Growth Finance Expertise

Management Buy-outs

Bank of Ireland

Begin

Why choose Bank of Ireland for MBO?

Bank of Ireland delivers funding for management teams to become owners across all key sectors. We know that a successful bank funded MBO relies on building a relationship, understanding the sector, structuring the transaction and delivering funding to make the deal happen.

MBO Introduction

Management buy-outs have become an increasingly common feature of the Irish corporate landscape. Recognising the opportunities associated with running or expanding their own businesses, management teams are seeking to take their business to the next level and realise greater financial rewards than perhaps available as an employee.

An advantage of an MBO is that existing managers have a deep understanding of the business and there is no learning curve involved. However, while this is the case and they will reap the rewards of having ownership of the business, they have to make the transition from being employees to owners which can require a change in mind set from managerial to entrepreneurial.

In order to unlock the revenue potential, the MBO plan often calls for increased investment in product development, new equipment, staff training or marketing. The main risk for any management team is having the appropriate level of finance available to fund both the initial payment to the vendor as well as future working capital requirements. The danger is that all available money is used to purchase the business, leaving insufficient cash available to invest in growth.

There is a strong level of MBO activity in Irish mid market space. This is driven by a number of factors:

Market Drivers

Funding

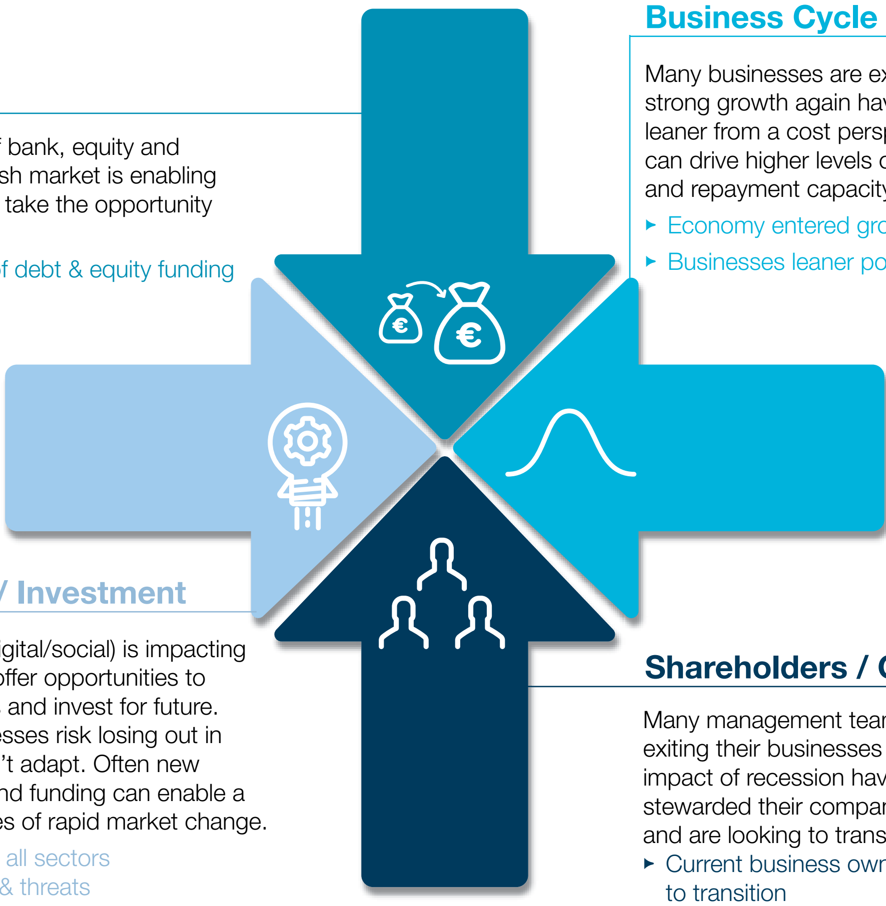
Increased availability of bank, equity and vendor loan notes in Irish market is enabling management teams to take the opportunity to transition to owners.

- Increased availably of debt & equity funding

Business Cycle

Many businesses are experiencing strong growth again having emerged leaner from a cost perspective. This can drive higher levels of profitability and repayment capacity.

- Economy entered growth phase
- Businesses leaner post recession



Market Change / Investment

Technology (i.e. cloud/digital/social) is impacting many sectors, this can offer opportunities to rethink business models and invest for future. At the same time businesses risk losing out in market place if they don't adapt. Often new owners, management and funding can enable a business to grow in times of rapid market change.

