This is the cash flow available to repay debts in the review period. This typically needs to be at least 1.2x, but often higher.

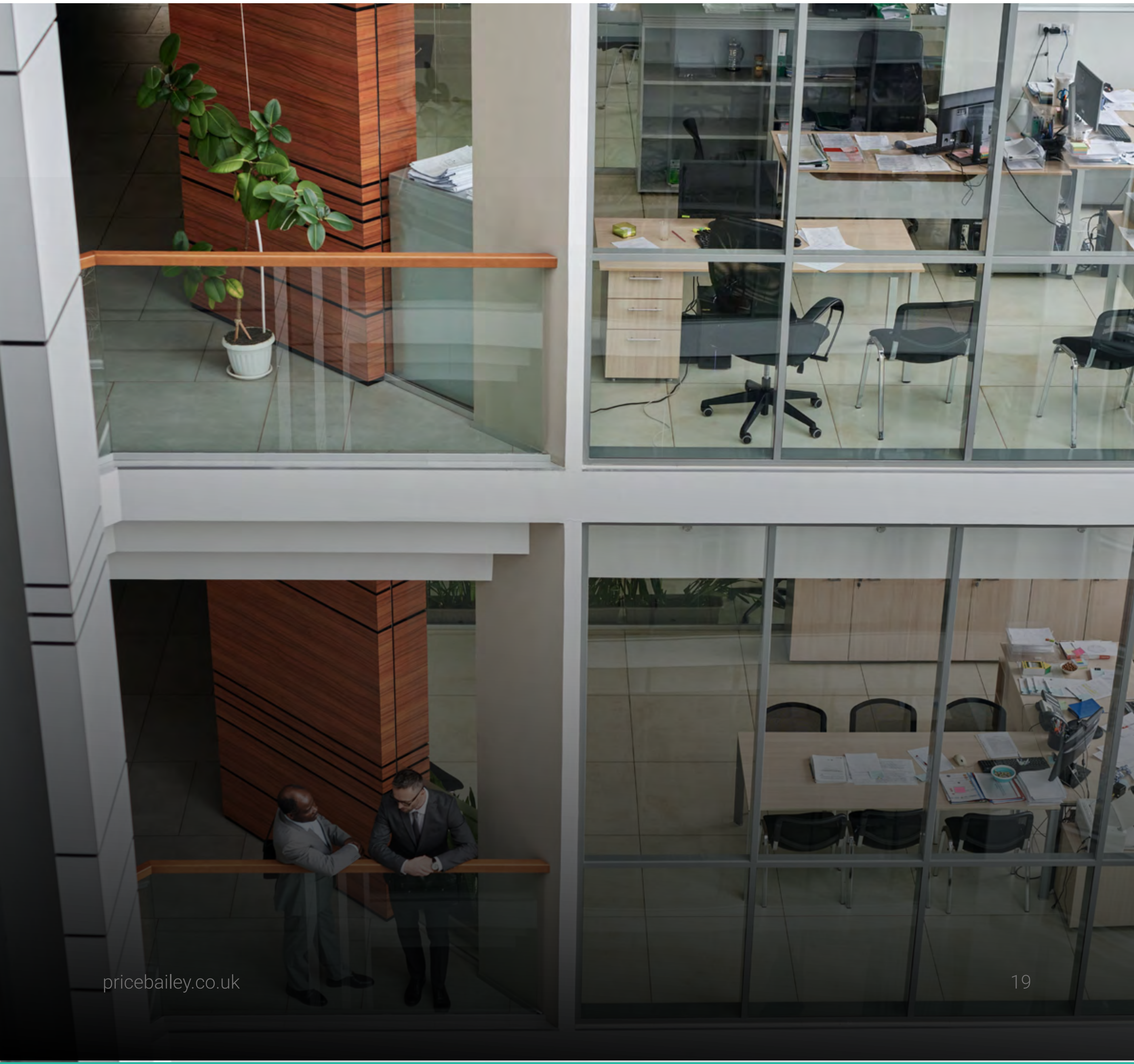
Mezzanine Debt:

Mezzanine finance is utilised to bridge the gap between secured debt, available equity, and the purchase price. It ranks lower than senior debt in repayment priority, resulting in a higher return rate and often includes warrants for ordinary shares.

Equity:

Equity represents ownership in a business and is the costliest capital source. Management must assess various funding options to determine the optimal capital structure for the company.

Private equity (PE) can be a funding source for buyouts, typically seeking investments in established, and growing companies with potential for substantial returns. In an MBO situation, it is our experience that PE interest in an MBO deal is highest if they see that it presents a secondary buyout opportunity and, therefore, invest in the MBO with the view to benefiting from the follow-on deal.



