# MBO Guide

VERTUS CAPITAL

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I've spoken with hundreds of owners of financial planning firms in the last three years and many of them state that they'd rather pass their firm on to an individual or team already working in the firm. Whether they call it a management buyout (MBO) or an adviser buyout, the message seems clear; if it's possible, it would be preferable. So why don't we see a lot more internal deals? After all, it should be more straightforward than selling to a third party - you negotiate with people you know, you avoid trawling around the market sharing your firm's confidential data and you can control the timing. In many ways, it is the very things that should make internal deals easy, that end up complicating them, but that need not always be the case. The truth is, management buyouts are both an art and a science, but that doesn't mean they have to be complicated. Careful planning and diligent preparation are both keys to a successful MBO. We've created this guide to help you increase your knowledge, so you can include the option of an MBO in your succession planning. We hope it helps you when considering your options.

*Matthew Marais of Vertus Capital*

# Strategy

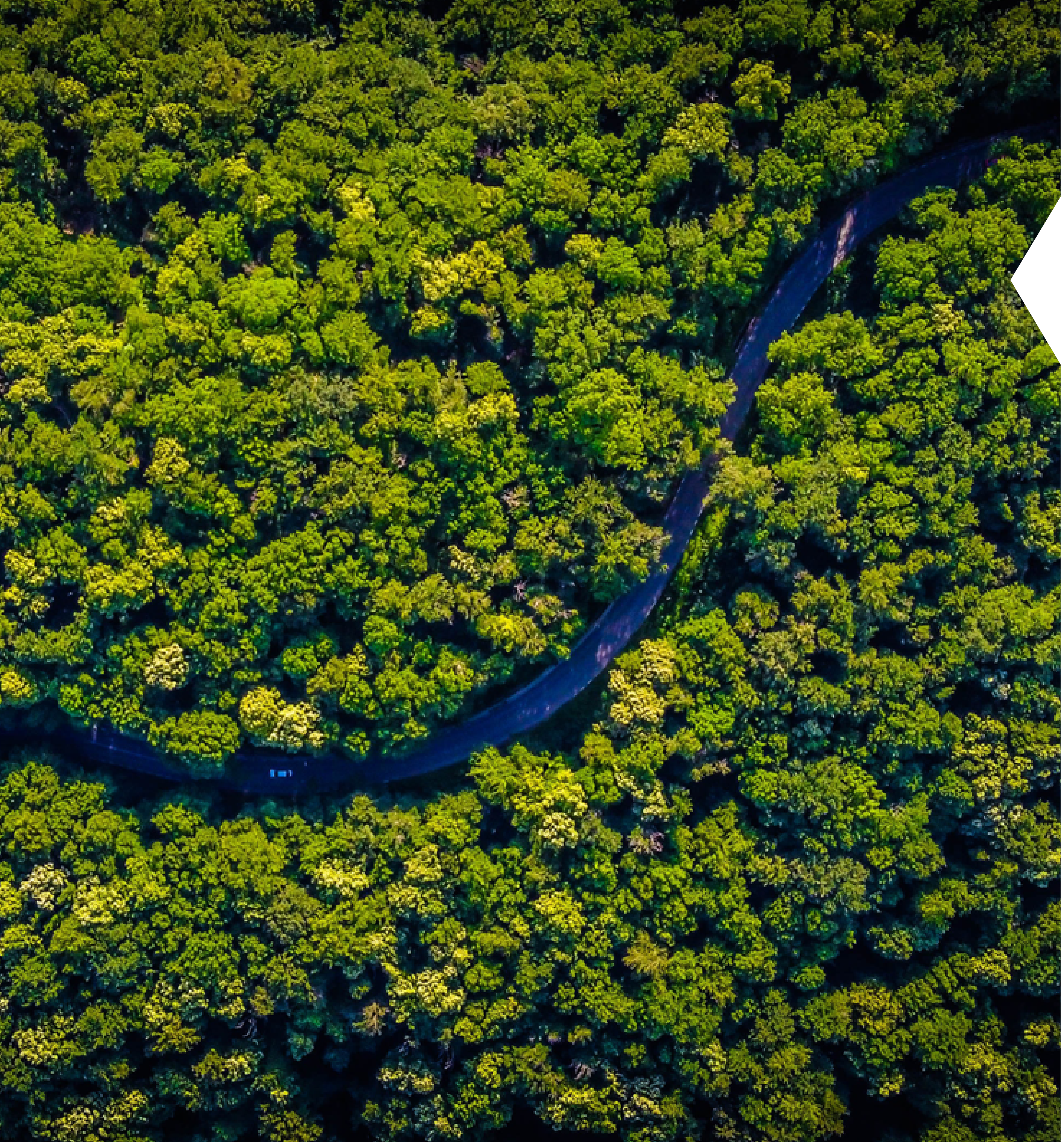
Most people reading this guide, will consider planning to be one of the key elements of the professional services they offer their clients. So, it shouldn't be too much of a stretch to suggest that we should undertake some planning before taking action, especially when dealing with fundamental changes to the ownership and management of a firm. Succession strategies can take many years to realise, so the sooner we get planning, the more time and options we have and the greater the probability of success.

