Monthly Review

May 2005 (GB£)

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The May edition of the Monthly Review contains a short focus on venture capital funded deals between January and March over the past three years.

In the first quarter of 2005, it is the month of January that has proven to be the busiest for Venture Capital-funded deals. Indeed, this is a trend that has remained constant since 2003, both at home in the UK and in Europe.

We also thank Manchester-based Cole Associates Corporate Finance for their contribution to the Professional Comment series, which can be found on pages 2 and 3.

For those wishing to contribute to the series, there are still one or two slots remaining throughout 2005. Prospective participants are asked to call Kelly Kaminski for more information.

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Ask most venture capitalists or acquisition finance bankers about MBIs and generally they'll regale you with horror stories of failed investments and great promise not delivered. An analysis of the hard facts supports this wariness – the IRR enjoyed by VCs on MBIs is historically much lower than on MBOs. All of this is no surprise – the old adage that the three most important criteria in evaluating an investment opportunity – management, management and management – suggests you're opening yourself up to increased risk when the management team comes from outside the target business.

However, there are also many spectacular MBI success stories so it's clearly a question of matching the right team with the right target. In this article we look at the reasons for failure, and at strategies and techniques that an investor and an MBI team can put into practice to reduce the traditional risks associated with an MBI.

A typical MBI scenario is a family-owned business where there is no family succession or where the non-family management team do not have the appetite or attributes to mount an MBO. Alternatively, a non-core division coming out of a large group may require fresh management resource.

Let's look at the normal issues arising, and what can be done to reduce risk:

1. Experience of the target company's sector: This is normally the area in which most funders focus first, obviously. The more specific the sector-relevant experience possessed by the MBO candidate/team, the flatter the learning curve. This experience should be evident during the due diligence phase, when the MBI candidate/team should be able to contribute meaningfully to the commercial and financial due diligence.

2. Experience of the target's circumstances: This is often overlooked in favour of relevant sector experience. It's equally important to evaluate whether the MBI candidate/team has experience relevant to the circumstances facing the target company, for example a turnaround situation, a roll-out strategy, a need to professionalise the target and introduce new systems, and so forth. We've seen MBI teams with little sector experience be very effective because they understood the dynamics of the target business and the challenges it faced. Conversely, we've observed MBI teams who have struggled, despite having plenty of sector-relevant experience because they didn't have experience of the changing circumstances.

3. Experience of the proposed role: Many MBI candidates are moving up a rung of the ladder when they take CEO positions as part of an MBI. For example they might have performed very strongly as a Sales Director in a large group in a particular sector, transitioning to the CEO role in a smaller business in the same sector. Again, sector experience doesn't guarantee the individual will be a successful CEO, as this role requires a range of different qualities to a Sales Director role. Management profiling can be relevant in this respect.

4. Track record of dealing with change: The one racing certainty about MBIs is that the business you acquire will be different to the business you thought you were acquiring, no matter how much due diligence you perform! This is the obvious distinction from an MBO team who know where the skeletons are in the cupboard. It follows that the MBI team will be better placed to deal with the unexpected (both good and bad) post-acquisition if they have experience of dealing with periods of rapid change and upheaval. Many of the unexpected changes relate to staff and customers, and culture, so experience in these areas is a plus point.

5. Motivation for the transaction: What is motivating the MBI team? It should be an entrepreneurial urge to create something of value and achieve a stellar exit for all shareholders. However often there are more negative motivational forces such as the desire to get out of 'big corporate life'.

6. Commitment up front: In terms of financial commitment, the usual benchmark of investing approximately one times salary is a fairly crude rule of thumb. It is worth getting to know the financial circumstances of the individual(s) in more detail – one times salary can be small beer to some individuals, but conversely can keep others awake every night, neither of which is in the investor's interests.

7. Ongoing commitment: As already noted, the 12 months post-acquisition is inevitably a period of unexpected issues, often predominantly adverse, so the MBI candidate/team should ideally have some track record either in business or personally of dealing with unexpected challenges, and evidence of the inclination to fight in a 'fight or flight' situation. Restrictive covenants and bad leaver share transfer clauses are not what motivates an MBI candidate/team to dig deep when the going gets tough – it's a spirit ingrained in their personality.

