Legally Talking

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Business succession and management buy-outs

Canterbury business owners in the autumn of their careers looking to retire are faced with a number of challenges in ensuring the ongoing success of their enterprise.

In many instances, these enterprises are family owned and the next generation does not necessarily wish to continue with the business.

The business owner is left in an invidious position whether to liquidate the company, transfer the company to a family member or consider industry consolidation.

Long held and established enterprises often have a key ingredient often overlooked, ie to facilitate a management buy-out of the business by a key member or members of the management team.

Vendor buy-out motivations may include the need to compensate management with an equity stake in the future prospects of the company, protect the business against the cyclical nature of the industry, etc.

In general terms, the motivation for a buy-out by the business owner is to retire and provide the current management team with an opportunity to participate in the future growth of the enterprise whilst providing for a coherent and reliable transition process.

Management will want to ensure that the purchase of the business is at a valuation that is fair and able to generate future value for the new shareholders.

It is critical for the parties and particularly the management team to analyse financing considerations when assessing a management buy-out. Use of capital that has been secured will be required for the purchase price, working capital and capex and to settle costs.

These sources of capital may include senior debt, mezzanine (sub-debt), institutional equity or management equity. Most buy-outs are financed through a combination of debt and equity, however sources of funds have fundamentally different characteristics with equity being considered the most expensive source of capital.

When deciding the appropriate funding structure, it will be important for the management team to consider cash flow, the quality of cash flows, whether the bank debt (if applicable) will need to be secured by assets held by the company and various tax considerations, ie the timing of tax payments and tax deductibility of interest.

Management need to assess the financial challenges of ownership and be self-starters and be happy to be independently accountable for the management of the business. Whilst the opportunity to conduct a management buy-out presents a lower risk, there are a number of problem areas to be avoided by the management team.

These problems include:

- the failure to select the appropriate funding mechanism and structure
- dealing with fatigue and management being distracted from managing the business
- the failure to have robust discussions concerning key due diligence issues
- not having the appropriate professional advisers on board to assess both financial and legal risk
- the failure by management to discern between business ownership and employment obligations once the deal has been finalised.

Other pitfalls to avoid are the failure to communicate effectively with staff during the transition process and management underestimating the personal commitments and securities that are required to fund the buy-out.

Detailed preparation with legal and financial advisers is more likely to avoid these pitfalls and ensure a smooth, effective transaction allowing vendors profitability to enjoy their retirement and for management to manage and own a thriving enterprise.