

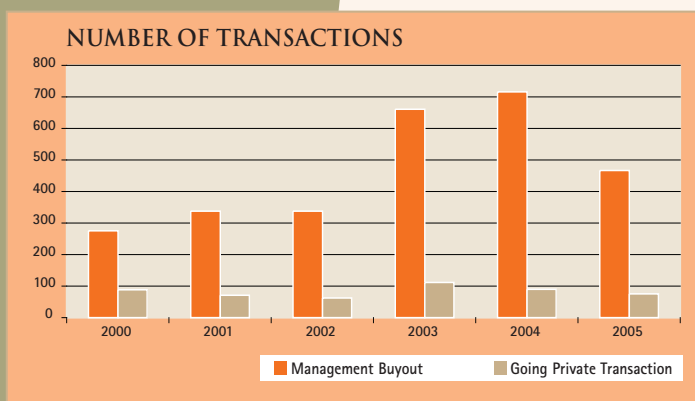
VIEWPOINT

FEBRUARY 2006

A Publication of
Mirus Capital Advisors, Inc.

SELLING TO MANAGEMENT: EASIER SAID THAN DONE

By Jameson J. Grant



In 2005, there were 466 announced transactions where management participated in the buyout of a private company or a corporate spin-off, in addition to 75 "going private" transactions in which the management team of a public company completed a recapitalization of the business that resulted in a buyout of the

company's stock. Nearly three thousand of these types of transactions have been announced in the past five years.

WHY THIS MATTERS:

- *Management buyouts make sense in some situations but not in others; it's important to know the difference.*
- *Both sides of a management buyout need to understand the complex and potentially contentious issues that arise with such transactions.*
- *Knowing the challenges of executing management buyouts is especially important to sellers who envision this as their exit strategy of choice at retirement.*

There are many reasons why a company's shareholders would choose to sell a business to its management. Having advised numerous companies on management buyout ("MBO") transactions, Mirus has seen the good, the bad and the downright ugly. In this month's Viewpoint, we take a look at why these transactions happen, and how to evaluate whether a management buyout makes sense.

The most common reason for a take-private transaction is to maximize shareholder value in a company that has fallen out of favor with investors. Many of the technology companies that filed for initial public offerings in the late 1990s are now smaller "penny stocks" that have been delisted from the NASDAQ or an exchange.

With a stock price of under a dollar, these companies are disadvantaged as a public company, having to spend millions each year on audit and legal fees associated with SEC compliance. By "going private," these companies can provide liquidity to their frustrated shareholders in a single transaction, and then execute a turnaround strategy with new investors out of the public eye.

In private companies and corporate divestitures, the reasons for an MBO are more nuanced. They typically include variations on these themes:

- **Confidentiality and Discretion:** When selling a business, it is critical to be discreet. Depending on the business, the risks associated with customers and

employees finding out about the sale can be catastrophic. By selling to management, the company can avoid letting anyone know that the business is on the market.

- **Lackluster Financial Performance:** A company that has had slow growth, or even declining revenues, may still have value, but would appear to a buyer to be a “fixer-upper.” As a consequence, a sale process may not yield an attractive offer, leaving the door open for management to buy the company at a price that might otherwise be considered a discount.
- **Non-core Asset/Corporate Orphan:** Mergers, acquisitions, management restructuring and budget cuts can often create “corporate orphans.” An example would be when a company is acquired, but some or all of the product lines don’t fit the strategy of the acquiring business. A proactive executive team would look to “spin-off” the non-core asset. Alternatively, the division might be neglected to the point where the divisional management begins to feel like an orphan, and then proposes an MBO to the parent company.
- **The Ultimatum:** In a private company where the owner of the business is not involved in the day-to-day operations, or the non-owner management team controls key customer relationships, it can be impossible to sell the business without management’s support. As such, management may give the shareholders (or the corporate parent) an ultimatum: “Let us buy it, or we walk.”
- **Insolvency:** Many companies that find themselves insolvent file for bankruptcy to protect the company’s assets. Often, this leads to a sale of the business to the highest bidder. Because management is in the unique position of knowing better than any outsider what the company is truly capable of, they are often in the best position to outbid other potential buyers.

POTENTIAL WAVE OF MBOS AHEAD

As business owners of the highly entrepreneurial baby boom generation approach retirement age, an increasing number of them are now seeking the liquidity and financial security that can come from selling their business.

