



An Introduction to Management Buy-Outs

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Types of management buy-outs

Comparison with trade sales

Typical transaction structure

Management duties

Institutional rights

Management incentives

Types of buy-out

A management buy-out (MBO) is where a group of senior executives purchase the company or business that they work for with the assistance of investment from institutional sources and lenders.

A management buy-in (MBI) is where a management team from a different business buys into the target business.

A management buy-in/buy-out (BIMBO) is where an existing management team is combined with an outside management team to purchase the target business or company.

An institutional buy-out (IBO) is where private equity institutions and/or venture capital firms bid for 100% of the equity of the target with a view to bringing in management after the deal is completed.

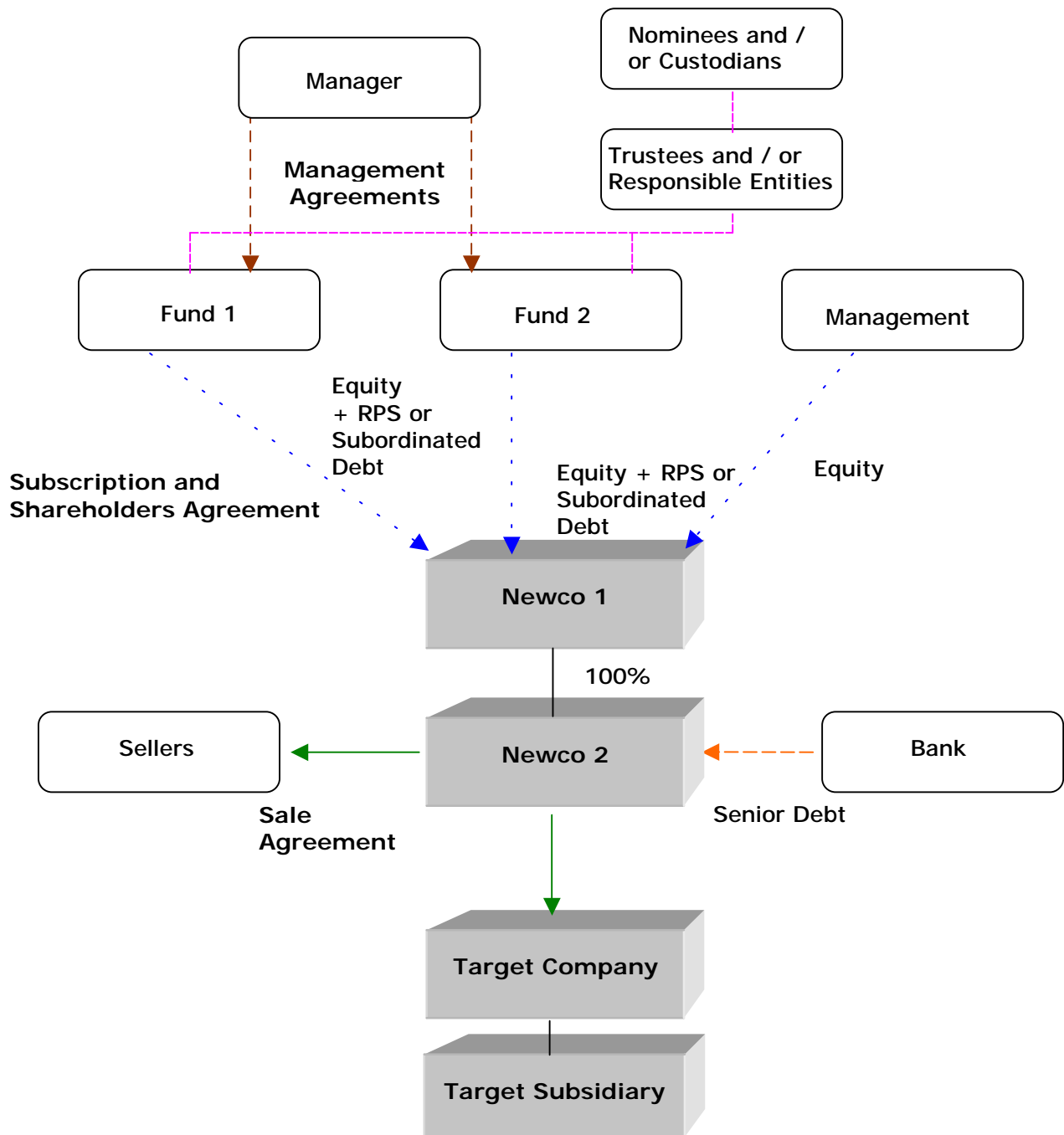
A leveraged buy-out (LBO) is where debt is used as part of the acquisition price to "*leverage*" the equity holdings and increase the returns to shareholders.