If succession is the challenge, then the goal is a successful transition of ownership, management and client relationships. For many owners, the underlying goal in an exit is to balance their personal financial security with that of their clients and employees. There are broadly two succession options to consider. The first is selling externally to a large organisation specialising in buying businesses, or to an independently owned firm of a similar size to yours. The second is selling internally, by placing the business into an Employee Ownership Trust (EOT) or selling to your team by way of an MBO. There are many ways to structure such deals, and each organization has their own approach, but ultimately, all options fit into one of these two categories.

There are more guides in this series covering selling and buying businesses in the IFA industry. This guide is focused on providing insight on internal sale options and primarily the MBO option. An EOT is also an option but the associated complexity means there is a need for significant professional advice. It's a type of employee benefit trust and an HMRC approved scheme. There are various tax benefits and therefore, qualifying criteria. If a company does qualify, they then face the challenges associated with a trust borrowing to create a meaningful capital event for the founder, which is often a priority. And finally, there is a requirement for a level of corporate governance that is often beyond what is practical for a typical financial advice business.

So, while EOTs are always an option to consider when undertaking succession planning, our experience suggests they are often discounted at the planning stage. MBOs on the other hand, have fewer challenges.

An MBO strategy must consider both parties' positions over time. In this economy, it is usually safe to assume that an IFA will become more valuable each year. As positive as this sounds, it often contributes to the creation of a conflict of interests between the buyer and the seller. For the individual or team looking to buy, this could put them in a position of working hard against their interest, striving to grow the firm, only to find themselves paying more for it when the current owners sell. Similarly, for the current owners, going the extra mile to support and train their management team could make them feel like they are working harder for a future growth they will miss out on. In our experience, a successful MBO has two primary stages: the first stage is where the future owner(s) take a minority stake in the company, and the second stage is where the balance of equity changes hands, with the transition of management and client relationships happening between these two stages. This process takes time and you should assume a minimum of three to five years in total to get it right. It is of course possible to undertake an MBO in less time, but there are compromises and they result in increased risk for all parties.



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# Transitions

Our MBO strategy outlines two stages required to conclude the transition of ownership, management and client relationships. Change management is at the heart of this strategy; so planning, communication, highlighting quick wins and consolidating performance towards a shared vision are all important activities.

## Stage One

To get an internal deal going, the future owners need to first acquire a minority stake in the business. This is an important jumping off point as it requires commitment from all parties to push to stage two. The principal agent conundrum is relevant here: aligning incentives such that two parties with different perspectives, behave in a similar way. The phrase 'skin in the game' is often used to express this and refers to the alignment of accountability: if we both hold equity in a company, then we should behave the same way towards it. And true alignment comes from paying cash for equity. That's real commitment. As the saying goes: when it comes to breakfast, the chicken is involved, but the pig is committed.