Structuring Considerations in Buyouts:

When formulating an effective structure for a buyout, several crucial considerations must be considered:

Cash Flow Primacy:

Cash flow emerges as the most critical factor. While profit generation is significant, a comprehensive understanding of projected cash flows is imperative. Factors like capital expenditure, depreciation, interest, dividends, and restructuring costs all play a role, with cash generation standing out as the primary driver of valuation.

Quality of Cash Flows:

The 'quality' of cash flows is determined by the sustainability of operating cash flows. Indicators of a business likely to generate high quality cash flows are those that boast predictable future orders, diversified customer types and strong market prospects. A higher-quality cash flow business is characterised by its consistent ability to cover operating expenses, capital expenditure, any dividend payments, and debt payments. As a result, high quality cash flows enhance a business's attractiveness to lenders and investors, on terms that are more favourable.

Timing and Fluctuations:

The nature of a company's trade may result in periods where expenditure exceeds income. Additionally, the timing of tax payments can influence cash availability. Preparing for these fluctuations is integral when determining an appropriate structure.

Security for Bank Debt:

Generally, a portion of bank debt must be secured by the company's assets. Banks consider not only projected cash flows but also the realisable value of the assets used as security.

Debt Finance Evaluation:

Assessing the level of debt a business can support is the initial step in creating a financing structure. This determination relies on factors such as business cash flow, available asset coverage, and interest coverage. Debt is usually expected to be repaid within a defined period, typically 5-10 years. Key aspects in any debt package include the interest rate, repayment profile, required security, and financial covenants.

06. Tax considerations

The tax benefits of selling a business via MBO are akin to those available through other sale scenarios, such as Business Asset Disposal Relief (BADR, formerly Entrepreneurs' Relief). While the tax outcome for the vendors in an MBO should remain the same as other sale routes, there are some MBO-specific traps that a vendor will not want to fall foul of.

Employment related securities

While we have not seen examples of this coming in to fruition, if a vendor overrides what is determined as the market value for the company and convinces the management team to pay more for it, any value above market value that the vendor receives would become taxed as income (and therefore at a higher rate) rather than taxed as capital.

Employment tax risk also exists for the buyout team. The reason for this is that by being a manager they are almost certainly an employee as well. As an employee, the buyout team are caught by additional tax legislation which is set out to ensure that employees cannot be given benefit without being taxed. Employment related securities kick in for the buyout team if it is deemed that they acquired the business for below market value, in the eyes of HMRC. If they do, HMRC will tax the value uplift that the employee has received between what they pay and the market value as income, with National Insurance payable for the employee and the company as a result. For anyone who does fall into this trap, it is incredibly expensive, particularly as the employee will receive a tax bill without any additional cash to pay for it as they have just invested their savings into the business.

A scenario where both sides of a transaction could fall foul of employment related securities is unique to an MBO scenario given that both sides are internal. HMRC is keen to ensure that the price negotiated reflects what a vendor could reasonably expect to receive if they were selling to an independent third party.

Transactions in Securities

Another tax risk for the vendors relates to the Transaction in Securities (TIS) rules. The Transactions in Securities (TIS) rules in the UK are designed to prevent tax avoidance through certain transactions involving securities (e.g., shares). In the context of an MBO, there are potential issues with TIS rules that could arise.

One of the key concerns is the possibility of a tax advantage being gained through the structuring of the MBO. The TIS rules may be triggered if the transaction is structured in a way that involves the company repurchasing its own shares and results in a distribution of value to the shareholders. This is the bigger risk for the vendor as they may be taxed on any non-cash consideration that they receive. Such distributions can be subject to income tax rather than capital gains tax, which can be charged at an income tax rate of up to 45% for a higher rate taxpayer. If that is the case, there will be no BADR available to reduce the tax liability.

To avoid falling foul of TIS rules, it is important for the MBO to be structured in a way that is in line with the legislation. The rules are complex and will involve considerations such as the nature of the company's activities, the relationship between the parties involved, and the specific details of the transaction. There are rules that mean the vendors consideration will not fall within TIS rules, and individuals can opt to disapply those rules if desired. Another way to avoid TIS is through a a non-qualifying corporate bond (non-QCB) loan.

- **Non-QCBs**

  A non-QCB is a type of loan note that does not meet the qualifying criteria for the more favourable tax treatment associated with qualifying corporate bonds (QCBs). QCBs are exempt from the TIS rules, and transactions involving them are generally treated as capital transactions, attracting capital gains tax rather than income tax.

  In contrast, non-QCBs are not exempt by default. However, certain non-QCBs are structured to disapply the TIS rules, ensuring that transactions involving them are treated as capital transactions rather than income transactions. This structuring is often done to make the terms of the loan note more closely resemble those of equity, and it is typically achieved through careful consideration of the legal and tax aspects of the instrument.

