THE EXPERTS' ADVICE

" Middle-aged company with comfortable lifestyle seeks young vibrant angel with money. Please send picture of cheque

Bryan Keating
angel investor and deputy chairman, Invest NI

AS ALWAYS business opportunities arise in all shapes and sizes and at different times. This particular one does not have your "classical" angel investment profile. According to Nesta's survey of 1,000 UK-based business angels, they are male, average age 53, invest £42,000 per opportunity, have made two to three investments and hold their investments for just over four years. Angels have in general most of their assets in safer havens and are investing their "spare" money in higher-risk ventures with expected higher rates of return with exits sooner rather than later.

Murphy's engineering company appears to be a "good solid family-based" engineering company and there is absolutely nothing wrong with that. To a business angel, however, there are numerous "flags" which make it very difficult to see how he or she could invest in such an enterprise given what angels expect from their investments.

Murphy has a deal he cannot refuse and a short timescale to complete. Accordingly, the new deal is not going to be cheap. If about 20 per cent is available to angels the cost will be in millions, which pushes it to the top end of the scale even for angel groups. The company has taken 30 years to grow to €10 million. Margins have been dropping over the past three years. All these indicate the company is not in growth mode.

However, maybe the greatest issue is around leadership. Paul Clarke, despite his natural cautious inclinations, has to be applauded for taking the courage to step forward with an MBO. However, his motives of wanting to protect his livelihood and not work for this new German chief executive are not exactly the sentiments an angel would want to hear. What is needed is a leader with the vision and courage to move the company on to a different sales and profitability trajectory; one that cannot only service the working capital of the company but also build up wealth for all parties concerned all on a timescale vastly different from what the company culture is used to.

Finally, if an angel was putting in one or two million it is likely to be done only if they have deep domain knowledge of the sector. In which case, they would more than likely want to be flying the plane as the new MD rather than simply being in the cockpit: more an MBI than a MBO.

As the famous ad in *Farming Weekly* said: "Middle-aged farmer with farm seeks young vibrant woman with own tractor to share life together. Please send photo of tractor." In this case read "Middle-aged company with comfortable lifestyle seeks young vibrant angel with money. Please send picture of cheque." Not sure either ad will attract much interest.

– Bryan Keating

Feargal Brennan
Partner, Corporate, ByrneWallace

EMBARKING ON an MBO can be a daunting and time-consuming project. Each member of the team will need to be aware of the key issues involved. Clarke and his management team feel they can only finance 20 per cent of the purchase price. To make up the balance, there are two ways in which an MBO can be funded. The first is by debt, the second is equity.

The cost of debt-financing consists of the interest payable to service the debt, together with any arrangement fees payable to the financing bank. A vital consideration is whether the target company will have sufficient cash-flow. If not, the management team will have little chance of obtaining this form of finance. A financing bank will also require security over all of the company's significant assets and business.

The cost of equity financing is the dilution of the management's shareholding. A new company would be formed to serve as the acquiring vehicle. This would be owned by the management and the equity investor. The investor will seek a substantial equity stake and may expect a minimum return in the form of a preferential percentage dividend. Both management and the investor will be represented on the board with the investor typically seeking a non-executive role and sometimes "step-in" rights to protect the company during a period of trading difficulty or to bring about a sale. The investor will seek key protections such as veto rights on certain operational and corporate matters, anti-dilution protection and extensive information rights. Both management and the investor will typically plan (via the investment agreement) for an exit for the equity investor within a defined period usually in the form of a sale or a stock exchange listing.

Financial and legal due diligence should be undertaken. The investor will seek warranties and indemnities from management on the target business. In turn, management will need to draft a disclosure letter setting out certain exceptions to the warranties being provided in order to minimise their personal risk as warrantors. This process presents a potential conflict of interest for management as they will be directors of the newly created company and are likely to be directors of the target company. A degree of common sense is required and management will need to act openly and honestly. As part of the legal process, management will need to negotiate their own service contracts with the investor. The investor is likely to seek to tie management in to certain restrictive covenants (for example a non-compete clause) and certain "leaver provisions", which seek to link the price a manager can obtain on the sale of his shares on exiting the company with the length of his service and his performance in his new role.

– Feargal Brennan

Dr Danielle McCartan-Quinn
Course director, MSc Marketing, University of Ulster

IN AN MBO situation, transition from employee to employer involves an often underestimated change in role and status within the organisation, even if personnel largely remain constant, with an altered structure affecting the nature of relationships within. The security of a regular salary is weighted against potentially higher returns with the risk of losing the shareholding should the business fail.

The motivation for an MBO should be the same as for any investment – will the commercial return satisfy the risk appetite of the investors? The motivation here is job security. Clarke is the only one of the three with financial experience and he appears to be somewhat dubious that the proposed MBO is either advisable in the current economic climate or feasible, given the difficulty of securing finance.

From the brief, price has not been discussed. There can be no assessment of the investment until the price is known. Who sets the price? Does the buyout team know how to put a value on the business? Has the team taken into account the "considerable investment" that Murphy says will be required to remain competitive?

Banks are wary of "over-leveraged" MBOs, the business may not be an attractive VC proposition, and the team may be unable to raise the requisite funding without asking Murphy to stay as a shareholder, this last option itself not without risk. The team will have to be sure there is no residual resentment towards him for not having discussed his plans with them in advance of the "bombshell". His team might have expected to be shown greater consideration since some have worked there so long and these same managers are reported to have "picked up the slack", safeguarding the smooth running of the business, when Murphy was unexpectedly incapacitated three years earlier.

The proposed MBO team understands the business operations but may not have been privy to any strategic planning or decision-making until now.

The management team is incomplete, comprising a finance and a technical design person. Clarke should not become the managing director by default and in any event, finance people are not necessarily the best people to lead new teams (too risk adverse and not necessarily strategic). This team also lacks marketing and production skills. That said, the MBO team cannot be too large; there is a scenario here of there being a larger number of staff joining the team to fund the bid. Only a small team can lead the bid as too many will complicate the issue with knowledge of the company sale becoming widespread. This may cause uncertainty among staff, customers and suppliers, resulting in a potentially adverse impact on trading.

So, MBO or not? Not yet. Much more information is required before risk/benefit analysis can facilitate a final decision.

– Dr Danielle Mc Cartan-Quinn