Baby boomers have founded 5 million businesses with annual revenues ranging from \$1 million to \$75 million in the past 30 years. With the leading edge of boomers turning 60 this year, studies by PriceWaterhouse Coopers, MassMutual and Marquette predict that one out of two of these companies will change hands between 2006 and 2016. According to MassMutual’s 2003 American Family Business Survey, approximately 30 percent of boomer business owners plan to sell their business to a family member, while another 18 percent plan to sell in some manner to current employees.

Many retiring business owners prefer to turn their companies over to the managers who worked side-by-side with them to build those organizations rather than to bring in outsiders. This is especially true if family members are involved in the business. While protecting their own financial interests is of paramount concern to these exiting owners, many of them also want to ensure that the company continues to provide a livelihood for their immediate heirs or other kin.

CHALLENGES GALORE

While these transactions can certainly be made to work,

they are not without challenges. In our experience, we’ve seen too many business owners and management teams enter into the MBO process without adequately appreciating the challenges that await them. Here are some of the stumbling blocks that both sides of an MBO often fail to anticipate:

- **The management team plays dual roles.** With an MBO, the management team finds itself in the unusual position of acting as both a buyer and a seller. Yes, they are buying the business from its owner, but to obtain the outside financing most management teams need, they are also selling their vision for the company to lenders and investors.

In this scenario, the management team says to the seller, “This company is only worth X dollars; in fact, without our support, you’d be lucky to get that much for it.” At the same time, to attract the financing they need, management needs to convince investors that the business has a significant

MBOS & INDUSTRY SECTORS

What industries are likely to be most impacted by this wave of ownership transfers? Historically, MBOs have tended to be more frequent among industrial, manufacturing or distribution/warehousing companies because these businesses have hard assets (inventory, real estate) that management can use as collateral to finance a buyout. Companies in the technology sector don’t typically have assets for management to borrow against, and as such, MBOs in this sector generally occur only in situations in which the company is financially troubled and therefore the seller is willing to accept a lower value for the business.

“If it becomes clear that a technology company is not going anywhere and the VCs want to stop wasting their time with it, that becomes a clear case where an MBO may be a possibility,” said Andrew Updegrave, of Gesmer Updegrave LLP. “If the company is only marginally profitable, these deals can be much simpler than in a classic MBO that involves real money changing hands because it will be difficult to impossible to bring any meaningful amount of debt or equity financing. Often, the VC funds are just washing their hands of the investment and converting their preferred stock into a minority common stock position so that if the company ever does turn around they have some upside.”

upside. To this group, they'd say, "This company is actually worth X + Y dollars, but we can get this seller to sell it to us for just X dollars." Carrying out these roles simultaneously can be awkward, and can lead to hard feelings that impede negotiations between the owner and the buyout team.

- **Conflicts of interest abound.**

The seller's desire for the highest price possible and the buyer's desire to pay the lowest price possible is just the tip of the iceberg when it comes to the conflicts of interest that can arise in MBOs. Consider the fact that the management team—the group that has devoted itself to creating value for the company—is suddenly in the position of working against its own interest. The harder they work to strengthen the company while it is "on the market", the more they will have to pay for it. In such situations, it's not unusual for an owner to detect a sudden lack of focus on day-to-day operations among the management team.

Also, the management team's responsibility for providing the owner with honest financial projections produces a conflict when the team wants to buy the company. To be able to make a sound decision on whether now is the right time to sell the company, the owner relies on management's honest assessment of the company's prospects.

"In addition to the going-private transactions, many of the MBO deals we are involved with involve non-core businesses being sold off to management teams," noted Todd Boudreau, a mergers and acquisitions attorney with the Boston office of the international law firm of Greenberg Traurig. "When you're thinking about price and negotiations, you want to be sure that management takes their immediate interests out of the equation. It helps to mitigate this issue by having the management team hire separate counsel and its own valuation expert, such as an investment banker. This takes some of the pressure off of management from their somewhat conflicting dual-role as buyer and seller and gives both sides a more level playing field."

KEEPING AN HISTORIC COMPANY ALIVE

In November 2001, Troy Mills, Inc., of Harrisville, WV, was operating under Chapter 11. Founded in 1865, the company was one of the oldest textile manufacturers in the United States and was a leading supplier of nonwoven textiles used in automotive applications.

Mirus was engaged to find a buyer for the distressed company, and when it became clear that the only qualified bidder would make a below market offer, Mirus suggested to the management team that they buy the firm. As with many MBOs, the financing had to be creative. In addition to a small amount of equity from the management team and local businessmen, the funding came from Mountaineer Capital, a West Virginia private equity firm that invests primarily within the state, as well as from the West Virginia Economic Development Authority, which provided an attractive mortgage for the manufacturing facility.