  When a shareholder receives non-QCBs as consideration for selling their shares during a takeover or reorganisation, they are typically treated as if they have not made a disposal for CGT purposes. Unless the shareholder chooses to make an election and claim BADR, the non-QCBs are considered to have been acquired on the same date and for the same value as the shares they were exchanged for. The calculation of the capital gain is deferred until the non-QCBs are eventually sold or disposed of.

TIS is often one of the areas where we will seek approval from HMRC during an MBO, to ensure we receive clearance that states that there is genuine commercial reason for the transaction and that tax avoidance is not the main purpose.

Stamp Duty

A final tax consideration to mention is that of stamp duty. Stamp duty on an MBO transaction is currently charged at 0.5% of the consideration paid. However, often there is a question of who should pay stamp duty on the transaction. Rightly or wrongly, stamp duty is typically paid by the buyout team, and the purchase price for the business is adjusted to account for the stamp duty cost. For example, if the business is being sold for £10m, and there is £50k of stamp duty to pay, then the vendor would likely agree a sale price of £9.95m so that, in the end, it costs the management team £10m. Vendors are not obliged to do it that way; in a third-party scenario the vendor would leave the third-party buyer to pay their own stamp duty.

07. Due Diligence

The MBO team should take the opportunity to undertake necessary due diligence. This could spread across matters such as financial, tax, commercial, legal, insurance and even due diligence on each other – the latter of which can be done in a collaborative and open way.

The introduction of third-party financiers will also bring further diligence requirements, and this will bring with it costs too.

The findings from due diligence should influence the drafting of the completion documents.

08. Drafting

A variety of documents will need to be read, drafted and/or negotiated. This typically includes:

- The Share Purchase Agreement (SPA).
- The Articles of Association of the MBO Company.
- The subscription agreement for the 'hurt money.'
- The shareholder agreement (SHA).
- Loan and financing documentation.
- The Directors' Service Agreements (DSA).
- The valuation.
- The business plan.

Of course, the list will vary by deal, but each of these matters will have both a legal and commercial perspective that is relevant to the deal and the future of both the operating company and the buyout company.

09. Completion and post-completion

Completion day varies by deal; some are straightforward, others have discussions and amends right up to the moment of signing. Inevitably the day requires focus from all sides.

It should be quite clear to both sides what happens after completion regarding communication with staff, suppliers, and customers- as well as how monies flow. Further, if the completion mechanism was completion accounts, then there is a post-completion action of undertaking a fresh set of accounts to finalise any minor adjustments to the price paid.

The weeks after completion are normally quite a relief to all sides as individuals move into a new phase of their life. Different personalities respond to this in different ways and the support network of family and friends will be important for all of those involved in this type of transition in ownership.

Working with funders

Working with third-party funders and vendors who have provided financing is often a positive experience in an MBO scenario. Typically, we have found both types of financiers to be accommodating to short downturns in performance. Of course, there is always risk if performance falls away dramatically, and this can result in a variety of negotiated outcomes.

However, the vast majority of MBOs in our experience have been successful and many deliver ahead of expectations and are proud to talk to us about how they have been able to pay off their financing quicker than expected.

Ultimately, relationships matter; after completion the important work starts, and all sides need to invest in the relationship together to keep a positive working environment that benefits everyone concerned.

Future sale

MBO teams typically want to realise value themselves at some point within 3 to 10 years. If the initial MBO requires equity funding, then these investors will heavily influence the timing of this second transaction.

Likely buyers can be trade purchasers, private equity or indeed another MBO. Our advice is for the board of the buyout company to keep the business in a state of readiness to entertain sale discussions; this means keeping the business in good order. Having good governance, appropriate board minutes, regular and comprehensive management accounts, management succession coming through, good market and supply chain data, an understanding of how the risk period regarding warranties and indemnities is passing, maintaining an accurate financial model for several forecast years and a periodically refreshed business plan are all good ideas. Much of this should happen in all businesses of course, but they make a future sale or refinancing far easier.

Power dynamics during MBOs

MBOs create a different set of power dynamics, and therefore stress, to a trade sale or sale to Private Equity.

It is common for MBO candidates in most businesses to claim they would earn more elsewhere and so, as they start to get enticed into an MBO, some candidates claim they will consider seeking employment elsewhere if the MBO fails on the terms they desire. We have seen this manifest itself in teams leaving when owners have changed the goalposts mid-discussions but, typically, this risk does not come to fruition as most MBO deals are friendly and positive. The reality is of course that, most employees can leave and earn more at any time, particularly good ones who are MBO-worthy. As always, having a positive company culture, good people management, training MBO candidates in the wider requirements of running a business and letting the MBO team have access to advice and valuation mechanics all helps build a positive culture that is worth more than short term earnings – the capital upside should be significant and the more meaningful financial matter to focus on for the MBO team.

