

Duran-Fernandez, Roberto

Working Paper

Unlocking the Potential of MBOs

Suggested Citation: Duran-Fernandez, Roberto (2023) : Unlocking the Potential of MBOs, ZBW - Leibniz Information Centre for Economics, Kiel, Hamburg

This Version is available at:

<https://hdl.handle.net/10419/280774>

Standard-Nutzungsbedingungen:

Die Dokumente auf EconStor dürfen zu eigenen wissenschaftlichen Zwecken und zum Privatgebrauch gespeichert und kopiert werden.

Sie dürfen die Dokumente nicht für öffentliche oder kommerzielle Zwecke vervielfältigen, öffentlich ausstellen, öffentlich zugänglich machen, vertreiben oder anderweitig nutzen.

Sofern die Verfasser die Dokumente unter Open-Content-Lizenzen (insbesondere CC-Lizenzen) zur Verfügung gestellt haben sollten, gelten abweichend von diesen Nutzungsbedingungen die in der dort genannten Lizenz gewährten Nutzungsrechte.

Terms of use:

Documents in EconStor may be saved and copied for your personal and scholarly purposes.

You are not to copy documents for public or commercial purposes, to exhibit the documents publicly, to make them publicly available on the internet, or to distribute or otherwise use the documents in public.

If the documents have been made available under an Open Content Licence (especially Creative Commons Licences), you may exercise further usage rights as specified in the indicated licence.

Unlocking the Potential of MBOs

Roberto Duran-Fernandez¹

April 2023

Abstract

This paper analyzes Management Buyouts (MBOs), where management teams acquire their companies. It explores various MBO types, such as Traditional, Employee, Management Employee, Divisional, and Buy-in Management Buyouts, each with distinct characteristics. The rationale for MBOs includes investor exit strategies and the alignment of management incentives for better company performance. Key triggers for MBO development include financial sector liberalization and a specialized financial ecosystem. Success factors for MBOs are identified as cash generation capacity and effective management. The paper also discusses the life cycle of MBOs, their impact on productivity and human capital, and the complexities involved, such as information asymmetry and agency problems. This paper contributes to the understanding of MBOs, providing insights that can inform both academic research and practical applications in the dynamic world of corporate finance.

Keywords: Management Buyout (MBO); Employee Buyouts (EBO); Management Employee Buyouts (MEBO); Divisional Buyout (DBO); Buy-in Management Buyout (BIMBO)

JEL Codes: G34; M12

¹ School of Government and Public Transformation, Tecnológico de Monterrey. E. roberto_duran@tec.mx

1. Introduction

Management Buyouts (MBOs) have emerged as a significant phenomenon in the landscape of corporate finance, presenting a distinctive avenue for company acquisition and restructuring. This paper delves into the intricacies of MBOs, examining their types, rationale, and the various dynamics involved in their execution. By exploring the different forms of MBOs, including traditional management-led buyouts, employee buyouts, and divisional buyouts, we aim to shed light on the varied nature of these transactions and their implications for corporate governance and financial management.

The study further investigates the motivations behind MBOs, from facilitating investor exit strategies to aligning management incentives with organizational performance. We explore the crucial role of financial markets and regulatory environments in enabling these transactions, alongside the necessary conditions and success factors that influence their outcomes.

Additionally, this paper addresses the complexities and challenges inherent in MBOs, such as agency issues and information asymmetry, providing a comprehensive overview of the financial structures typically employed in these deals.

Through a blend of theoretical insights and empirical analysis, our research offers a nuanced understanding of MBOs, contributing to the broader discourse on corporate restructuring and finance. This introductory exploration sets the stage for a detailed examination of the multifaceted world of Management Buyouts, their strategic importance in the modern business environment, and their impact on the evolution of corporate entities.

2. What is an MBO?

A MBO is a type of corporate finance transaction through which a company can be acquired by its management team, increasing the control of those most directly involved in business management (González 2018). The MBO is a type of transaction that has significantly expanded since at least the 1980s across different geographies, covering both developed and emerging countries (Deloitte 2014). There is no typical MBO transaction, and they vary significantly in size and complexity. In Europe, the MBO market is valued at approximately 1-1.5% of GDP (Wright et. al. 2006).

The common feature shared by MBO transactions is that a portion of the management team gains control of a company. At least 5 types of transactions can be identified in general (González 2018):

- a) **Traditional Management Buyouts (MBO)**: In this type of transaction, the senior management team or a portion of it is the promoter of the acquisition operation.
- b) **Employee Buyouts (EBO)**, also known as **Workers Buyouts (WBO)**: In this transaction, the acquisition is carried out by the employees of the company who are not part of the senior management team. In this type of transaction, labor unions can play a relevant role.
- c) **Management Employee Buyouts (MEBO)**: In this transaction, both senior management and non-managerial staff are part of the group promoting the acquisition.
- d) **Divisional Buyout (DBO)**: In this transaction, the management team in charge of a division of the company promotes the spin-off and acquisition of that division.
- e) **Buy-in Management Buyout (BIMBO)**: In this transaction, a new management team or an external manager is incorporated into the team promoting the acquisition.

