

MBOs: An Optimal Exit Alternative in the Current Economy

An Appealing Opportunity

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Middle market investment banking activities felt the effects of the financial crisis. M & A deal volume for the middle market fell 39 percent in 2008 compared to 2007 and has fallen even further into 2009. The harsh credit markets have left their mark on the middle market. The average deal value in Q1 2009 was \$64.1 million, down from \$93.4 million in the fourth quarter of 2007. The decrease in average deal size can be accredited to conservative valuations due to the added risk and limited debt funds available. The incentive for an owner or principals to sell their business has sharply decreased and left many waiting for a more optimal, but indefinite exit timeline.

Traditional business models and financial investments have lost effectiveness, allowing a higher demand for alternative strategies and investments. Private equity groups are tentative to invest because of the risk coupled with difficulty accessing debt to leverage the scale of their investments. An alternative investment like a Management Buyout (MBO) presents an appealing opportunity to private equity. Why? First, the baby boomer generation is reaching their retirement age and ripe for an exit strategy with a structure that creates choices for owners. Second, investing in the current management team to take ownership allows for a familiar and

friendly transition, and in turn a more reliable and sustainable future for the company. Lastly, the trends in buyout valuation, debt capital, and equity capital are all enablers of MBOs for owners who want to control their destiny at the times they wish to exit, as well as the values at which they prefer to monetize their business' value.

Baby boomers make up 28 percent of the US population and 77 percent of the financial assets in the US are controlled by the baby boomers. Baby boomers in ownership do not have to conform to company retirement regulations and plans, so they are free to retire when they desire, most likely sooner rather than later in this current environment. However, retirement in the current marketplace is more uncertain than it has been in the past. Asset management firms investing in safe and reliable stock and bond portfolios have historically managed typical retirement funds. USA Today reported in October 2008 that retirement portfolios have lost \$2 trillion (20%) in value, and that workers are beginning to withdraw funds from retirement accounts in fear of more losses.

An MBO provides a comfortable alternative exit strategy because of the secure financial gains heading into retirement and the comfort and familiarity of passing the company reigns to the current management team. Creating a greater level of certainty is mutually valuable to both private equity investors and owners wishing to exit at the values they desire for retirement. For all owners, it is not only a question of price when selling your business, but also about structure of the terms agreed, which are more optimum in an MBO transaction, given the familiarity with the risks and the upside of the target company between seller and

management/owner. Apart from the raw data illustrating that a large group is looking for a retirement strategy, certain indicators also point to MBOs as an optimal investment alternative compared to typical buy/sell side investments, retirement plans, and equity markets. Private equity groups have access to funds, but not at the traditional volume or interest rate. The limited credit available allows more investment opportunities in the lower middle market because the transaction size is more realistic and affordable. Management buyouts in the lower middle market offer a relatively low risk and feasible investment opportunity based on several factors.

- The marketplace is turbulent because of weak credit lines and the mountain of bankruptcies that have resulted, making a large equity investment intimidating. The management team of a company should, assuming competence, be the best group to produce success after the current owner has left. A strong company, before the MBO, with a talented management team is a reliable option for continued success.

- Second, deal financing is a concern for any investment group during a credit crisis. Reputable and experienced private equity groups still have access to limited lines of credit. Private Equity Groups in the lower middle market have a distinct advantage due to the lesser amounts of funds required to invest and run successfully.
- Mezzanine financing is thriving in the middle market because of the limited commercial funds available. Mezzanine financing is ideal for MBOs because of the equity warrants and the flexibility of terms and conditions.

A smart investor/management team must be aware of possible weakness. During this financial crisis, company weaknesses will be exposed quickly, and a sound management team, familiar with the company, can adapt appropriately.

The strain on the debt market has prompted private equity groups to inject the highest levels of equity into their transactions. The

percentage of equity injected by private equity groups in leveraged buyout deals with companies having EBITDAs below 50MM increased to 38.9 percent up from 30.9, 31.1, and 29.8 percent in 2007, 2006, and 2005, respectively. Reduced debt-to-equity ratios push private equity groups to more dependable investments.

Businesses and investors must be committed to weathering the crisis with new strategies. Companies in the middle market still have desire for progression and private equity groups are keen for conservative but rewarding investments. Management buyouts are attractive for their security, potential long-term reward without the added risk, and friendly ownership transition. There are companies that are prospering during the recession and could provide lucrative returns to the forward thinking investors, while creating optimal liquidity events for owners at preferred monetized values and with clear and determinable structures.

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