

The True Management Buyout:

A financing overview for executives who are interested in buying the company they currently manage

Over the last two decades when a company changed hands from the prior owner to a private equity firm, it was not uncommon to read public descriptions of the transaction that included the softer language of “management buyout” in lieu of the more applicable “leveraged buyout.” This friendlier tone was often used to reassure employees, vendors and customers about new ownership. In many cases, however, this contrasted with the reality that the company had been acquired and was now controlled by a private equity investor.

Private equity ownership is fairly common given the number of privately held companies with aging shareholders and no heir apparent. Some sellers and their advisors have long been under the impression that selling their company to a third party financial or strategic acquiror is the only way to maximize value. While both are viable buyers, a third option exists. Management teams have the ability to use leverage to their benefit, match a financial buyer’s bid and buy the company they’ve been running for years; the **True MBO**. In today’s environment, with a wide range of capital sources and sellers who may be less inclined to sell to a financial or strategic buyer, the idea of selling the company to the management team is attractive for several reasons, and in many cases, it can be completed with the same proceeds at close.

Management is a viable buyer that should not be overlooked in some processes. **True MBOs**, where management has board and economic control moving forward, have closed between management teams and sophisticated sellers, including founders, private equity funds, investor groups and public companies alike, and can be a compelling transaction for everyone involved.

Advantages for the Sellers

Management Buyouts have the potential to achieve the same valuation hurdles as a sale of the business to a third party, and furthermore, the sellers may ultimately recognize a number of additional benefits including (i) speed and certainty of close, (ii) improved confidentiality and (iii) ensured legacy.

Having worked within the business and well-positioned to understand its risks and opportunities, the management team may prove to be the most knowledgeable buyer in the process. While diligence will be important to management’s financing sources, the process doesn’t need to become overly complicated due to an outside buyer attempting to understand the nuances of an industry or spending valuable time on issues that are immaterial to the enterprise’s operations, go-to-market strategy or cash flow. The management team can streamline the diligence process by focusing on the areas that need further clarification for its lenders, tax and legal teams. Management is well positioned to understand the company’s strengths and weaknesses and has longstanding customer and vendor relationships; all of which provides additional confidence for the financing sources that will be supporting management’s bid in the process.



Equally important, confidentiality may be significantly improved by selling to the management team. Regardless of the industry, the perceived strength of nondisclosure agreements or the lengths advisors may go through to prevent anyone from learning about a pending sale, the mere perception of a transaction can result in rumors, which competitors may leverage to undermine customer relationships and can easily result in anxiety across the employee base. Furthermore, by selling to the management team, the seller can limit the company's detailed records from being shared with numerous counterparties, some of which may be direct competitors.

Particularly common with family, founder and entrepreneur-owned companies, a select group of shareholders will place an increased emphasis on preserving the company's legacy. Many privately held companies serve as major employers within their communities, creating a sense of pride for the family that owns it and providing financial stability for the people they employ. While selling to the management team doesn't necessarily ensure a legacy for decades to come, a third-party financial or strategic buyer rarely has the same loyalty to the local community and may decide to make organizational and ownership decisions that are incongruous with the seller's vision for the company, its employees and the communities it serves. Unlike a financial or strategic buyer whose decision makers may live far away from the company it acquires, management shareholders often live in the same community as the company's employees and their families. This has a tendency to broaden management's perspective as it considers the impact of short- and long-term decisions on more than financial metrics alone.

Looking for a buyer with a vested interest in the community, ensuring their decisions are aligned with your vision for the company and people who are impacted the most?

Sell To Management

Structuring an MBO

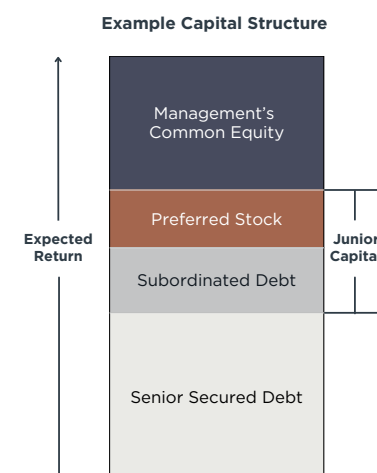
To many unfamiliar with the mechanics of an MBO, the concept sounds too good to be true, yet the framework for this type of transaction has been utilized in leveraged buyouts for decades. The main difference is that in **True MBOs**, the benefit of financial engineering goes to the management team instead of a financial buyer. To do this, management will leverage their existing stock option, grant, appreciation right or minority equity position into a controlling stake, often without having to personally contribute additional equity capital to complete the transaction.