Nonetheless, the power dynamics can shift during discussions and this is normally driven by 1) whether or not buyer or seller wants to do the deal more, 2) how emotionally steady the individuals on both sides are and how well they understand, listen and adapt, 3) how fair both sides are willing to be, 4) how good the MBO team are (which is both the individual's responsibility and the sellers' to train them) and, 5) the trading performance and prospects of the company.

Powershifts driven by these factors and others can both give and take away oxygen from a deal. Momentum can shift to or from each party and this can cause the 'emotional rollercoaster' that many people experience during a transaction. This ebb and flow can be more magnified in an MBO because those involved have known each other for longer and should have deeper relationships when compared to the sides working on other types of M&A deals.

Good advisors should be able to both see these powershifts happen and appropriately pre-empt how to handle them; this is an art not a science but there is no doubt that experienced advisors can help those involved understand to what extent a powershift warrants a reaction. In the heat of a deal (particularly one that all sides say should be friendly) this type of grounding and context can be critical to keeping all sides on track.

The role of advisors in an MBO

In any MBO scenario, there is a critical role for an experienced advisor to guide all sides through the journey and facilitate a beneficial outcome, which may include advising that the deal does not happen.

As experienced corporate finance advisors to both buyers and management in an MBO, guiding both buyers and sellers through this pathway is a key part of what we do.

Impartiality in managing power dynamics - We are often introduced in to an MBO process at the point at which both vendor and management team have collectively decided to pursue sale via an MBO and are asking 'How do we do this?'. In those circumstances it is unhelpful for each side to seek their own advisors. Instead, finding one impartial advisor who can sit between both parties is likely to create the best value for all. Having one party as facilitator ensures that the deal does not get drawn into one sided perspectives and ensures early on that the core objectives of the deal for all are clearly understood.

Managing value trade-offs - The advisory team sitting in the facilitator role need to be able to look down the middle of the table between the vendor and the management team and foresee any risks or limitations that could occur in the period between the initial completion of the transaction and the final pay out and exit of the sellers. This end point will often occur after several years (typically between 3-5 years, compared to 1-2 years for trade sales) before the vendor has received the full consideration in respect of their shares. It is therefore vitally important to be able to consider the repayment period from both sides; the structure needs to encourage the managers to buyout as quickly as possible without restricting their ability to run the business for. If the buyout team are not going to get any opportunity to see any real value for them for five years plus, then there is not sufficient upside and incentive for them to create consistent value growth.

Valuation expertise - The team at Price Bailey are also expert valuers. In a typical year we will undertake around 50 valuations covering a variety of scenarios. We have a detailed understanding of value drivers across a multitude of deal structures and sectors, alongside privileged insight into valuation data and trends. We are well placed to consider the valuation from the perspective of the best value for the seller of the asset, the best value that can be achieved from a management buyout, and how value differs in an MBO scenario compared to a third-party buyer, a trade buyer or a private equity buyer. Our valuation work also ties into our tax advisory team's work that helps both buyers and sellers to understand the tax risks and opportunities regarding MBO transactions.

Independent legal advice - When it comes to legal advice, each party will need to appoint their own legal advisors as no lawyer can advise both sides. However, with the presence of good 'facilitating' advisors in the middle working alongside both parties' lawyers, then often what might be perceived as a conflict of interest can actually be the way to get the deal done. There is a very fine line between a perceived conflict of interest and having enough knowledge of both sides to be able to properly help them achieve the objective that they want to do a deal.

Who pays the costs?

The first few steps of evaluating an MBO are normally centred on the business model understanding, the valuation and the affordability analysis.

In a friendly MBO these items are normally quite straightforward and relatively low cost to understand. The target company often, but not always, bears these costs and the resulting work is shared with both sides.

From there the balance of costs depends on how complex the deal needs to be – the buyers will typically incur more costs than the sellers though the target company may agree to underwrite the costs up to a certain point, often once Heads of Terms are signed.

The MBO team must be ready to take some risk and, one way or another, the management team will have to fund the costs that follow including due diligence, legal and advisor fees to get the deal over the line. The sellers will also have their own legal costs.

All third parties contracting with either buyer or seller will typically be experienced enough to agree with both sides what happens if the deal aborts at different stages. The Company often needs to be an underwriter of the fees, but the generosity of the seller, rightly, can vary.

Recovery of VAT on professional fees is a question that we often receive from clients. With foresight, planning and a normal corporate structure, NewCo ought to be able to get the VAT on professional fees back.