8. Fit with incumbent management and within the MBI team: This is a crucial area. Pure MBIs are fairly rare, more often there is an element of buy-out within the team. Often the transaction starts life as an MBI, and by completion has become a BIMBO, to ameliorate some of the risks outlined above. The chemistry between the buy-out and buy-in elements of the team, as much as the fit of their respective roles is critical. Again, management profiling provides an impartial and professional perspective, and the more exposure of the two elements of the team to each other pre-completion, the better.

9. Vendor behaviour pre-completion: Vendors will seek to restrict the access of the MBI team and its advisers to the company and its customers etc, being concerned about confidentiality in the event the transaction does not complete. Up to a certain point in the transaction this is of course understandable. However, the severity of the issues referred to in 2. and 4. will be reduced by more effective commercial due diligence, often under a suitable cover story. The main areas on which to focus are normally customers and staff. An MBI team and their funders can be too willing to accept limited access, maybe because, at that late stage in the transaction they're too keen to leap to completion, or because the MBI team are inherently optimists. A related point is deferred consideration and vendor re-investment – if it's resisted aggressively, this should be a warning sign.

In summary, where MBIs inject higher quality management into a business the outcome should be positive. The strategies to mitigate risk revolve mainly around the 'fit for purpose' assessment of the MBI team, and the relative success of due diligence in flushing out all the likely challenges.

Jeremy Cole is the managing partner of Cole Associates Corporate Finance - a corporate finance firm based in Manchester, specialising in MBOs, MBIs, corporate acquisitions and disposals and development capital. www.cole-group.co.uk

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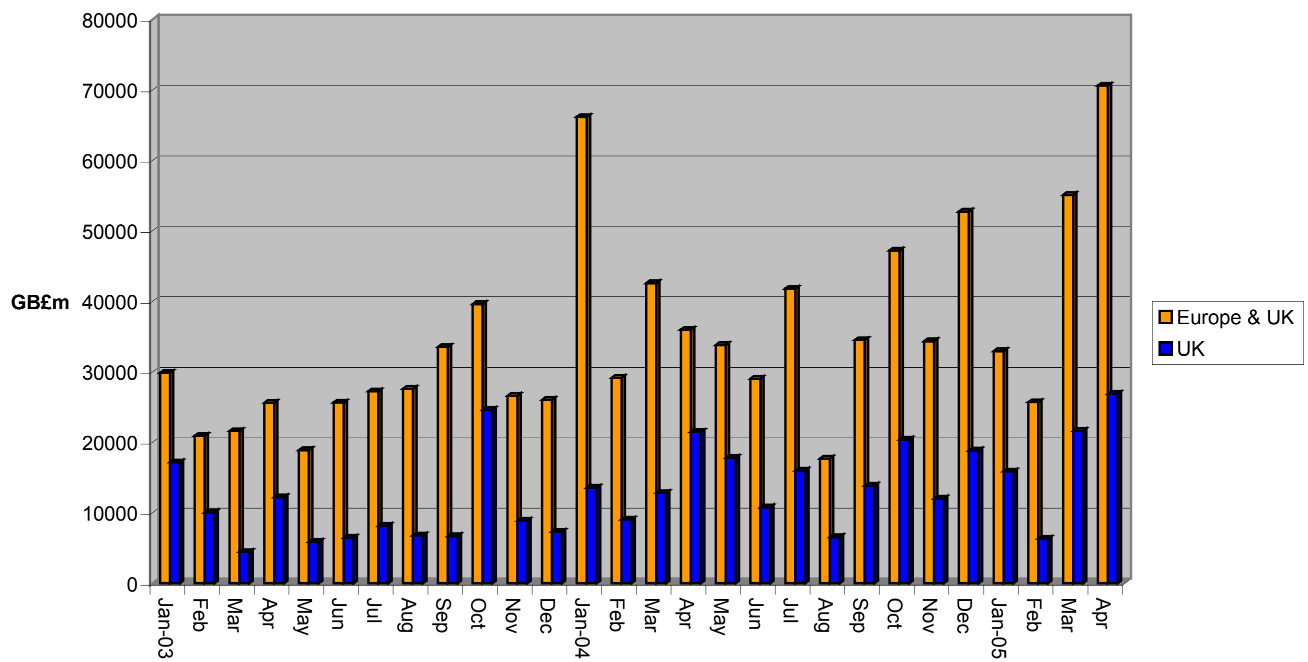
Total Value of Acquisitive Deals
January 2003 to April 2005



