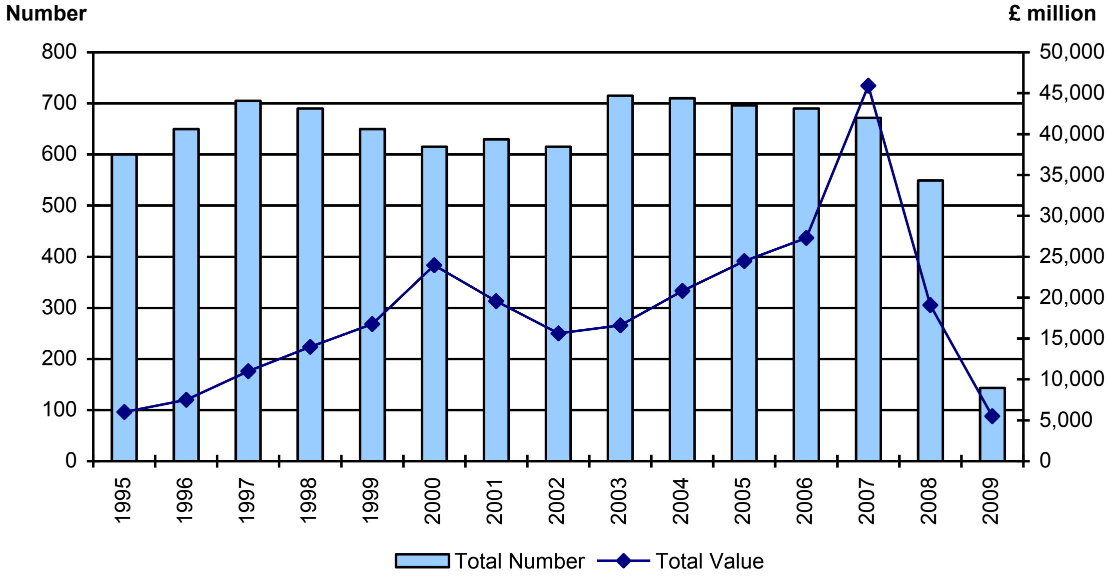
Management Buy-Outs ("MBO")

Gambit Corporate Finance Quarterly Update – February 2010

Whilst there is continuing turmoil in global financial markets, there are signs of stabilisation in the real economy, and indications to suggest increased levels of buy-outs and other private equity transactions in 2010. Management Buy-Out activity is widely perceived as an indicator of the health of the economy. The chart below plots the development of the UK buy-out market during the past fifteen years.



Source: Centre for Management Buy-Out Research

The Centre for Management Buy-Out Research ("CMBOR") reported that 2009 saw a 72% decrease in MBO activity to £5.5 billion as compared with £19.7 billion in 2008, representing a return to 1995 buyout levels. However, there was a 48% increase in the value of private equity-backed buyouts in Q4 as compared with Q3 of 2009, suggesting a measured return in investor confidence. The ongoing turmoil in financial markets during 2009 continued to impact on the ability of companies to raise funding in the debt and equity markets, reducing the number of M&A transactions and valuations. This substantial decrease in valuations, combined with the fact that debt is currently cheaper than in recent years, makes a MBO a significantly more attractive proposition for management teams.

Key trends

In the five years leading up to the peak of the market in 2007, there was a significant increase in average transaction size. This trend was largely a function of private equity providers, who raised significantly larger funds for investment, strategically focusing on increasingly larger transactions. The increase in the quantum and value of investment funds raised led to higher profit multiples paid in MBO transactions to a point whereby private equity providers were increasingly out bidding trade purchasers even though a trade buyer would expect to leverage greater synergistic benefits. Many private equity providers have invested in “buy and build” platforms which enable them to replicate the business models adopted by trade buyers.

The data for 2009 highlights three interesting short term changes. Firstly, current market turmoil has had a more pronounced impact at the larger end of the deal spectrum. 61% of buy-outs (by number) completed in 2009 have been in the sub £10 million range.

Secondly, investors have focussed on sectors which are considered resilient in an economic downturn, such that business and support services transactions was one of the leading sectors by volume of deals. Thirdly, there has been a change in the funding structures used in buy-outs, with private equity investors being forced to provide a greater proportion of the funding in a transaction. The senior debt element within buy-outs has reduced from 40% to 31%. The equity element has increased correspondingly from 48% in 2008 to 64% in 2009.

Our view of the outlook for MBOs in 2010

We believe that there will be an increase in the number of MBOs during 2010. This will arise due to increased investment appetite from private equity funds, allied with parent companies reviewing their strategic options as a result of the following:

- forced sales in order to raise cash and improve liquidity;
- greater focus on core activities, and the subsequent disposal of non-core businesses; and
- overseas groups disposing of UK subsidiaries which are deemed to require a significant amount of management time and where sterling earnings values are decreasing on consolidation.

The anticipated increase in disposals of non-core subsidiaries offers strong management teams significant opportunities to complete an MBO at a time when price expectations remain at their lowest level for several years and the wholesale cost of debt is at an all time low.

From a vendors’ perspective, a MBO has several advantages over a trade sale. They typically represent the easiest and quickest transaction due to the inherent knowledge of the business held by its management, which can allow due diligence to be limited. Vendors might be prepared to accept a lower offer from a management team in competition with a trade buyer, in the belief that the transaction risk is lower, and there is less risk of price erosion during the due diligence process.

There are two key factors which are likely to increase levels of private equity investment. Firstly, historically, challenging economic conditions have represented a good time for private equity funds to invest, as prices are reduced, allowing them to generate outstanding returns to investors as they exit investments at a time when valuations are significantly improved.

Secondly, this is reinforced by the structural nature and investment timeframes of private equity funds. Those funds which were raised during 2006 and 2007 are now in the second half of their traditional five-year investment cycle. Reduced investment activity in 2008 and 2009 has meant that many of these funds are at risk of being unable to fully invest their funds.

Availability of leveraged finance remains restricted, especially for larger deal sizes. The reduction in the availability of credit is far less pronounced at the sub-£50 million end of the deal spectrum. Whilst rates have increased and debt multiples have become more conservative, banks remain open to leveraged MBOs involving strong management teams. There are some indications that banks are beginning to relax their tough stance on credit, although a return to 2007 levels of leverage are highly unlikely. We anticipate that this easing will continue during 2010.

Finally, we anticipate that vendor finance, whereby vendors defer an element of consideration, will become an increasingly important element of funding transactions.