

Management Buyout Returns: The New Power Shift Between Banks and Private Equity

In the halcyon days of the pre credit crunch period, Private Equity firms bestrode corporate life, buying and selling businesses on fancy earnings multiples and making vast fortunes for both clients and themselves.

In recent months - as the full impact of the credit crunch has affected all parts of the economy - the availability of debt finance has dried up. This dramatic change, combined with a collapse in corporate earnings, means that returns from these Management Buyouts have changed significantly.

This article sets out to analyse these changes and highlight the key issues that now must be addressed by lenders and PE houses, if many of these leveraged companies are to survive the worst downturn in economic activity for more than 30 years.

Two years ago, a simple MBO would be forecasting the kind of cash flow performance described in **Figure 1**.

FIGURE 1 Simple MBO. 4 year exit horizon. £000's						
Company A	Year	2006	2007	2008	2009	2010
EBITDA		5000	7000	8000	9000	10000
Working Capital Change			1000	-500	-500	-500
Capital Expenditure			-500	-500	-500	-500
Taxation			-1500	-1575	-1943	-2321
Cashflow From Operations			6000	5425	6058	6679
Acquisition (EV = 10 x EBITDA inc fees)		-50000				
Disposal (EV = 10 x EBITDA inc fees)						100000
Project Return		-50000	6000	5425	6058	106679
IRR	28%					
Debt Finance (borrow 6 times EBITDA)		30000				
Interest (assume 7.5%)			-2250	-2025	-1763	-1388
Repayment			-3000	-3500	-5000	-18500
Total Debt Flows		30000	-5250	-5525	-6763	-19888
Cashflow After Debt Finance		-20000	750	-100	-705	-13209
Return to Equity		-20000	750	-100	-705	86791
IRR	45%					

The business making an EBITDA of £5m would be acquired for a heady 10 times earnings multiple. A bank might well have funded 60% of the purchase price - with Private Equity subscribing the balance. This type of structure was by no means aggressive when capital was cheap and plentiful. As profits are forecast to double over the following 4 years, and with some working capital improvements, together with modest capital expenditure and the same acquisition multiple, the whole project would generate a 28% return on exit. The bank debt would account for 7-8% of that Weighted Average Cost of Capital - leaving equity with a very healthy IRR of 45%.

In this pre Credit Crunch scenario, the Private Equity Investor would expect to drive towards an exit with active Portfolio Management, appointing a Chairman to push his agenda and rewarding senior management through aligned incentive schemes. As long as the business serviced its interest and capital as planned and did not breach any of the financial covenants, the bank could maintain a relaxed monitoring role.

Private Equity could enhance its returns further, typically by refinancing the bank debt in the first 2 years of the project life. They could also reduce their exposure to the deal, taking cash off the table - either by borrowing on an enhanced multiple of increased profits, and/or by reducing the interest burden _____ thereby improving their returns from 45% to c66% in this example.

Interestingly, if they did this, the business would not be changed and would still generate exactly the same operating cash flows and the 28% project return. An example of true financial engineering, with Private Equity benefiting from more leverage being injected into the project - allowing it to make part of its return early.

BUT!... That was then!

A year on and the economic climate has changed.

So what is going to happen to these projects, now we are in the credit crunch?

There will be less debt around to fund new deals but what is going to happen to the existing deals? Let's look again at the example highlighted earlier and assume that this same MBO is now about 2 years old.

The credit crunch is beginning to bite. Profit growth has fallen to pre buyout levels, so still not disastrous!

Working capital has probably tightened, so that any gains made in Year 1 have reversed in Year 2. Capital expenditure is maintained in order to rebuild future profits.

However, the corporate finance market has changed fundamentally; there is little opportunity to refinance early and acquisition multiples have collapsed from ten to six times earnings.

Let's assume that an exit in 2010 is the earliest that can be achieved, but on a six times multiple.

Figure 2 shows the effect on the cash flow of the project, which makes an overall return of 0%, that is, the business generates the same cash over 4 years to match the purchase consideration.

FIGURE 2 Simple MBO. 4 year exit horizon						
£000's						
Credit crunch hits, working capital gains reversed, exit multiples reduce						
Company A	Year	2006	2007	2008	2009	2010
EBITDA		5000	7000	5000	5000	6000
Working Capital Change			1000	1000	-500	-500
Capital Expenditure			-500	-500	-500	-500
Taxation			-1500	-1575	-1043	-1043
Cashflow From Operations			6000	1925	2958	3958
Acquisition (EV = 10 x EBITDA inc fees)		-50000				
Disposal (EV = 6 x EBITDA inc fees)						36000
Project Return		-50000	6000	1925	2958	39958
IRR	0%					
Debt Finance (borrow 6 x EBITDA)		30000				
Interest (assume 7.5%)			-2250	-2025	-2025	-1950
Repayment			-3000	0	-1000	-26000
Total Debt Flows		30000	-5250	-2025	-3025	-27950
Cashflow After Debt Finance		-20000	750	-100	-68	-23993
Return to Equity		-20000	750	-100	-68	12008
IRR	-11%					

Under this scenario, the bank's covenants are likely to be under some pressure - if not breached. With patience, it is possible for the bank to recover its facility in full, but it would need to manage the business through a tricky period until an exit could be found. Capital repayments are likely to be postponed and the project probably warrants a risk premium attached to the debt service rate.