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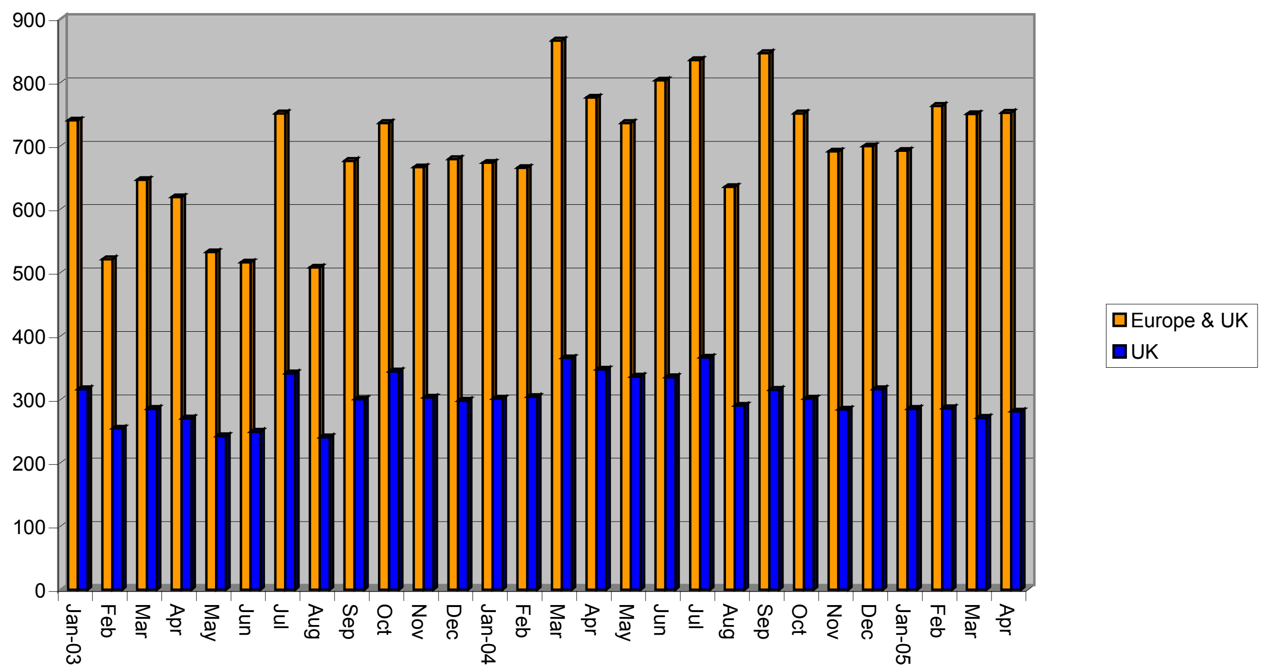