Advantages of an MBO

In consideration of the advantages that an MBO can bring to both the deal and post-deal process, these can include:

- **Smooth transition of ownership:** The existing management's intimate knowledge of company processes, culture, and relationships ensures a seamless transfer. This familiarity facilitates a quick understanding of organisational nuances, minimising disruptions, and accelerating the integration of new ownership.
- **Reduced risk of failure:** The inherent understanding of the business by the management team significantly mitigates the risk of post-acquisition failure. Their nuanced awareness of market dynamics, customer relationships, and operational intricacies provides a solid foundation for strategic decision-making and continued success.
- **Confidentiality in internal changes:** It is understandable that in any sale process the vendors and the business being sold will want to keep exposure to a minimum to avoid any adverse impacts on the business' performance as a result of any nervousness on the part of suppliers of customers. In MBO scenarios, the confidentiality surrounding internal changes is crucial. The discretion maintained during the transition protects employee morale and prevents unnecessary disruption. This confidentiality extends to negotiations, employee communications, and strategic adjustments, ensuring a harmonious changeover.
- **Efficient due diligence:** The management team's close familiarity with the company expedites due diligence processes. From financial assessments to operational evaluations, streamlined due diligence reflects the team's ability to provide comprehensive and accurate information to funders, enhancing transparency and trust.
- **Critical evaluation of management strength:** Funders meticulously assess the skills and experience of the management team. Specific attention is paid to leadership qualities, industry knowledge, and the team's ability to adapt to changing market dynamics. The depth and strength of the management team become pivotal indicators of the MBO's potential for success.
- **Mindset transition from managerial to entrepreneurial:** The transition from employee to owner requires a profound mindset shift. Management teams must embrace an entrepreneurial mindset, taking on additional responsibilities, risks, and strategic thinking. Training programmes and mentorship initiatives can facilitate this transition, ensuring a unified and forward-thinking approach.

Potential challenges of an MBO:

Each MBO scenario will be different and the challenges unique to that situation, however, some of the common pitfalls and challenges that we have experienced, in addition to those considerations we discuss earlier in this document, include:

- **Principal-Agent problems:** A further common challenge that we observe during the MBO process is one that is often referred to as 'principal-agent problems' in which the buyout team, in their capacity as the management team, are either perceived to be or are in actual fact subtly pulling back on developing the business and driving performance during the period of negotiating the buyout deal in order to achieve the most favourable valuation possible. Often this is a 'perception' on the part of the vendors; however, it can cause disagreements and unforeseen tension in what should be a more harmonious sale process.

- **Governance and fiduciary issues:** In circumstances where the buyout team are also directors of the business, there are some fiduciary and governance considerations that need to be kept in mind. As directors, the buyout team will have a lot of information available to them that other non-directors would not be privy to. That privileged information should not be used by the same individuals to help them advance what would potentially be seen as a personal gain in the potential buyout of their shareholding without the permission of the other directors of the business. Otherwise, in practical terms, they are using confidential information for their own gain, as opposed to being for the company's benefit. Therefore, an important piece of procedure that should happen early on in an MBO process is a board meeting, to discuss any of these potential information uses or issues and to document whether the manager(s) and director(s) have the permission of the other non-management directors to use data that they have available to them to consider the management buyout in itself.

  Throughout the process, anyone party to the transaction needs to be mindful of which hat they are wearing in which scenario. They must also be able to remember and act within the different rights given to them depending on whether they are the employee, the director or the shareholder in that situation and ensuring, where required, seeking the backing of the whole board in making certain decisions. In essence, the management team should not be able to put together a bid for the business they work for as a surprise to the other non-directors of the business because if they've done so they have used data that they hold, in the wrong way.

- **Recovery and protection of vendor loans:** Negotiating favourable terms for vendor loans involves setting realistic repayment schedules and ensuring cash flow stability. Detailed financial projections, contingency plans, and transparent communication between vendors and management are essential for securing the recovery and protection of vendor loans.
- **Post-Buyout reputation and performance:** Managing reputation post-buyout requires a proactive approach. The management team should develop communication strategies to address stakeholder concerns, provide consistent updates, and showcase their ability to maintain operational excellence. Demonstrating a commitment to quality, financial objectives, and stakeholder satisfaction is key to ensuring a smooth transition and sustained growth.

In navigating these intricacies, a nuanced understanding of the specific challenges and advantages associated with a Management Buyout enhances decision making and positions the management team for success.