The importance of stage one for both parties is that it turns the successor into a vested stakeholder in the business, with the requirement to behave accordingly. What's important at this stage is that the successor starts to undertake some management responsibilities, acting and behaving with a vested interest in the company, but not a controlling interest. The earlier stage one happens, the more progressive the learning curve and the more time there is for the seller to mentor them thoroughly, setting the stage for a stable transition of control.

Then we come to clients. A founder often perceives great risk in transitioning responsibility for client work to other advisers in the firm. The true value of the firm is in the client relationships, and restrictive covenants are rarely an adequate tool to manage the risk of an adviser leaving and taking clients with them. Stage one is a great tool to protect against this risk, as it brings key advisers into the ownership structure, aligning interests with them and making it more likely they will stick around. To ensure a smooth handover of client relationships, the most effective solution is for the founder to convert their personal relationships with clients, to being relationships with the business (i.e. the team). The client needs to be able to identify the value in a clear proposition, a team approach to the advice process, unique know-how and methodology and a strong brand that expresses all this.

## Stage Two

Now that the future owner(s) hold equity to align accountability, responsibility for management and client tasks can increase in a structured manner that is controlled by the majority owner, as they progressively step back from day-to-day activity. The founder needs to gradually become dispensable, which may feel counter-intuitive, as the business has probably been built around that individual. On client work, there is also a natural progression: from a team approach where the successor supports the founder, to the successor managing the day-to-day client engagement, to the successor taking the lead adviser role. When the founder's role with clients is to serve as an advocate for the successor, the transition is complete.

The conclusion of stage two is marked by the final transition of ownership and control, which we will come on to.

