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FEATURED RESEARCH

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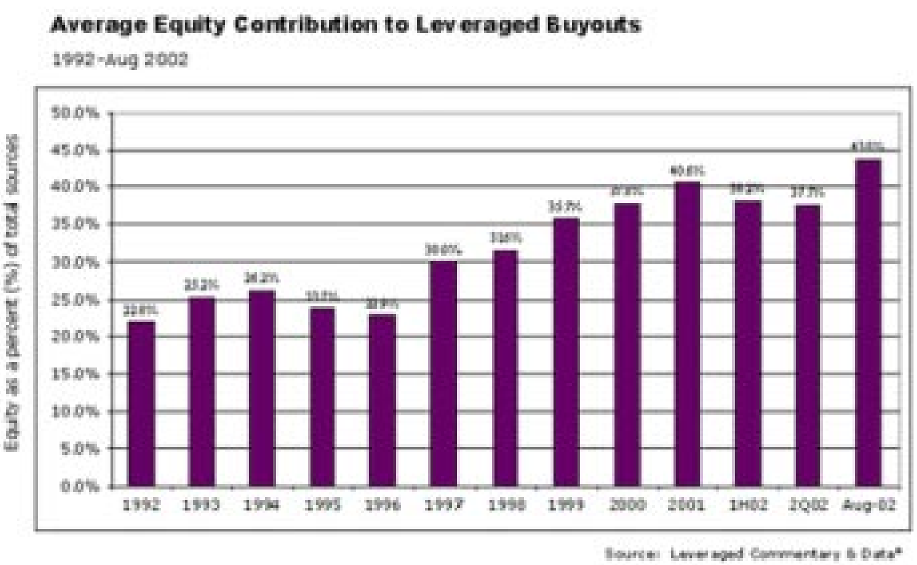
MANAGEMENT BUY-OUTS REVISITED

As slow economic growth has caused many large organizations to rethink their operational goals, many corporations have been selling off, “spinning out”, or winding down underperforming or non-core businesses. This trend has generated more opportunities for professional management teams to become business owners. In the last weeks of December 2002 over a dozen transactions were completed in which a corporation or entrepreneur sold a business to its management team. With over 200 management buy-outs in 2002 alone, the MBO is back.

There are many different circumstances or events that may facilitate the initiation of a management buyout including: wealth management and succession planning for a business owner, divestitures of corporate divisions, and public-to-private transactions.

A decline in public company valuations and access to capital from public offerings has lead to an increased popularity of buyout transactions. In 2001, the buyout deal volume fell by 44.2% as bank lending tightened and deal valuations dropped. However, in 2002 buyout volume nearly doubled to a 3-year high of $41.5 billion according to *Venture Economics*.



MBO CANDIDATES

A management buyout is a form of a leveraged buyout (LBO) used to transfer ownership of a company. MBO transactions usually rely on debt instruments to finance a significant portion of the purchase price, consequently, the majority of these types of deals occur in stable, mature companies that have an established track record of generating strong and sustainable cash flows. Typically, companies within the following industries are candidates for MBOs:

- Industrial
- Manufacturing
- Distribution/Wholesaling

However, as technology valuations have dropped off, making it difficult for those companies to raise capital and refinance debt obligations, a growing number of software and technology companies have been sold to management-led investor groups, such as Printer Solutions Holdings (2002) and Renaissance (2001). The management of Resonate, Inc., a California software provider, had their December 2002 offer of $50.4 million trumped at the last minute by another financial buyer, but these transactions and others demonstrate that the leveraged buyout model can work for tech companies as well.

Naturally, investors pursue investment opportunities that are likely to generate high rates of return relative to the risks involved, thus they are likely to target traditional businesses with solid fundamentals.

An ideal transaction would be characterized by the following:

- Cash on the Balance Sheet
- Attractive Purchase Price
- Strong Projected Cash Flow
- Adequate Debt Capacity
- Strong Management Capabilities
- Attractive Industry Fundamentals
- Strong Market Position
- Discernible Exit Strategy (4-7 years)

FINANCING MANAGEMENT BUYOUTS

Middle-market management buyouts (up to $150 million in enterprise value) typically use the private equity markets to finance the transaction. The deal process may take anywhere from three to twelve months to complete (on average, nine months – but closings are happening faster as these transactions are becoming more common), depending on the complexity of the transaction. Private equity or buyout firms typically provide the equity portion and banks, financial institutions or insurance companies provide the debt.

The capital structures of post-management buyout companies are very different from those seen in the late 1980’s and early 1990’s. The failure of many companies to successfully operate under a tremendous debt burden has taught the capital providers a very important and costly lesson. The application of this lesson becomes apparent when taking a look at the significantly greater amount of equity injected in leveraged transactions today when compared to the LBO’s of the late 1980’s. The average equity contribution to a LBO a decade ago was 25% while today the equity portion of the capital for an LBO is approximately 44%.

RISK/RETURN

Buyout funds do not take on the risk of a venture capital fund, so they don’t expect the same sort of return, but they do look for a thirty to thirty-five percent return on investment. Mezzanine debt funds typically invest in the subordinated debt of the company and take the equity portion of their investment in the form of warrants.

In conclusion, the structure must provide new equity investors with an acceptable rate of return and give the acquired company enough financial flexibility to pursue its growth objectives and service debt. It is important that the capital structure fully considers the interest of all parties concerned, including the employees, selling shareholders, and the management and perhaps most importantly, that the structure is in the best interest of the business itself.

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RECENT TRANSACTIONS

Date	Target Company	Industry	Description
12/16/2002	Limbach Facility Services (Enron)	Electrical Contractor, Engineering Services	A management-led investor group, backed by FDG Associates acquired Limbach FSI from Enron Corp. for $81 million.
12/11/2002	Printing Solutions	Computer Printers	A management-led investor group, backed by Arsenal Capital acquired the Company in an LBO. Terms were not disclosed.
12/12/2002	Julien J. Stradley Inc.	Real Estate Brokerage	JJS was aquired by a management-led investor group with bank financing. Terms were not disclosed.
12/19/2002	Furturelogic	Thermal Printing Parts	An investor group, backed by Clearlight Partners and ACS, backed the management team to acquire FutureLogic, a manufacturer of small-format therm printing assemblies. Terms were not disclosed.
12/12/2002	Easy Gardener	Manufacturer of Landscaping Materials	A management-led investor group has acquired Easy Gardener from U.S. Home & Garden for $19.3 million plus the assumption of certain liabilities.
12/16/2002	Colonel's Inc.	Manufacturer of Automotive Bumpers	A management-led investor group, including the CEO of Parent Company SRI, agreed to acquire Colonel's Inc. (a manufacturer of automotive bumpers) together with Rugged Liner, Inc. for $38 million.
12/20/2002	Concepts Direct, Inc.	Mail Order Catalog	A management-led investor group including CEO Phillip Wiland, has agreed to acquire the remaining 59.5% of outstanding shares in CDI for $2.1 million.
12/23/2002	Sports Chalet	Sporting Goods Retail	A management-led investor group has agreed to acquire the remaining 66% interest in the Company that was not under management control. Manage ment structured a leveraged buyout to acquire the remaining 4.4 million shares.

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