On March 15, 2002, the management team took over the firm and it was officially out of bankruptcy. "It took about six months to get back on terms with vendors," reports Richard Kerns, the plant manager who participated in the buyout. Kerns now serves as the firm's Chief Operating Officer.

After several tough years of working to diversify the business and reduce the focus on the automotive market, Kerns projects that the company, now known as Troy LLC, will return to pre-bankruptcy revenues in 2006. Among the new products added to the firm's repertoire are an underlayment for floating hardwood floors and a line of oil absorbent products for the steel industry.

- **Lack of competitive bidding can lead to a lack of trust.**

With all the inherent conflict of interests involved in MBOs, you'd think the natural thing for a seller to do before going down this path would be to test the external market for the business in an effort to try to arrive at a realistic, reasonable price. But some owners try to "keep things simple" with the naïve expectation that it will be easy for both sides to agree on a suitable price.

The unfortunate truth is that dealing with people you've worked beside for a long time is often harder than dealing with strangers when money is at stake. This lesson is learned the hard way by owners who present their non-market-tested price only to have the management teams counter with a far lower valuation. Once that happens, things can quickly go from congenial to ugly, as the owner begins to feel that management is self-dealing. This can be especially true in family-owned businesses, where one sibling is the buyer and the other is the seller.

Of course, seeking competitive bids also entails

risks. "One of the problems sellers can face when they set management up for competition with other potential bidders is alienating the management team," said Frederick P. Callori, a partner at Choate, Hall & Stewart, LLP, of Boston. "Management is thrust into the dual position of facilitating diligence for other bidders and trying to establish their own winning bid. Other bidders may be concerned about having a defeated management team on their hands if they do end up being the buyer."

Even with that risk, Callori still advises seeking external bids first. "I would hold off on including management in the initial bidding process and really do a thorough market check of what others would be willing to pay before I included management as a bidder," he said. "This could help to keep management initially focused on the sale process from the company's perspective and also enable them to evaluate whether they can compete with other bidders as the process develops. Presumably management

will not need the same amount of time as a third party bidder to reach a conclusion as to value."

"In a situation where, for whatever reason, you'd like management to have a good shot at winning, but want to be sure they pay a fair price, the most straight forward way is to have the company shopped," adds Andrew Updegrave, a partner at Gesmer Updegrave LLP, a Boston law firm that specializes in representing technology clients. "You can always give management a head start so they're not at too big a disadvantage; give the buyout team six months to go out and get the price you want."

- **Where is the money to come from?** Probably the biggest challenge for most management teams is how to raise outside capital for the deal. "The biggest single issue for an MBO is the fact that the buyout group has to find the money," said Updegrave. "The buyout group is seeking financing in a landscape where the financiers don't know if they are going to be the winning bidder. So the management group may or may not be looked at very favorably. To help overcome this uncertainty, the buyout team often needs to get some sort of assurance from the business owners that management is in the running."

Most teams need to put together a series of transactions to make the purchase feasible. They'll start by leveraging their own assets, such as their savings and home equity. But that is only the start, as they quickly find themselves needing to become

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— Andrew Updegrave of Gesmer Updegrave LLP

familiar with how to pitch an opportunity to lenders, private equity firms, and in some cases governmental funding sources. (See sidebar for an example.) This can certainly be a huge learning curve for managers, and the seller may spend many sleepless nights wondering whether this group can actually pull it off.

The owner can help provide the solution to the buyout group's funding dilemma, of course, by helping to finance the deal. "Another thing you'll sometimes see is for the owner to hang

onto a piece of the company or provide some seller debt and take a board seat," said Updegrave. "We did an MBO a few years ago when the owner kept a board seat and 10 or 15 percent of the stock. If the company still has some growing room, this certainly makes sense for both sides."

THE UPSIDE

With outside assistance to help negotiate the inevitable hurdles MBOs encounter, both sides can come away winners. Sellers can take pride in knowing that the business they worked so hard to build will live on as they move on to new business challenges or into retirement. Buyers have the opportunity to take that business to new heights that will help ensure their own financial futures. With such an attractive destination at the end, the MBO road, bumpy as it may be, can be worth traveling.

Jamie Grant is a Partner of Mirus Capital Advisors, Inc. He heads the firm's Family Business Advisory. Jamie can be reached at Grant@merger.com.

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