- Technology impacting all sectors creates opportunities & threats

Shareholders / Owners

Many management teams who delayed exiting their businesses to manage the impact of recession have successfully stewarded their companies to growth and are looking to transition.

- Current business owners seeking to transition

Bank of Ireland and MBO

Bank of Ireland provides a range of business finance products that can be combined to fund a successful and sustainable MBO.

Bank of Ireland is in a unique position to understand the challenges and opportunities facing businesses in all key sectors. This knowledge has been further enhanced by our teams of sector and transaction experts supporting our relationship managers as they help our customers pursue their growth strategies. When it comes to completing the transaction, Bank of Ireland ensures that we deliver against credit approved Heads of Terms.

Why Bank of Ireland?

Sector

- Team of sector experts recruited from industry with real "hands on" experience
- Relevant sector insights and benchmarks to inform value added customer dialogue
- Support application through credit process

Delivery

- Record of delivery of MBO funding in complex transactions across key sectors
- Confidence in credit terms offered

Transaction

- Team skilled in structuring credit proposals
- Mix of credit & lending experiences

Relationship

- 85 skilled Business Banking relationship managers in our retail network
- Supported by the Sector and Transaction Support teams

In the table below we highlight some recent MBO approvals from Bank of Ireland Business Banking.

Background	Facility	Purpose	Metrics	Security
Company creates software solutions for businesses operating in regulatory environments	‣ €3m+ ‣ 5 year term	To acquire 3rd party shareholding in the business	‣ Leverage 2 times ‣ Debt Service cover 1.6 times ‣ 'Rollover equity' & cash input 70% / Bank funding 30%	‣ Company Debenture and Inter company Guarantees ‣ Facility benefited from the InnovFin SME Guarantee Scheme
ICT Services	‣ €10m+ ‣ Combination of term and Invoice Discounting	MBO purchasing 75% of the company shares	‣ Leverage 2.9 times ‣ Debt Service cover 1.25 times ‣ Equity 8% / Bank funding 92%. Note – significant implied equity cushion given acquisition price.	‣ Company Debenture ‣ Element of recourse to new owner
Publishing Company	‣ €1m+ ‣ Commercial Mortgage provided over 6 years ‣ Term loan provided over 2 years	Management buy-out including purchase of company property	‣ Leverage 3.41 times ‣ Debt Service cover 3.2 times ‣ 26% equity / 74% Bank funding	‣ Company Debenture and Charge over company premises

Advisors

Advisors and financial backers can help make or break a deal. For a manager / owner, a MBO is a transformative experience and so it is important to pick an advisor that understands the MBO process.

Structure

The financial structure will evolve throughout the transaction; however, it is important that at an early stage, the vendor, the management team, and their advisors arrive at a rough outline of the structure that they believe is appropriate, as the financial structure often determines the price an investor can afford to pay for the business.

Valuation and price

The vendor will want fair compensation for the business they helped to build, which can create tension between the management group and the vendor – clear value expectations going into the transaction is crucial. Valuing any company is not an exact science and there will always be an element of judgement in arriving at the price. Broadly, there are three methods employed:

- **Market based valuations:**
  Method of determining the appraisal value of an asset based on the selling price of similar items or companies and adjusting accordingly for the asset in question.
- **Net Asset valuations:**
  Value of an entity's assets minus the value of its liabilities.
- **Discounted cash flows:**
  Future free cash flow projections discounted to present value estimate.

Strategy

The new management need to articulate in detail how they will generate value from the business. Strategy will need to take account of market / industry characteristics and macro forces affecting Irish business: Brexit; consumers buying online etc.

MBO Timeline / Process

There is no set MBO process but experience suggests MBOs follow the process outlined below. Being prepared for the next phase of the process is key to a successful MBO.