Typical leveraged buyouts have a 50-60% loan to value; however, many commercial banks and private credit funds will not provide the same amount of debt to a management team as they might to a private equity buyer. The reason for this is because private equity funds, by definition, have a substantial pool of committed capital that they can access when necessary. Unfortunately, management shareholders rarely have the same access to capital, so lenders look at management and family-owned businesses as inherently having a higher risk profile. For that reason and depending upon the company's size, collateral base and a variety of other factors, management teams may only be able to raise up to 30-40% of the overall enterprise value from senior-secured lenders. Very few executive teams have the ability to raise 60-70% of the overall purchase price without bringing on a traditional private equity fund, which will generally want economic and board control in exchange for their capital. To avoid this and reduce the amount of common equity that a management team needs to complete an MBO, some management teams have looked to junior capital.



Junior capital sits between senior debt and common equity in the capital structure and may take the form of either subordinated debt, preferred equity or a combination of the two. It often has multiple features, including an interest component, an equity-appreciation feature (such as a warrant or option) and typically a liquidation preference. Some junior capital providers are willing to lend and/or invest in excess of 70% of the enterprise value because, as shown in **Exhibit I**, junior capital has a higher return expectation than senior debt and sits ahead of common equity in the capital structure. As a result, while junior capital may be more expensive than senior debt, it is less dilutive than common equity, and therefore increases management's rollover common ownership position.

Exhibit I



An additional benefit of junior capital is its structure; while there is typically a quarterly interest payment, there are often no required principal payments on the subordinated debt during the investment period, which gives management more freedom with the company's cash flow. Instead of making large repayments right away, the company can use that extra cash to accelerate the reduction of senior debt, invest in new projects or keep it on hand for future opportunities, including strategic acquisitions. Additionally, subordinated debt often includes an accruing interest component (payment-in-kind or PIK), which allows the company to defer a portion of interest payments by adding them to the principal balance, which is repaid at maturity. This flexibility can be crucial, especially if management is focused on reinvesting profits in opportunities with a higher return or responding to market fluctuations. PIK is a component found in subordinated debt and preferred stock securities alike.

Preferred stock is often looked at as equity by those more senior in the capital structure, but this patient security is a hybrid of subordinated debt and common equity and has a repayment priority ahead of the common equity. Redeemable (also known

A True MBO, when management has **BOARD, ECONOMIC & OPERATIONAL CONTROL**, is more easily achieved when using less-dilutive junior capital.

as participating) preferred stock resembles subordinated debt in the sense that it has a scheduled redemption for the full principal amount of the investment and requires an additional payment to preferred holders, which normally comes in the form of a current or compounding (PIK) dividend. This dividend represents a contractual fixed return and is a portion of the overall expected return of the security. Redeemable preferred stock also has common equity characteristics in the sense that a portion of the investor's return comes through the company's equity value appreciation by way of a warrant or common equity position affiliated with the security. Given the fixed return element embedded in the security and priority in the capital structure, whatever equity is allocated to the preferred stock, it is typically less dilutive on a dollar-per-dollar basis than issuing or selling a comparable level of common equity.



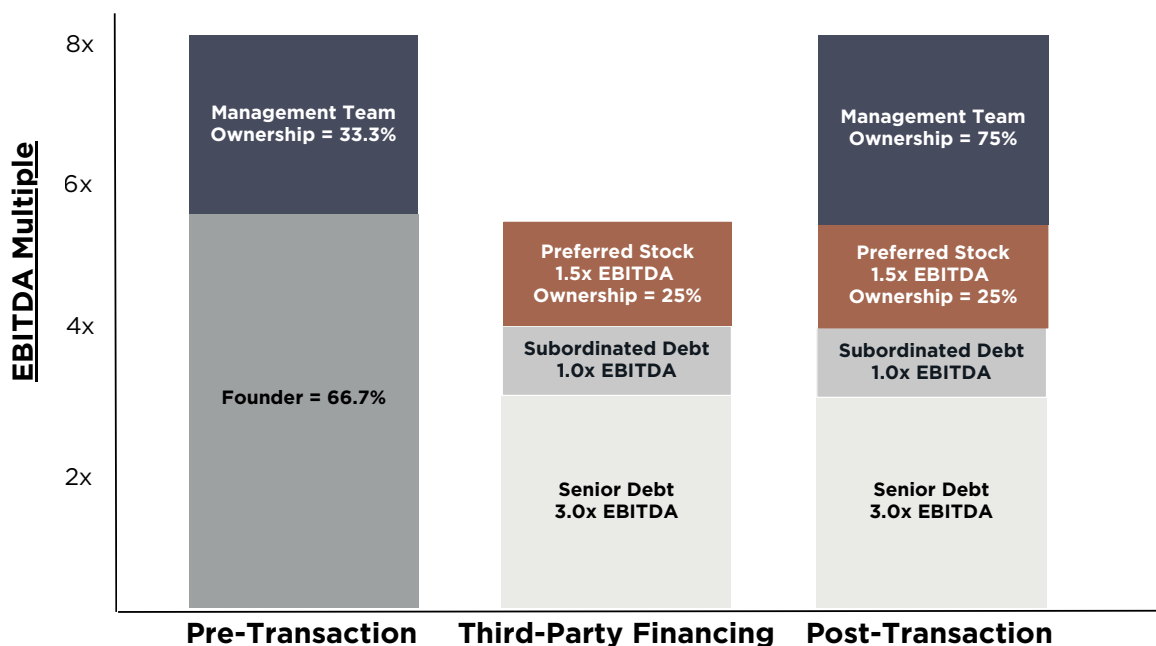
To appropriately understand their financing options, management teams should survey various senior lenders and junior capital providers with the goal of building a capital structure that meets their financing needs and allows for manageable principal and interest payments, paying close attention to the company's cash flow forecast and the blended cost of capital. Management can then refine the mix between senior debt and junior capital as it evaluates the tradeoffs between their ideal capital structure and what is commercially available.