Other considerations

01. MBO and Employee Ownership Trusts (EOT)

EOT's by their nature are generally directed at the employee group as a whole, whereas the management buyout is more focused on the key people that really drive business. That's not to disparage those below management and those working in the provision of a service or product, but instead it is to say that the management team are often the pivots that makes the difference between profit and loss in a business. This is another reason why we are increasingly seeing a hybrid model developing in which a combination of EOT or employee benefit trust (EBT) and management incentivisation is structured, whether that incentivisation is through share options for management or the direct share purchase via an MBO occurs. This hybrid approach became a topic of almost daily conversation in a recent employee-owned deal.

While EOTs are justifiably popular mechanisms for exiting shareholders whose business culture lends itself best to an employee-owned future, EOTs do tend not to provide sufficient incentive for key managers because the approach of an employee ownership trust is to treat all employees (broadly) equally. The differentials then between what are meaningful bonus outcomes from an employer ownership trust vs. the value of shares in the business on a sale are, unfortunately, very different.

In an EOT scenario, the terms of the trust might be able to differentiate a manager to receive maybe 4-5x what a junior might receive in the distribution of funds out of an EOT. Conversely, in an MBO there are no limitations around that. In fact, we often find that the employee is getting nothing, and a manager might be getting 25% of the business value, which is a very different outcome for all parties involved but it is easy to see under which circumstance management are more likely to be incentivised. That is not to say that a pure MBO is a better option than an EOT as trust is hugely valuable to an employee who otherwise would have no entitlement to the profits or equity of the business and the ability to reach that. So, we are increasingly seeing a combination of a portion of the business going into an EOT, whilst the other portion is earmarked for management to hold direct stakes.

Case study – PA Collacott

We were initially approached by P.A.C. Electrical Services Limited in late 2018, following a recommendation from their accountant. Trading as P A Collacott & Co, the company is a leading firm of electrical contractors and building management system engineers. Established in 1978, the company has offices in Cambridgeshire and Abingdon, Oxfordshire.

As the founders approached retirement and gave thought to succession planning, they were initially considering a sale of their company and we were subsequently engaged to act as their advisors in early 2020 but in light of COVID-19, the sales process was halted.

However, by July 2020, consideration was being given to alternative exit methods other than a trade sale, which included employee ownership and management buyout options.

We worked with the founders and presented various ownership structures; it was decided that a combination of an EOT and an MBO offered the best solution for the shareholders and the business.

We undertook a valuation of the company, analysing past financial results and reviewing the current pipeline of work to get an indication of forecast performance for the business. Once the EOT and MBO scenario was agreed in broad terms, we gave presentations to the management team introducing the core concepts, an overview of financial performance and valuation and the practicalities of investment.

By structuring the transaction such that the EOT took place immediately ahead of the MBO, it was possible to effectively offer the shares to the management team at a discount to reflect the Company's commitment to making the repayments to the vendors on behalf of the EOT. In doing so, it became more affordable for managers to purchase shares and to benefit from future growth in the business, both through their direct shareholdings and indirectly as employees through the EOT.

02. MBOs and management incentives

It is common to see management share incentive mechanisms being implemented alongside an MBO. In close to half the cases that we work on, Enterprise Management Incentive (EMI) schemes are implemented either during or after the MBO process to encourage people to help the management team grow the company. EMI and other management share incentives are often used when your current, primary management team are those involved in the buyout and they are contemplating how to incentivise the next generation of management as part of the deal.

We have also seen examples where there is an element of equity rollover by the original sellers which is then connected with share options as well for the ongoing managers. In doing so, the buyout team are double incentivised to finish the buyout from the original vendors, through both being able to acquire the vendors remaining equity and being granted additional options more common in the private equity scenario.

The advantage from a tax perspective is that with an EMI scheme, HMRC will give management clearance for the valuation as part of the advanced clearance on the scheme and they will agree a valuation as unrestricted market value of a minority of shares. EMI is, therefore, inadvertently a useful mechanism to give management comfort that they are at no real risk of ERS.