	Preparatory phase	**Initial contact & indicative offers**	**Due diligence**	**Final negotiations**	**Path to closing**
Milestones	▸ Information gathering ▸ Agree acceptable deal parameters with owner ▸ Draft investment memorandum ▸ Draft NDA	▸ 'Warm-up' discussions with potential backers ▸ Issue confidentiality agreements ▸ Issue investment memorandum ▸ Follow up calls / Q&A ▸ Commence work on management presentation	▸ Engage with bank funders ▸ Management presentations ▸ Access to Due Diligence materials	▸ Revised proposal(s) received ▸ Meetings with preferred backers ▸ Finalise heads of terms	▸ Final confirmatory due diligence ▸ Legal negotiations ▸ Signing ▸ Closing

MBO Financing Structure

- It is essential to ensure a healthy mix of debt and equity to achieve the right balance between maintaining ownership and control of the business, achieving the appropriate funding levels required and managing the appropriate business gearing ratios.
- Aside from deciding on the overall amount of debt it is also important that the debt is structured appropriately.
- Detailed planning and sensitivity analysis are essential in ensuring there are no surprises going forward.
- Bank of Ireland provides a range of business finance products that can be combined to deliver the right mix for your business. One such product is Invoice Finance, a flexible and increasingly prevalent funding tool that releases the value inherent in your trade debtors, often your biggest asset. Funds may be released from the debtor book at an early stage, to assist in the purchase of the business and also to provide an ongoing source of working capital.

When putting together an appropriate structure, it is important to consider the following:

- Cash flow is the most important factor and it is of crucial importance that the buy out team has a detailed understanding of projected cash flows. Profit generation is important, but capital expenditure, depreciation, interest, dividends and other factors such as restructuring costs come into the equation, making cash generation the key driver of valuation.
- The 'quality' of the cash flows is another consideration, which includes the predictability of future orders (backlog), the prospects for the marketplace and the types of customers. The higher the quality of the cash flows, the more debt a company should be able to raise.
- Depending on the nature of the company's trade there may be certain periods when expenditure exceeds income. Likewise, the timing of tax payments and outflows may dictate when the company will be short of cash in certain periods. When determining an appropriate structure it is important to plan for these fluctuations.
- In general, at least some of the bank debt will need to be secured by assets held by the company. In addition to the projected cash flows, the banks will also consider the realisable value of the assets they will take security over.
- Tax considerations such as the tax deductibility of interest (but not dividends), and the timing of tax payments.

The various sources of finance and the number of factors taken into account means that securing a buy out, is a matter of integrating different layers of funding. This provides a structure which enables the purchase price to be paid yet enables the business to operate with some freedom in the future. The main criteria of the various finance providers are as follows:

Debt Finance

Evaluating the level of debt that the business will support is the first step to coming up with a financing structure. As noted above, this will generally depend upon the cash flow of the business, the asset coverage available, and the interest coverage – Bank of Ireland has guideline ratios in mind for each of these. Debt will be required to be repaid within a defined period, typically 3–7 years depending on the business. Among the key features for the business to consider in any debt package will be:

- Track record of lending institution to deliver
- The interest rate
- The repayment profile
- The security required and financial covenants.

Equity Finance

The level of equity may be influenced by the amount of debt that the business can support. Equity may be in the form of 'quasi equity' with no repayment of any kind until Bank debt is fully repaid.

The key features to look for in any offer of equity finance will include:

- The deal structure (the relative split of ordinary shares, preference shares and other instruments)
- Management's equity share (and the funding that they are required to provide)
- Whether any equity stake is dependent upon achieving a particular level of performance (a ratchet)
- Non financial terms such as any constraints over the operations of the business
- The dividend and interest structure.

Vendor Finance

Vendor finance can be either in the form of deferred loans from, or shares subscribed by, the vendor. The vendor may take shares alongside the management in the new entity. This form of finance has become more common as it bridges the price gap between vendors and buyers.

Legal Considerations

Due Diligence

Legal due diligence will often involve a questionnaire from the buyer's solicitors requesting information from the seller. The buyer's solicitors will then prepare a legal due diligence report for the buyer, highlighting any potential legal issues. The buyer will be particularly interested in issues that potentially affect the value of the target company, such as large potential pension or environmental liabilities.

Share Purchase Agreement

The share purchase agreement (also known as an SPA or sale and purchase agreement) is the principal contractual document in a share acquisition. The share purchase agreement will set out all the terms of the transaction, including details of the company being acquired and the respective parties' obligations in connection with the transaction. It will also provide for key warranties and disclosures on the part of the incumbent management.

Shareholders Agreement

A well drafted Shareholders Agreement has to address all those difficult "what if" questions such as what happens if someone gets sick, dies, is fired (with or without cause) and what are the issues going forward that require a majority consent from the shareholders.