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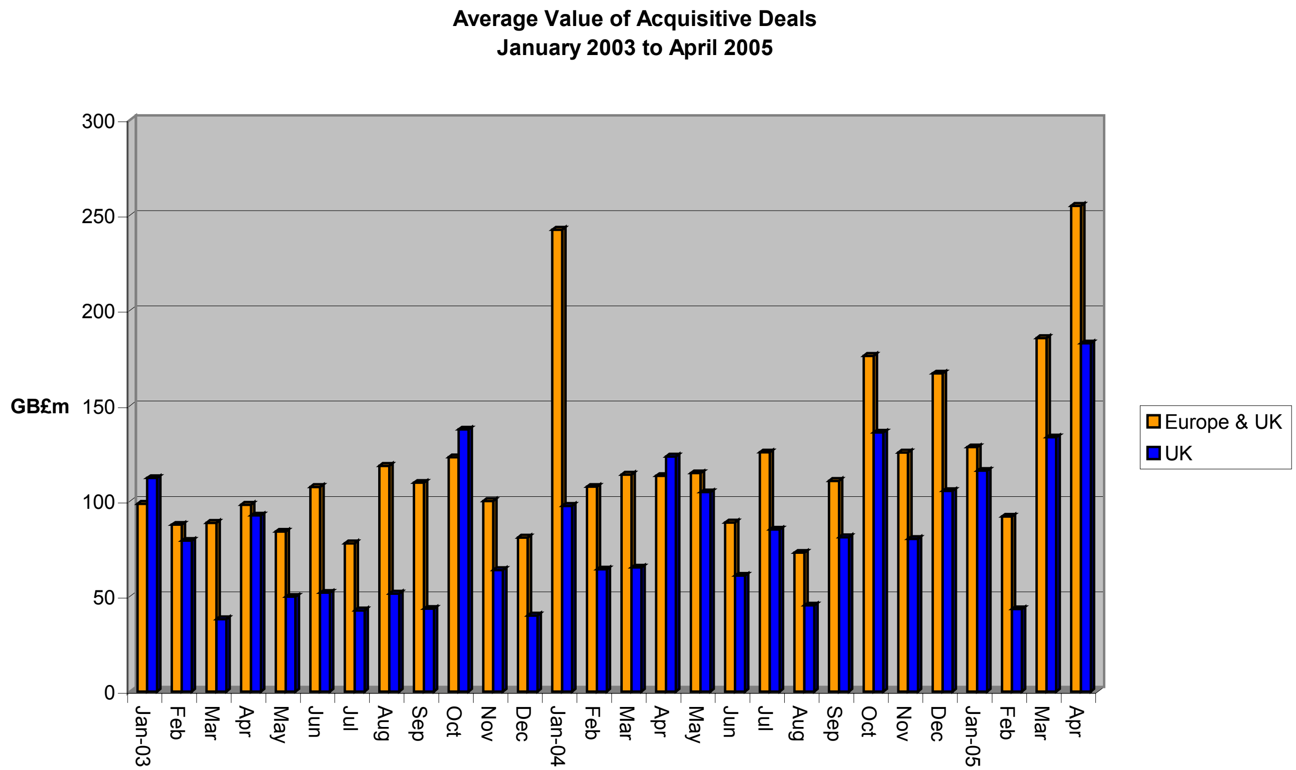
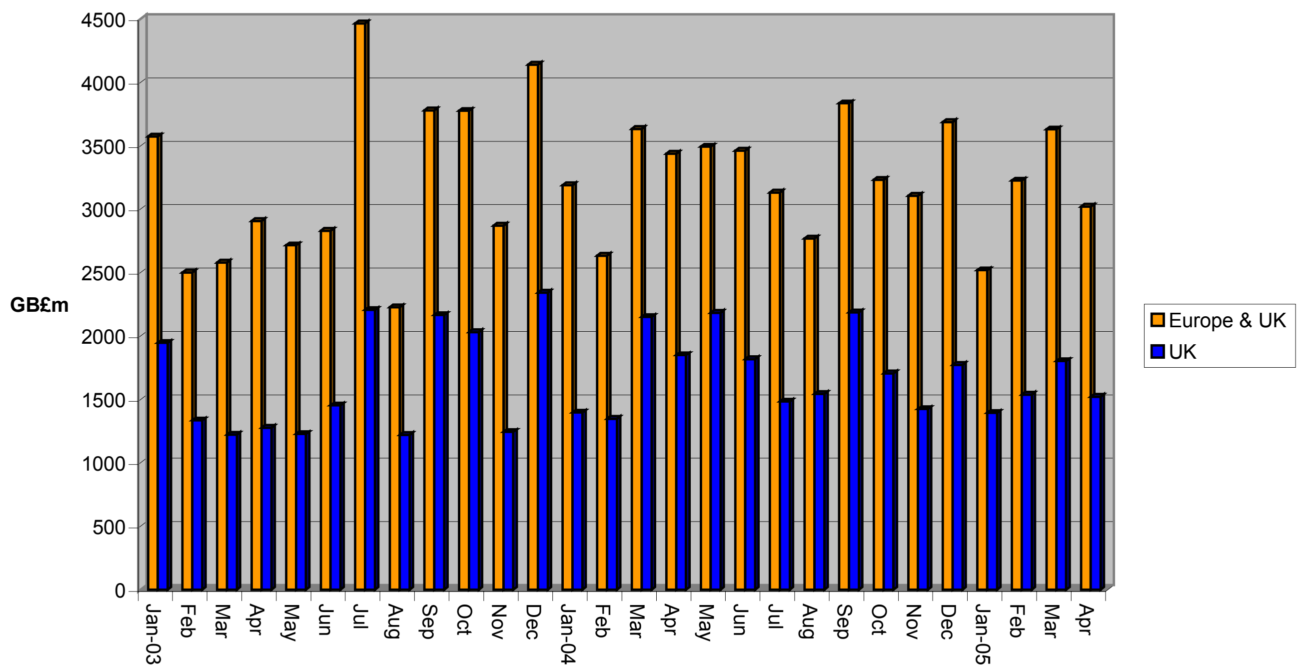


