

# How management buyouts unlock value for all parties

The ability to quantify value and internal rates of return are critical

**Kevin Homann**

A MANAGEMENT buyout does three things: it leverages returns on capital, facilitates a change in business ownership, shareholding and significantly reduces the operational risks of the business for the private equity investor.

To illustrate this, it is helpful to look at a typical structure, using round figures for the sake of simplicity.

Consider a scenario in which the original business owner accepts a R20m deal. The proposed transaction satisfies a bank's credit processes and a loan of R10m (senior debt) is advanced to be repaid over five years.

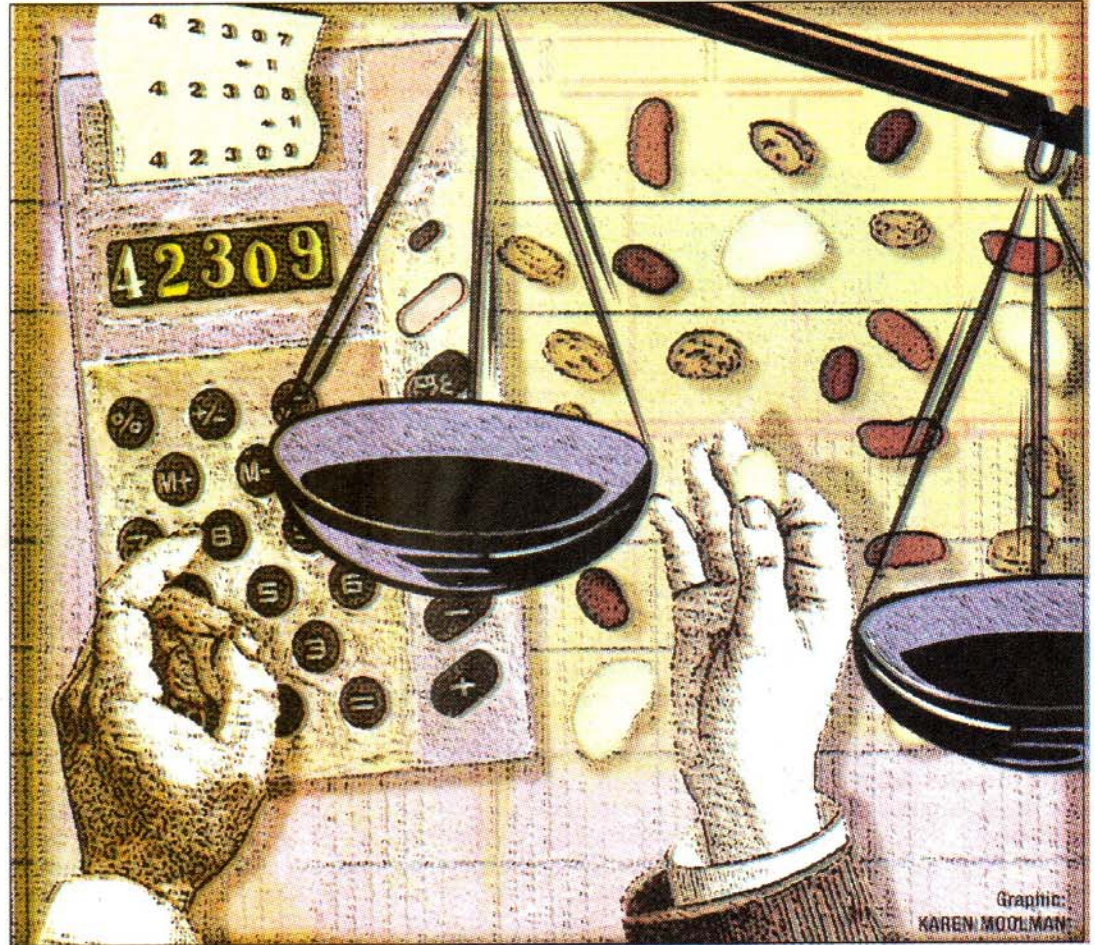
The management team pays R2m of the purchase price and R8m is provided by the private equity investor, R6m of which is in the form of mezzanine debt (an unsecured loan that commands a premium above normal lending rates). The remaining R2m provided by the private equity investor forms its equity portion of the transaction.

The private equity investor has paid the same for its equity as the management team (R2m), at the same time advancing mezzanine finance — a resource that may be unavailable to the management team without the private equity investor's involvement.

Five-year income statement, balance sheet and cash-flow projections are developed. Debt-servicing requirements are built in to progressively settle the bank loan and the mezzanine finance.

Included in these projections is an assumption about the growth in the value of the business (in this case, R20m rising to R50m).

The models establish the shareholding which the private equity investor requires in order to generate its internal rate of return (IRR), the "hurdle rate" expected by the private



Graphic:  
KAREN WOOLMAN

equity investor over the transaction period. Most private equity investors target an after-tax hurdle rate of between 20% and 30%.

Based on the financial models, the management team and the private equity investor agree on how the shareholding will be allocated.

In our illustration, a 60/40 split in favour of the management team is agreed.

Remember, the management team invested only R2m as compared to R8m for the private equity investor.

At the end of the period (normally five to seven years), the private equity investor will make a complete exit, either by a sale to the management team or an outside bidder.

The private equity investor will realise the full value of its

shareholding, R20m (40% of R50m). All in all, the private equity investor has placed R8m at risk, without security.

If things go horribly wrong, the bank (provider of senior debt) is first in line for debt repayment. In contrast, the private equity investor could lose everything.

The private equity investor will participate in the business on a financial monitoring, strategic and corporate governance level.

One of the attractions of private equity investment is that there is no cap on the return when the parties find they have a real winner on their hands.

The private equity investor takes equity risk. It therefore wants returns to commensurate with such risk, and will do

all it can to maximise it.

The team should appoint corporate finance specialists as expert advisers to manage the financial interests of the private equity investor and the management team which are closely aligned.

Therefore, the shareholders' agreement between the private equity investor and the management team will include clauses covering "step-in" rights and pre-emptive rights. These provisions will be explained in our next article when we look at the management buyout process in detail.

■ Homann is director of corporate and structured finance service provider Spirit Capital. This is the second in a series of articles on management buyouts.