With junior capital providers sitting behind senior debt and investing up to and at times in excess of 70% of the enterprise value, management will need to contribute approximately 15-30% of the enterprise value at close as common equity or a common equity equivalent. At these levels, management should be able to preserve board control and own 51% or more of the company's common stock at close. While very few individuals can write a check of that size in a multi-million-dollar transaction, there are a range of options at their disposal, which depend on a variety of factors.

As shown in **Exhibit II** below, an MBO can be completed in a single step if the company is debt-free or nearly debt-free and the management team owns 33% of the equity prior to a transaction, either directly as common equity or indirectly through options, stock awards or stock appreciation rights. The management buyer will then rollover their common equity or use their after-tax option proceeds as the new common equity, raising senior debt and junior capital to purchase the remaining 67% of the stock held by the departing shareholders.

Exhibit II

Illustrative example of management boosting their equity from 33.3% to 75% by utilizing leverage to the benefit of their common equity ownership.



For illustrative purposes only. Not representative of actual results. Outcomes will vary based on transaction terms, financing ability and market conditions.

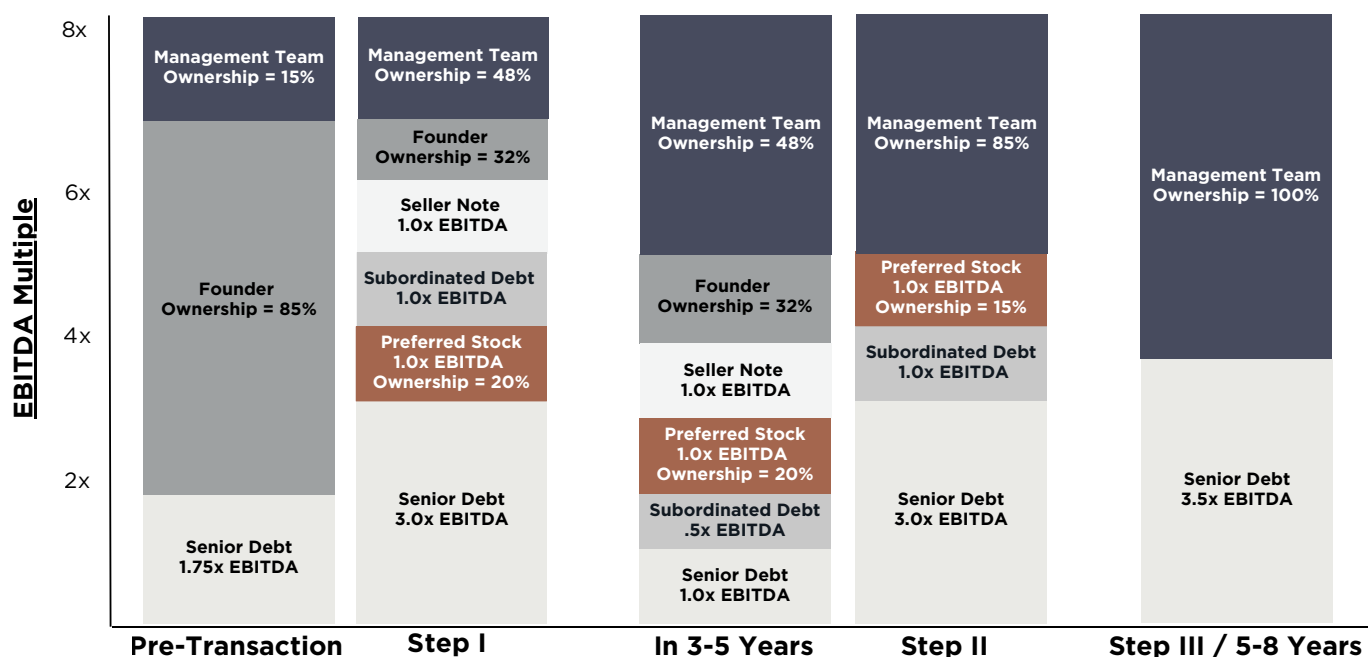


If management owns less than 20% of the company, or the company has a meaningful level of long-term debt, which reduces the equity value of all shareholders at the time of a transaction, then a multi-step process may be required.