How a shareholder exits the business and how, and at what value, do they sell their shares is a key topic that needs to be spelt out in the Shareholders Agreement.

Key Legal Documents

Document	Parties	Issues
Share purchase agreement	Management, Seller and Newco	Warranties, commercial issues
Disclosure letter	Management and Seller	
Articles of Association	Newco	Share classes and rights dividends, voting, transfer of shares, pre-emption rights, drag and tag along rights, good / bad leaver provisions
Subscription / investor agreement	Management and outside investors	Management warranties, vesting periods, conduct of business
Loan stock agreements	Outside investors, Newco and possibly Seller	Interest, repayment, security, interaction with financial covenants
Security documents, inter-credit deed and cross guarantees	Bank, outside investor, Newco and possibly seller	Security ranking of creditors
Board minutes and resolutions	Newco	Companies Registration Office filing required
Director service and contracts	Management and Newco	Terms & conditions

Tax Considerations

The tax aspects of an MBO are an important structural and commercial feature of most transactions. The following key areas usually need to be investigated, alongside others which are situation specific.

Seller's position

A seller will want to minimise the capital gains tax payable on the disposal of shares.

MBO Team

The MBO team will have tax issues relating to the shares or "sweet equity" that they acquire in the Newco. It is important not to trigger any income tax liabilities as a result of acquiring the shares which occurs when they are seen to be acquired at less than their market value. Equity ratchets sometimes offered to MBO teams to incentivise performance also need to be structured carefully so as not to create income tax liabilities. If the manager borrows to make an investment into the company, tax relief should be available on the interest.

Private Equity / VC Funders

Funders may have particular tax driven requirements for the transaction which may, for example, drive the debt / equity mix. Another requirement could be that the target needs to satisfy VCT requirements and if the venture capital investor is a VCT fund, this will also limit the stake that they can take in the business.

Newco tax position

- **VAT recovery on costs** It is imperative to get the MBO Newco vehicle created as soon as possible and for that company to undertake some activity.
- **Tax deductibility of costs** Broadly, if the costs relate to the acquisition of shares there will be no revenue deduction for the costs but if they relate to accessing financing, they will normally be allowable.
- **Interest relief** By their nature, MBOs are normally leveraged. It is important to ensure that the interest relief is deductible against profits and does not get "stranded" in a holding company.

Appendix

Glossary

Articles of Association:
The legal constitution of Newco.

BIMBO:
A combination of management buy-in and buy-out where the team buying the business includes both existing management and new managers.

Bought deal:
Where an Institutional Investor buys the target company as principal, later allowing either the existing management or a new management team to subscribe for equity.

Deferred consideration:
An element of the purchase price that is to be paid at some time in the future. Payment can be contingent upon the outcome of defined future events.

Enterprise value:
The debt-free value of a business equivalent to the business valuation plus the level of debt to be absorbed by the purchaser.

Equity Kicker:
A mechanism whereby holders of debt or mezzanine finance are given the option of subscribing for shares, usually at Exit.

Exit:
The point at which the Institutional Investors realise their investment. Venture capitalists may, depending on the business and their own situation, look to achieve an exit in anything from a few months to over 10 years.

Fixed or floating charge:
A legal mechanism whereby security over the assets of the business is granted.

Goodwill:
The difference between the price which is paid for a business and the fair value of its assets.

Institutional Strip:
A proportion of the total finance provided by Institutional Investors, which may include some or all of ordinary shares, preference shares and loan stock.

IRR Internal rate of return:
The average annual compound rate of return (IRR) received by an investor over the life of their investment. This is a key indicator used by institutions in appraising investments.

Loan stock:
Subordinated debt which carries fixed interest and is repaid in defined period, typically on exit.

Newco:
A new company formed to effect the buy-out by acquiring the operating subsidiaries.

Ratchet:
A mechanism whereby management's equity stake may be increased (or decreased) on the occurrence of various future events, typically when the institutional investors' returns exceed a particular target rate.

Senior debt:
Debt provided by a Bank, usually secured and ranking ahead of other loans and borrowings in the event of a winding up.

Subordinated loan:
Loans which rank after other debt. These loans will normally be repayable after other debt has been serviced and are thus more risky from the lender's point of view.

Warranties and indemnities:
Legal confirmations given by the seller, regarding matters such as tax or contingent liabilities, to assure the MBO team and Institutional Investor that any undisclosed liabilities that subsequently come to light will be settled by the Seller.