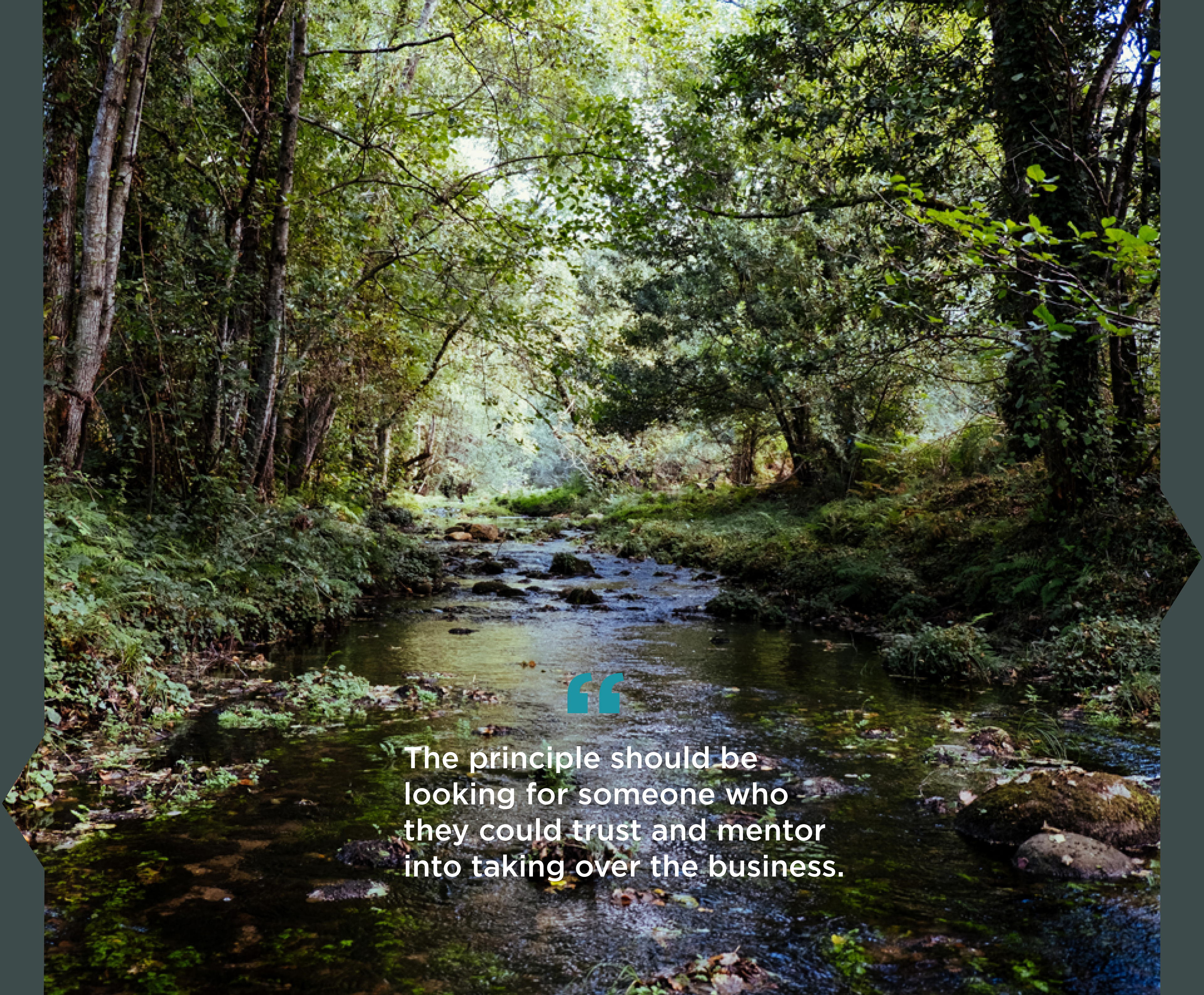
# Creating future owners

Most small businesses are started by individuals who are either tired of the politics in their current firm or want to share in the commercial value that they are creating in the business. Most often, it is the latter which drives them to setup alone, and bring a new firm into existence. For an individual to take over an existing business from the founder, means taking an entirely different type of risk. As such, the skills they need are not necessarily the same as those that helped the founder create the business that exists today. So how are these different and what really makes a good successor?

The first thing to say, is that becoming the owner of a business, is a transition that happens over time. Even if the right person is  thrown in at the deep end, they won't behave like a business owner straight away, and that's ok. It takes time, work, and patience, as well as a strong sense of self-awareness and readiness to learn. Good self-awareness and a trusted mentor (often the owner) will create an environment of learning, co-operation and mutual benefit. As the saying goes, 'it's lonely at the top'. The team need leadership, the seller needs reassurance that the transition will work, and the clients need to trust the business and the process. All things considered, it is a phase that demands resilience, problem solving and ambition from the successor.

As the role of a business owner is broader than client advisory work, it requires a different skillset to that of a good financial planner. These skills will almost always need to be learned when the time is right. The role of business principle requires vision, strategic thinking and a pro-active approach . Many planners will grow into this role very proficiently if given the right environment, but ownership and management is not for everyone. In most instances, the successor(s) will be known to the owner, often because they will identify themselves! However, don't mistake a lack of boldness for a lack of ability. There are many reasons why a worthy successor may not push for a deal, and that should not be why they are overlooked. The principle should be looking for someone who they could trust and mentor into taking over the business, and their single biggest challenge is to choose the right individual(s) at the outset.

However the person is identified, it helps to identify the long-term objective, the requirements, and the development journey they need to go on. It is also helpful to discuss broad timescales, and these should be considerate of the time it will take the successor(s) to grow into the role. A personal development and responsibility plan would also help to clarify what the transition will look like and gradually increase the level of responsibility. Regular feedback sessions should be put in place and some formal training and qualifications may be required. Most importantly, it should be a slow and steady transition, guided and supported by the mentor. A strong interest in the personal development of the successor is critical to a successful outcome for all parties. Beyond the commercial value of this exercise, it can also present a very fulfilling journey for a founder in the final phase of their career as an entrepreneur.  This should be structured and planned in conjunction with the two-stage execution process.



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# Valuations and terms

The popular phrase ‘a business is worth what someone is prepared to pay for it’ is particularly relevant when considering an MBO. Although the ownership of the business will be transitioned internally, there is no justification for a unique valuation process. The parties constitute a willing buyer and a willing seller, hopefully acting in good faith and with all necessary information at their disposal. As such, an open market valuation is relevant and a useful starting point for discussion.