At exit, Private Equity makes a minus 11% return, recovering approximately 66% of its original investment (probably a very good outcome in the circumstances), which raises the question of whether the scenario is sufficiently realistic?

Clearly, if the business can avoid Administration, the bank needs to act as the de facto majority shareholder and will want to be rewarded for the unexpected risk it has taken on. The lender can lead negotiations with the Private Equity house to discuss: equity participation, the appointment of its own chairman to the board and the need to re-incentivise management to achieve the lower levels of likely profitability.

Private Equity companies can be notoriously difficult to deal with in these situations, often because the discussions often take place far too late. Private Equity monitoring systems do not pick up the warning signals early enough and typically the first reaction is denial of the problem! This delay can lead to crucial initial discussions not taking place until the business is already in dire straits.

In this scenario, the Private Equity house may well have mentally written off its investment and has nothing more to lose. Ironically the PE house may well negotiate harder from this position, giving the lender the whole problem to deal with, rather than coming to an outcome where risks and rewards could be shared in a more appropriate manner.

Figure 3's cash flow repeats the last example, except this time the banks take a 50% stake in the business. The project still has a break even return of 0-1%. However, the lender enhances its return from 7-8% to 14% by sharing in the upside on exit. The Private Equity house on the other hand still has an interest in the success of the business and could recover 25% of its original cost. It is therefore probably worth complying with the lenders wishes in order to achieve a modest recovery and realise this amount.

FIGURE 3 Simple MBO. Four year exit horizon, bank participation in equity Credit crunch hits, working capital gains reversed, exit multiples reduce						
Company A	Year	2006	2007	2008	2009	2010
£000's						
EBITDA		5000	7000	5000	5000	6000
Working Capital Change			1000	-1000	-500	-500
Capital Expenditure			-500	-500	-500	-500
Taxation			-1500	-1350	-840	-840
Cashflow From Operations			6000	2150	3160	4160
Acquisition (EV = 10 times EBITDA inc fees)		-50000				
Disposal (EV = 6 times EBITDA inc fees)						36000
Project Return		-50000	6000	2150	3160	40160
IRR	1%					
Debt Finance (borrow 6 times EBITDA)		30000				
Interest (assume 10%)			-3000	-2700	-2700	-2600
Repayment			-3000	0	-1000	-26000
Total Debt Flows		30000	-6000	-2700	-3700	-28600
Cashflow After Debt Finance		-20000	0	-550	-540	-24440
Return to Equity		-20000	0	-550	-540	11560
IRR	-14%					
Equity Split						
Bank	50%	0	0	-275	-270	5780
Total Bank Return		-30000	6000	2425	3430	34380
Total Bank IRR	14%					
PE House	50%	-20000	0	-275	-270	5780
PE House IRR	-28%					

This example is a relatively benign situation as there is no requirement for further cash, other than the modification of capital repayment schedules. However even in other situations where further cash is required and profits deteriorate markedly, the business can still be saved. If Administration can be avoided, which may only serve to crystallise latent losses, then there remain opportunities for banks to profit from their powerful position in existing transactions.

What is clear is that if lenders are to maximise their outcome in the current economic environment, they will need to act as owners of -rather than lenders to- businesses. In turn, this shift in power will have an impact on resources and the skill base required within the banking community. Negotiations with PE houses will need to become a more common event during the life of a project, as will the appointments of Chairman and Non Executive Directors led by the banks. Equity structuring skills and a thorough understanding of equity instruments will be paramount. Unless these issues are understood and tackled then the banks will not maximise their opportunity as the economic downturn bites.

In these scenarios it will be interesting to notice the change in behaviours by Private Equity executives towards their existing portfolios. Will they recognise this shift in power towards the lender quickly or prevaricate? The key issue will be whether lenders and PE houses can quickly agree upon the risk-reward relationships in a re-negotiated deal. Who will receive the marginal equity upside for allowing the business to survive? If negotiations become protracted then the business will undoubtedly suffer as it remains starved of cash and faced with growing uncertainty. In the long run both the lender and PE house will certainly suffer as procrastination will lead to a sub optimal deal.

Let us hope that both parties recognise the new order in the post credit crunch world and will accept a healthy dose of reality. Then all parties will be able to work together through very difficult times and come out stronger in the end.

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