Total Value of Mid-market Acquisitive Deals
January 2003 to April 2005



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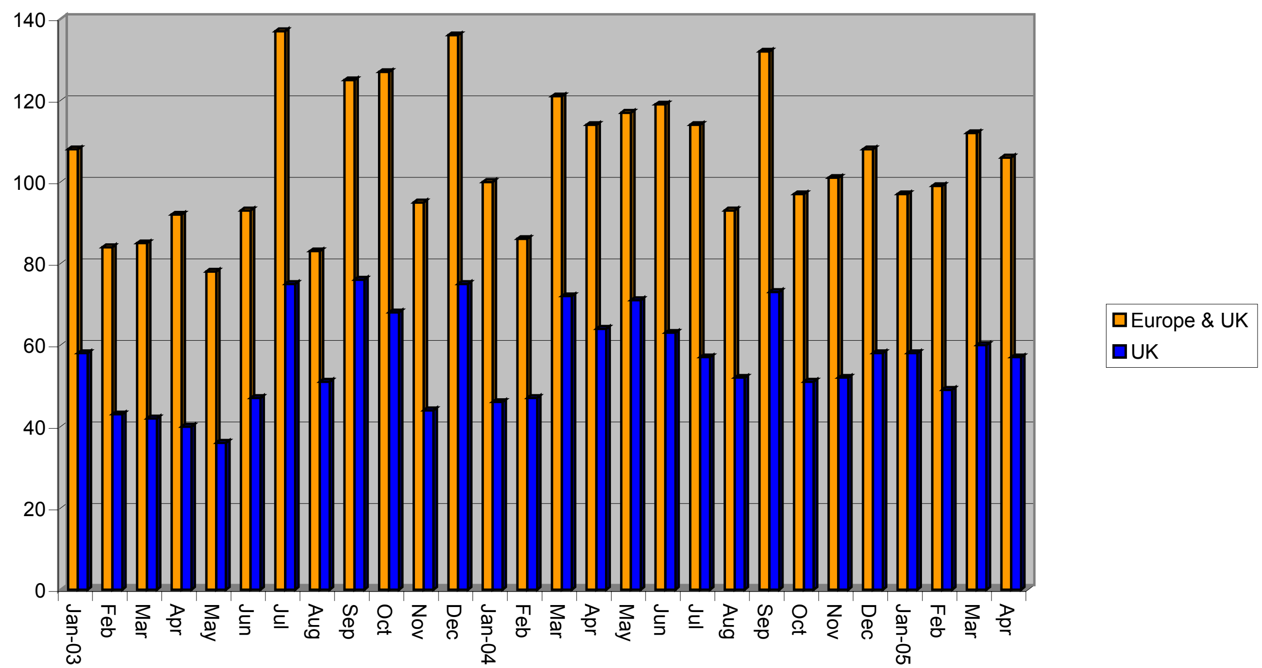