As shown in **Exhibit III**, the 15% management block has less equity rollover value due to the senior debt that sits on the company's balance sheet today; however, by increasing senior debt and adding junior capital and a seller note to the capital structure, management goes from being a small shareholder into the largest. Over the next few years, the company's excess free cash flow may be used to reduce debt. Within 3-5 years, the company can refinance the balance sheet again (Step II), using the available proceeds to buy out the remaining shares previously held by the sellers and refinance the seller note. In time, as the company reduces debt, it will have the opportunity to refinance yet again (Step III), buying any equity held by the junior capital provider, at which point management may own 100% of the company's stock.

Exhibit III

Illustrative example of management boosting equity from 15% to 100% over a multi-year process.



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For management teams that might not own any equity in advance of a transaction, an MBO is still achievable. Some executives will raise 10-30% of the required equity capital from passive investors within their extended social and professional networks, which is then used to fund part or all of their equity contribution.



Cyprium MBO Case Studies

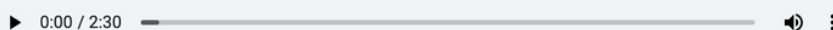
Arbor Contract Carpet ¹



From its locations in Texas, Florida, Colorado, California and Nevada, Arbor Contract Carpet provides flooring replacement services to multi-family residential apartment complex communities. The company was 100% owned by its founder, who had already retired from day-to-day operations and was now interested in monetizing his ownership stake in the business. The owner retained an investment bank to run a process, which was limited to financial buyers given management's interest in rolling a portion of the after-tax proceeds once their stock-appreciation rights were executed. Cyprium proposed an MBO, which was appealing to the president and vice president of sales. Once the seller and his investment bank recognized that the enterprise value and the proceeds at close were the same as those from financial buyers in the process, management was selected as the winning bidder. Cyprium invested a combination of subordinated debt and preferred equity and led the process to raise a senior credit facility from a commercial bank. At close, management owned in excess of 60% of the company's common stock and retained board control. **To hear Arbor's CEO, Matt Gilbreth, discuss this transaction and his relationship with Cyprium, please click the audio below.**



Matt Gilbreth
CEO, Arbor Contract Carpet



Kellermeyer Building Services (KBS) ¹



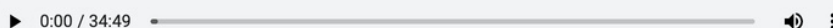
Kellermeyer was a national provider of outsourced janitorial services to 2,500 retail stores in 46 states across the United States. Customers included "Big Box" mass merchandisers, department stores, grocery stores and other specialty retailers. The company was 80% owned by a private equity fund, and the remaining 20% was owned by management. After owning the company for six years, the private equity fund hired an investment bank to sell the company. After receiving multiple offers from highly qualified buyers, the private equity fund accepted management's bid. Management selected a senior lender and Cyprium to finance their MBO. Through that transaction, some members of the management team were interested in retiring and selling their equity. Only a portion of managers rolled their equity, which was the equivalent of 8% of the purchase price; with this level of rollover, management owned 66.5% of the company at close. **To hear Ken Sander, CEO at KBS, and Dan Kessler, Partner at Cyprium Partners, discuss this transaction, which was featured on the University of Chicago Polsky Center's Entrepreneurship Through Acquisition Podcast, please click the audio below.**



Ken Sander
CEO, KBS



Dan Kessler
Partner, Cyprium Partners





In Summary

An MBO supported by junior capital can be a highly flexible and strategic solution for businesses looking to transition ownership while allowing management to maintain control over their future direction. Specifically:

- Management teams have the opportunity to take majority ownership without the need for significant upfront capital, allowing them to retain the board, economic and operational control required to execute their vision.
- An MBO provides a compelling alternative to external buyouts, particularly in situations where there is a lack of alignment between existing shareholders and potential buyers or where the company's culture and long-term goals need to be preserved.
- Junior capital's flexible mix of subordinated debt, preferred equity and common equity may allow for the customization of a financing structure that aligns with the company's strategic and financial goals while minimizing dilution and financial pressure.

To discuss your interest in a **True MBO**, including any questions about the content or transaction structures presented herein, please contact:

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Disclosures

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