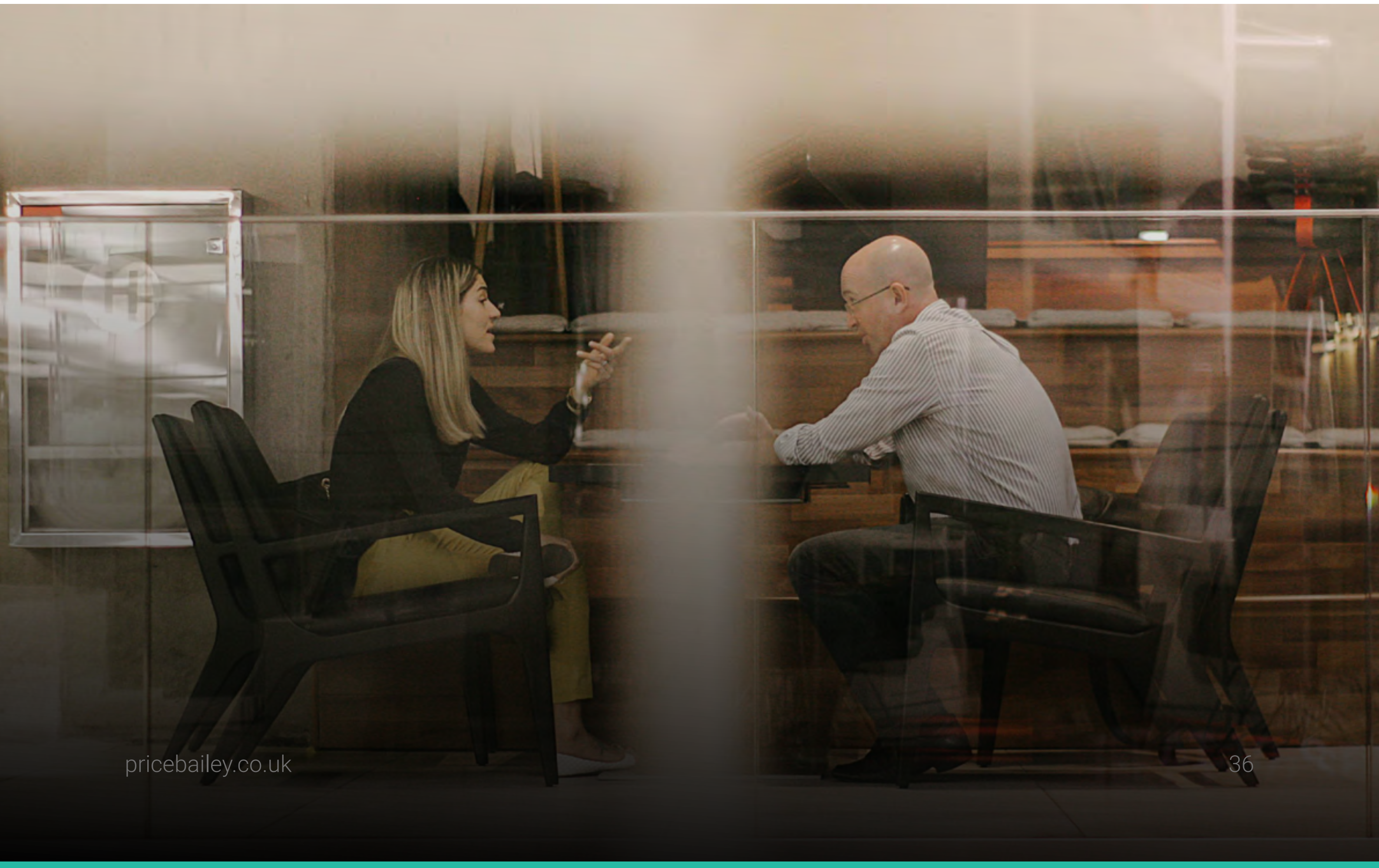
03. MBO in family business

An MBO can be a viable exit route for retiring and departing family members within a family business who want to pass the business on to the next generation of management, be that all family members or a blend of family and non-family members. However, given the connected nature of at least some of the key stakeholders, some of the considerations that we have discussed earlier, particularly regarding the TIS rules, need to be paid considerable attention in a family business scenario.

In a family-owned scenario, the most important thing that needs to be established is, who currently owns the business and who will own the business after the MBO completes and understanding the connections between shareholders. Understanding these relationships is essential to navigate potential conflicts of interest, ensure a harmonious transfer of ownership, and maintain family cohesion. It also aids in addressing any issues related to decision-making and governance during and after the MBO process.

Often in family business scenarios, the retiring family member will seek to gift shares in the family business to the next generation of family members as part of their succession plan and inheritance options. It is a simpler way to pass on the business to the next generation compared to an MBO, however, it does come with some tax complexities including Inheritance Tax (IHT) considerations, Capital Gains Tax (CGT) and understanding whether Business Property Relief (BPR) applies or not. Gifting shares is also not a quick way for current business owners to realise cash consideration for their stake in the business, so may not be a suitable option if liquidity is a priority.

However, in scenarios where the departing or retiring family member(s) want to realise cash for the business, then an MBO can be a helpful mechanism. However, this needs to be handled carefully from a tax perspective as the proposed deal will hinge on whether HMRC considers if the TIS anti-avoidance rules will apply or not. As we discussed earlier, typically the tax clearance sought from HMRC which evidence that the proposed transaction is not for the sole purpose of tax avoidance and is, instead, for genuine commercial reasons, is usually granted by HMRC. In a family business scenario however, HMRC is more likely to take a closer view on the particulars of the transaction, given the connect nature of the parties involved. It is not to say that it will not be granted, but all parties should prepare themselves for greater scrutiny from HMRC during the deal structuring process. The reason for the increased scrutiny on behalf of HMRC is that they will want to ensure that the parties involved are not trying to avoid IHT payments.