Comparison of trade sales and MBOs (from the vendor's viewpoint)

Trade Sale	MBO
Higher price can usually be obtained from third party purchasers	Management team will have a better idea of the value of the company and the business risk
More certainty that the purchaser will have finance	Management will be more dependent on outside finance
More warranties will have to be given to a trade purchaser	Management already know the business so the vendor will be less willing to give warranties about it
Transaction may take longer	Less due diligence will be required by management as they already know the business
More chance that confidential information will leak to competitors	Transaction will remain 'in-house'

Structure

A typical management buy-out structure might look like this:



Key to diagram

Trustees are entities that hold investments or property on trust for the beneficiaries of the trust (ie. the investors in the funds).

Responsible Entities must be appointed over a fund, where units in a trust are made available to the public. Under the *Corporations Act 2001*, the trust must be a registered scheme and the trustee must be appointed as the responsible entity. A responsible entity is required to hold an Australian financial services licence.

Custodians may be appointed by a trustee as its agent to hold trust property on behalf of the trustee to assist it in carrying out its duties.

Nominees hold property on behalf of another. A nominee is similar to a custodian but usually has more limited ongoing obligations.

Redeemable preference shares (RPS) are shares which carry a preferential right (usually to a dividend) and which can be redeemed by the company.

Subordinated debt is debt which is repayable only after the senior debt has been repaid in full.

Management duties

Whether or not management hold shares in the purchaser, they will owe a duty of confidentiality and other fiduciary duties to the target in their capacity as directors and employees of the target.

However duties will also be owed to the purchaser in their capacity as directors of the purchaser (whether or not they hold shares in the purchaser), which can cause conflicts of interest.

Institutional rights

Institutional investors in a management buy-out will require certain rights and protections in the transaction documents. These will include:

- Ø the right to veto certain critical business matters
- Ø the right to receive certain management and financial information
- Ø the right to appoint a director
- Ø warranties from management
- Ø a restriction on the payment of dividends
- Ø a restriction on a manager competing if he leaves the business
- Ø restrictions on share transfers and issues
- Ø the inclusion of a provision which compels a manager to sell his shares if he leaves the business (with the exit price to be determined based on whether he is leaving on good or bad terms)
- Ø the inclusion of a provision which compels a corporate shareholder to sell its shares if there is a change in control of the shareholder
- Ø the inclusion of "*tag along*" provisions (to ensure that if an offer is made to the majority shareholder for its shares, the minority shareholders can elect to sell their shares to the same purchaser on the same terms)
- Ø the inclusion of "*drag along*" provisions (to ensure that if a majority shareholder wishes to sell its shares then it can force the minority to sell their shares to the same purchaser on the same terms)

Management incentives

Institutional investors in a management buy-out usually want to incentivise the managers to improve the company's performance. This can be done in several ways, including:

Service Agreements

By way of salary and long notice periods.

Bonus Schemes

By way of incentive / performance based bonuses and exit-based bonuses.

Sweet Equity (Envy Ratio)

Managers pay a lower subscription price for their initial equity stake and therefore make a higher profit than the institutional shareholders when the shares are sold.

Managers may have to pay tax on the difference between the market value and cost of the shares.

Options

These give the managers the opportunity to acquire additional shares at a low price and make a significant profit when the shares are sold.

Ratchets (special incentives)

Ratchets allow the management team to ratchet up its percentage shareholding in the company, depending on its success. The ratchet is primarily based on the return achieved by the institutional investor on its investment, which is referred to as the "internal rate of return" or "IRR". This is usually measured on an exit (trade sale, share sale or IPO and share buyback).

Commonly a mechanism can be used where the managers receive an amount of additional equity for each percentage point that the IRR reaches over a set figure at the date of the exit.

There are various methods of exercising a ratchet to give managers a greater percentage of the shares (or the economic benefit attaching to the shares). These range from issuing the investor with redeemable shares which are redeemed and cancelled immediately prior to an exit (leaving the investor with proportionately less equity and the managers with more) to the investor instructing a purchaser to pay an additional proportion of the purchase price on an exit to the managers.

The corporate team at Swaab Attorneys is committed to working with companies to help them meet their ambitions. If we can help you with any of the issues raised in this Guide, please contact either Fred Swaab or Alistair Jaque. We would be very pleased to discuss any issues with you.

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This Guide is intended to give an overview of the issues involved in management buy-outs in Australia. It is not intended to be fully comprehensive or to be a substitute for legal advice.