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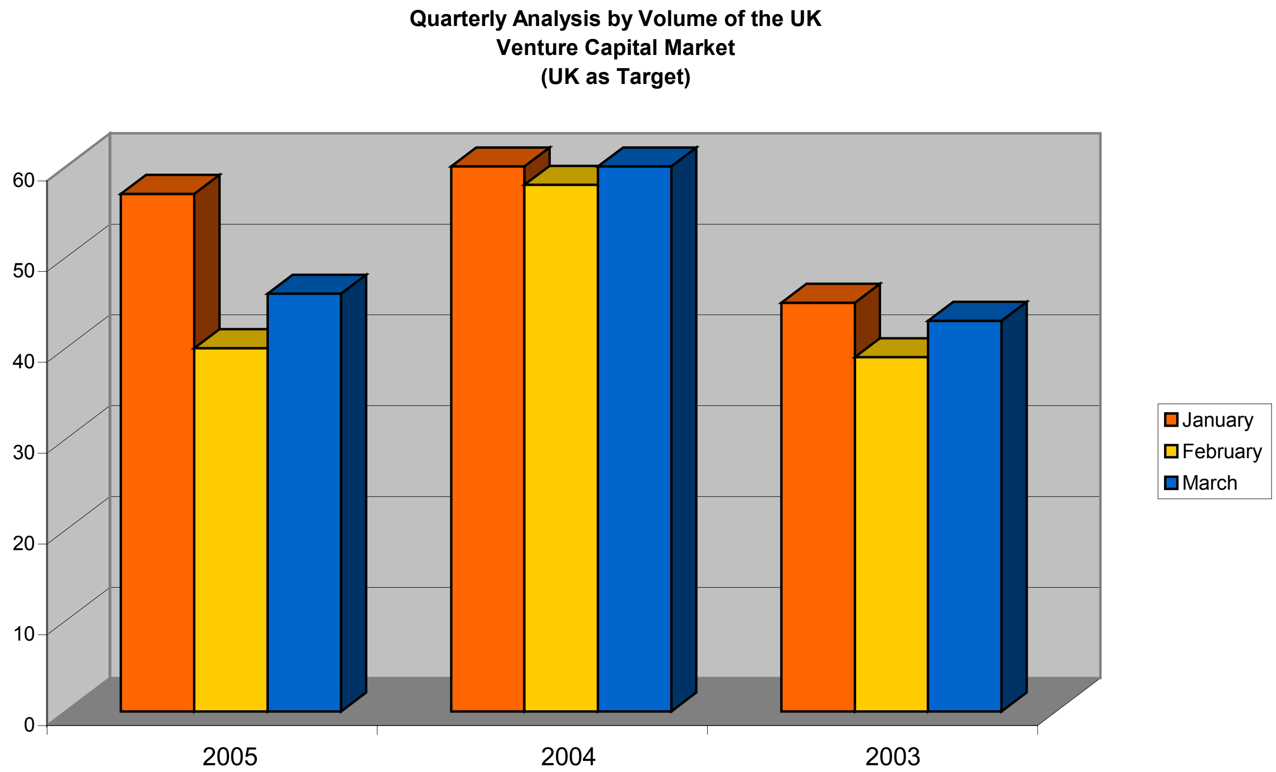