There are many ways to value a business. They fall into three primary categories: relative, intrinsic and book value. A relative valuation will likely be familiar and is created by identifying primary performance factors (recurring revenue, adjusted profit and assets under management in this case) and applying multiples to them. The resulting range of values provide a useful starting point when determining value. It is often a good idea to start in the middle of this range of values and adjust up or down based on how much control is being exchanged (ie minority stakes generally don’t come with control) and the proposed terms of the deal (ie amount of money paid upfront, period of deferred payment, related conditions and so on).

An intrinsic value is a measure of forecast free cashflow, adjusted for the time value of money. It gives an indication of the amount of money the buyer is expecting to make from the firm over time and is a very useful tool to check against the relative valuation, to make sure there is an expectation of value and therefore a return on investment. Finally, a book value is a measure of the current assets and liabilities, that does not take account of goodwill (ie how those assets and liabilities are brought together to create shareholder value). It’s generally reserved for use in distressed situations.

However the parties agree to value the firm, it is essential that the chosen valuation methodology is applied consistently over time. Returning to the two stage MBO strategy, it will be necessary to value the firm several times over a period of change. Agreeing the method reduces friction while still allowing the change in performance and external market conditions to be considered. A new shareholder agreement will be needed when the successor first acquires equity, which presents a great opportunity to document the valuation methodology. In our experience, it is generally worth the seller’s while to give the purchaser(s) a favourable stage one valuation because it enables them to receive commercial value in stage two, in an exit deal that they can be proud of!

One important point on valuations that comes up regularly with MBOs, is the tension between seller’s and the buyer’s incentives. A two-stage MBO balances these dynamics by giving the successor some upside in the growth during the transition phase – growth to which they are contributing. For the seller, despite a favourable entry value at stage one, the alignment of interests helps them secure a low risk exit option when stage two comes around, at a good commercial value. As an added upside to the seller, they have had some management help along the way!

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# Funding the deal

There are multiple ways to fund the purchase of a business. If a valuation reflects anticipated cashflow generation over future years, it is fair to say that the money needed to acquire the equity of a firm, will be generated by that firm in time.

Time, as ever, is the critical factor. Few sellers will accept all the value on a deferred basis. The seller's need for capital is an obvious reason, but the risk associated with selling one's equity (the right to dividends and control of the business) in return for capital paid over time, is also an important determinant. The seller becomes a creditor in this scenario and that risk must be carefully weighed. If a seller is comfortable to wait for their money and carry the credit risk, then they should probably consider an EOT. For the majority, this will not be an attractive option, so there is a need for external capital.

Capital can come from the buyer's savings, buyer debt, or from debt taken on by the firm itself. The former is rare for many reasons. Within the UK financial advice market, there is a clear generation gap between seller and buyer. It's very common to be discussing an MBO with a founder in their sixties and a successor in their thirties. The latter will typically be focussed on family, the home that goes with it, school fees, caring for their parents and so on. A capital-intensive period that rarely includes space for the acquisition of a business, whether that be from personal reserves or personal debt.

In theory the company could buy back its own shares using reserves, but this is often used in situations where there is no active market for the business. The current shareholders must sacrifice retained profits to fund the purchase, as a share buyback cannot be funded with debt. There are detailed rules around this process that can make it difficult and professional advice is essential.

So, if there is minimal capital coming from the prospective buyer and assuming a share buyback won't work, we are left with the company borrowing to fund the deal. In simple terms, the company borrows funds and uses them to purchase the founder's equity. In practice this is generally done using a separate company, which is explained in more detail in the next section. Where the business takes on the debt to fund the acquisition, the successor usually contributes a meaningful amount, as a show of commitment. Debt can be utilised for both stages of our MBO strategy: the purchase of a minority stake and the purchase of the balance of that equity later. This provides management with access to capital throughout, reassuring the seller with the involvement of a capital partner to facilitate the entire process. Furthermore, despite there being debt in the structure to facilitate stage one, the seller has the comfort that they still have control over the handover process, until they are ready for stage two. If stage two never arrives, for whatever reason, the debt would be repaid and the management individual(s) would still be vested shareholders in the business, aligning interest for all parties.