But why are management buyouts always relevant?

Firstly, because they provide a safeguard for vendors and sellers to prepare for whomever they are going to sell the business to. SME owner-managers often struggle to decide when to exit and delay informing key personnel about their plans.

This late communication can create problems, as good managers are usually already wondering about the shareholders' intentions. Keeping them in the dark can be damaging. Instead, by opening up a conversation about the possibility of an MBO, shareholders can approach the subject of succession in a positive manner, showing that long-term plans are being considered. This allows managers to consider future ownership well in advance. If managers decide not to buy the business, they can help find the best future owner, aligning with the shareholders' goal to protect the company's future.

As mentioned earlier on in this report, MBOs often become more attractive during economic challenges, such as the current conditions (as of May 2024) with political uncertainty, a continued cost of living crisis and prevailing overseas conflicts. These factors can slow corporate acquisitions and consequently more MBO opportunities present themselves, and this is certainly something that we have witnessed in practice in recent months.

When an MBO is not suitable for a business

Where there are very high multiples on offer for a business, perhaps because of very strong recurring revenue or very significant value in Intellectual Property that has not yet been exploited.

This is not necessarily because a seller, in this instance, would be able to achieve a greater deal value. While that remains true, the main reason this circumstance makes MBO a less suitable exit route in comparison to trade or other routes is because it will be almost impossible for the management team to raise the finance to fund the deal. Management buyouts tend to work best when the multiple is around 4-6x profit, simply because most debt funders are not going to fund more than half the valuation or more than 2-2.5x EBITDA, unless there is a valuable asset. If there is the presence of a valuable asset, funders will still only value up to 70% of the funding and that asset will then leave the remaining 30% to be funded, which may be unreachable, unless the seller and management team are at the other extreme of bringing Private Equity funding in. In cases where the valuation dictates that the management team must bring another equity investor in, it is likely that that equity investor will probably take the larger equity interest, leaving the management team with a modest equity interest. Most of the owner managed MBOs that we are involved with are with the view that the managers end up with a majority stake, perhaps not beneficial to them in the short term, but certainly in the medium term.

In the owner-managed business sector, the most common opportunities are where the business is transferring the controlling ownership from the seller to the management team, not from the seller to a Private Equity house backing a management team. When Private Equity are interested, it is typically because they are looking at the MBO as a platform deal and backing the management team to go into a buy and build. When life is a bit less certain and there is a bit more negativity around, then we tend to see Private Equity move their focus more towards bolt-on acquisitions for their existing portfolios, rather than creating new portfolios.

Management Buyouts – Key takeaways

Understanding the key factors that contribute to the success of an MBO is crucial for both vendors and the management team involved.

Everything discussed in this publication is relevant to all parties in the transaction. Some of our key takeaways for success are:

- The success of an MBO heavily relies on the diverse skills and cohesion of the management team. The MBO team must trust each other, and work well together, understanding their strengths and weaknesses, and align on equity, roles, and compensation. Advisors can facilitate this alignment and provide necessary training.
- The MBO team will need to invest their own money, typically around 1x annual salary, to demonstrate commitment and secure funding. MBOs are typically funded through a combination of management contributions and external debt or vendor loans. The ability to secure and manage this financing is crucial for the MBO's success.
- It is common for part of the purchase price to be paid over time. Structuring this as a vendor loan with interest can benefit both parties, but vendors must trust the MBO team to maintain business performance.
- MBOs rarely achieve premium valuations without Private Equity (PE) involvement. Vendors should be realistic about the business's value and obtain a professional valuation.
- Predictable cash flows are key to supporting the MBO. Volatility or declining profits can jeopardise the deal, especially when third-party funding is involved. The market and business model must be strong enough to sustain profits and cash flow during the repayment period of the purchase price.
- MBO teams are often strategically incentivised through a combination of ownership from the deal and performance-based rewards. The process of negotiating this within the deal can sometimes be tricky and cause disagreements with other MBO team members and vendors.
- An impartial advisor who can sit between vendor and MBO team can navigate the entire process and, keeping the needs of all parties in mind, advise on the optimal outcome for all.

Moving your MBO forward

If you are thinking about selling to an MBO team, or indeed approaching your employer about buying them out, we would be happy to arrange a discussion with you to see how we can support you in moving forward.

Price Bailey
CHARTERED ACCOUNTANTS

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