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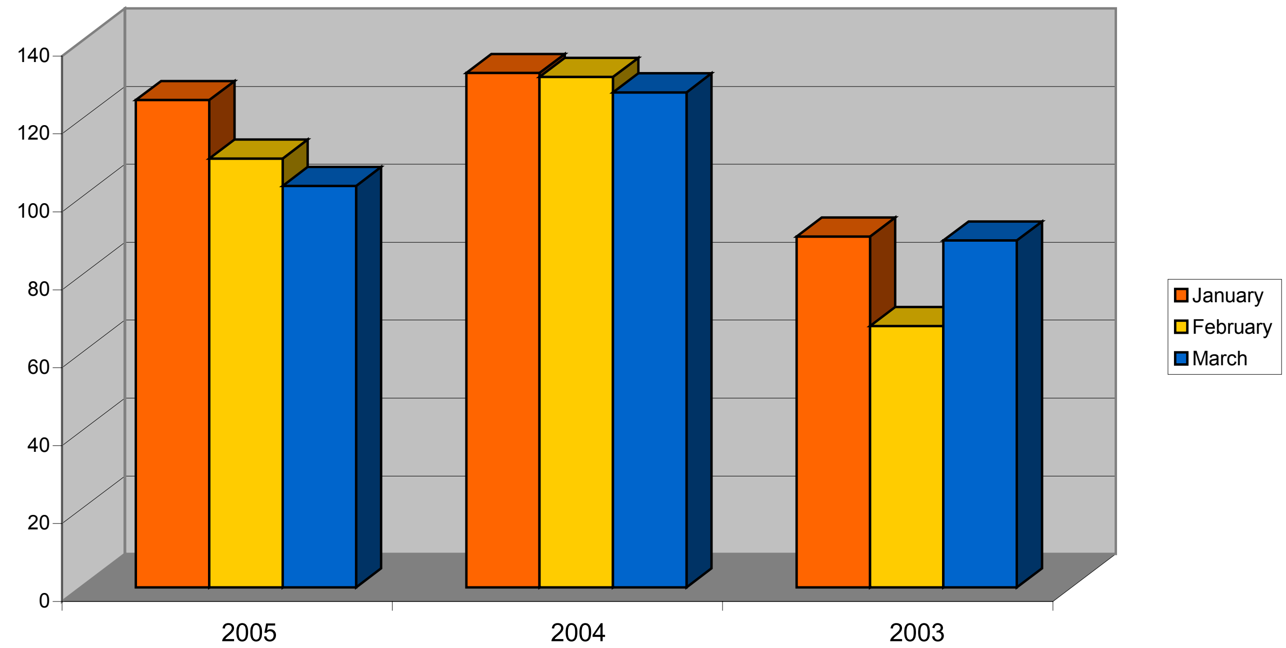
Quarterly Analysis by Volume of the European Venture Capital Market (Europe as Target)



European deals are inclusive of the UK.

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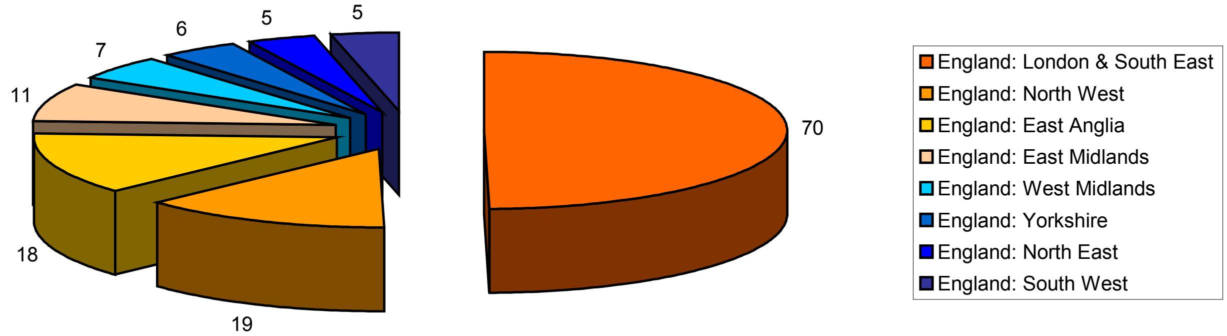
Number of Venture Capital Funded Deals by UK Region, January 1st to March 31st 2005



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Name of Firm supplying information

Company/Client details

Name:

Location:

Type of business:

Type of Deal

Acquisition	Management Buy-out
Demerger	Management Buy-in/Buy-out
Development Capital	Merger
Disposal	Minority Stake
Employee Buy-in	Public to Private
Employee Buy-out	Reconstruction
Exit	Receivership restructuring
Flotation	Reverse Takeover
Investor Buy-in	Rights/Other issue
Investor Buy-out	Secondary Buy-out
Leveraged Buy-out	Share Buy-back
Management Buy-in	Start-up

Deal Details

Date completed	Consideration	Consideration satisfied by:	
		Company share issue	Mezzanine finance
		Existing resources	Other companies
		High Street Bank	Vendor placing
		Merchant Bank	Venture Capital

Deal description – please include other companies involved, locations etc

Advisors – please supply all advisors, noting for who they acted and in what capacity

Advisor + office	Team (individuals)	Client	Role

Funding – please supply all investors

Investor + office	Debt/Equity	Team (individuals)	Client