# Corporate structure

Balancing the seller's need for a capital event and the lack of personal capital available to the buyer means that we are probably going to utilise debt to fund a two stage MBO strategy. There are some challenges that relate to using debt and they drive the need for a specific corporate structure. Firstly, the FCA does not recognise goodwill in the calculation of capital adequacy, as it is an intangible asset. As goodwill is the asset to be purchased, regulated entities automatically fail the capital adequacy rules if they introduce debt into their regulated company for such a transaction. In addition, if debt is introduced to fund the transaction, it will need to be provided to the buyers, not the seller. This is a complex area and advice prior to activity is always preferable.

Circumstances differ but a typical corporate structure for an MBO will include a holding company. The holding company is established by the buyer(s). Capital can then be loaned to the holding company to purchase the shares of the regulated entity from the founder. This allows the debt liability to sit in the holding company, legitimately separated from capital adequacy rules. Future profits derived from the regulated subsidiary, can be moved efficiently to the holding company to service the debt. This structure requires regulatory approval.

In terms of security, debt providers will often want to obtain a charge on each corporate entity, as well as obtaining a capital contribution and a personal guarantee from the successor. In simplistic terms, the more general the lender, the less they will know about the mechanics of the specific business and the more security they will require to cover the perceived risk. In many instances, this is incongruous with the needs of the business, which impedes day-to-day operations. As the only niche lender focussed solely on lending to financial advice firms, Vertus Capital has a bespoke lending proposition for financial advisers, with security requirements tailored to suit the ongoing operation of the firm.

A typical Vertus Capital transaction differs from the traditional high street lenders. A first charge is taken on the meaningful entities in the structure, and corporate security taken in preference to personal security, especially where the buyer already has a minority stake, as this signals their commitment and an alignment of interests. Any personal guarantees that might be required are limited in quantum and nature and can be apportioned where there are several individuals acquiring in different proportions. Covenants (certain activities that either will, or will not be undertaken throughout the term of the loan) from a niche provider like Vertus are designed to ensure firm risk management but not at the expense of operational ease.

# Final thoughts

It is perhaps the ultimate conclusion to the entrepreneurial journey: pass the firm you founded, cared for and grew over many years, to people you hired and inspired, so they can take it forward and preserve your legacy, as you become financially independent. As the successor, you joined a firm, developed yourself and progressed to take ownership of it. In the process, both parties maintained the continuity of the proposition for both clients and staff.

It's so compelling you could be forgiven for wondering why anyone would sell their firm to an external buyer. The answer is foresight. If you've read right through this guide, you should be struck by the amount of time it takes to execute the two stage MBO strategy. There's plenty of preparation, the sale and purchase of a minority stake, transitioning control and client responsibility, and then executing the final transaction with all the complexity that goes along with that; and all that is secondary to the essential ingredient: an individual or team with the qualities that are required to lead and manage a business.

You need time, but provided you have three to five years to go before you want to ease back, you can close the gap between possible and probable, as the other challenges can all be met by following a strategy and processes. Even finding the successor isn't as tricky as it may at first seem. Many of the characteristics of a future business owner can be developed over time. So you can identify an individual or two with the right mindset and work with them, progressively introducing them to your plan as they mature. If it turns out that the successor leaves or decides they don't want to take the final step to full ownership, your actions will only increase the value of the firm in the external market. Transitioning management of the firm to your successors in any measure serves to reduce the reliance on you as the founder, which increases the viability of the firm after your departure.

As Vertus Capital, we are a lender that works exclusively with independently owned financial advice firms, which is a great advantage. Our detailed knowledge of the market and what makes for a successful MBO, are reflected in the terms we can offer. So if you take the time, an MBO is a viable option that could help you optimise your succession for you, your family, your team and of course, your clients.

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