An MBO is ultimately one of several exit strategies available to an investor who wants to monetize their position in a company (Deloitte 2014). In developed countries, the vast majority of MBOs (45-75%) originate from divestitures of a parent company, that is, DBOs. The reason for the parent company to sell is that it seeks to focus on its core business, withdrawing from secondary lines of business (Lowe & Naughton 1993). This motive is particularly important in the case of DBOs involving international parent companies and subsidiaries. For example, in Australia in the 1990s, DBOs of domestic subsidiaries of multinational companies were the main driver of this type of transaction (Fleming 2018).

Another important source of MBO transactions is family-owned businesses that do not have a clear succession plan. The rationale for these companies is to transfer control to the management team to ensure business continuity. In developed countries, between 18-56% of MBOs originate from family-owned businesses (Wright et. al. 2001).

From the management team's point of view, the rationale for an MBO lies in the alignment of incentives. The management team, as owners of the company, has better-aligned incentives to improve the company's performance (Jensen & Meckling 1973). Empirically, some studies have identified substantial improvements in companies' productivity following an MBO, supporting this argument (Wright et. al. 2006).

There may be other reasons that justify an MBO. For example, an MBO may be implemented as a defensive strategy by senior management in the face of a hostile takeover due to fear of losing their jobs if such a takeover materializes (Lowenstein 1985). Another reason may be that management has a better understanding of the company's value because they have better information than the market or even the shareholder. This asymmetric information can lead to an undervaluation of the company that can be exploited by management for their benefit (Harlow & Howe 1993). The impact of this type of arbitrage on the valuation of companies has been widely studied in literature (Renneboog & Vansteenkiste 2017). Finally, there is a subjective element related to management culture and the risk aversion of a company's executives. Some executives may simply prefer taking risks and taking control of a company (Wright et. al. 2006).

3. Recent trends in MBOs

Historically, MBOs have been a commonly used instrument in the privatization processes of state-owned companies. The privatization processes in the United Kingdom in the 1980s and 1990s were implemented significantly through MBOs (Wright et. al. 2006). In Eastern Europe and the former USSR, MBOs, EBOs, and MEBOs were widely used as privatization instruments during the transition to market economies (Ellerman 1993, Filatotchev I 1992). More recently, in China, the privatization processes of state-owned enterprises have been carried out through MBO-type transactions (Sun et. al. 2010). In general terms, the liberalization of the financial sector and regulation that allows the design and implementation of innovative financial structures have been some of the most relevant factors that have triggered the development of MBOs (Fleming 2018).

The execution of an MBO requires a highly specialized financial ecosystem in the form of financial, legal, accounting, and tax advisors, as well as the availability of institutional investors (Wright et. al. 2006). Thus, the consolidation of a deep financial market and the availability of financing sources in the form of private equity funds are necessary conditions to trigger this type of transaction. The role of private equity funds specialized in MBOs has been highlighted as a driver of this market in some geographies such as Japan and Australia (Fleming 2018). In some jurisdictions, the public sector has played a relevant role in promoting and boosting these transactions, as is the case in South Korea and Japan. In the 1980s, the governments of these

countries promoted ambitious corporate restructuring that favored MBO-type financial solutions (Fleming 2018).

It should be noted that literature does not relate any specific macroeconomic scenario to the development of MBOs. However, a crisis environment favors corporate restructuring within which the MBO can be an alternative. Likewise, a low-interest-rate environment can incentivize these transactions (Wright et. al. 2006).

Some emerging markets, such as Latin America, can potentially benefit from the development of MBOs, as the region has a well-developed institutional and financial environment to support these types of transactions. Additionally, there may be opportunities for MBOs to occur as multinational players shift their global strategies and divest from secondary objectives, potentially leading to the development of a DBO market in the region. However, the success of MBOs in such markets will depend on various factors such as business maturity, cash generation capacity, and robust financing structures.

4. Success factors in MBOs

The most relevant success factor, recognized by all specialists, is the company's cash generation capacity. Since the acquiring party typically does not have liquid resources to finance the transaction, the company's cash flows ensure payment to investors and creditors, making a stable cash flow essential (Wright & Thompson 1994). While there is no particular industry sector that is more prone to carry out MBOs, companies operating in mature and stable markets should offer the best candidates (Lowe & Naughton 1993).

The management style of the acquiring management team is also a decisive success factor. For example, there is evidence that shows that specialized private equity funds prefer teams with leadership ability, recognized industry experience, and a proven track record as an entrepreneur and in management (Muzyka et. al. 1996). There is a preference for transactions led by people who can inspire their teams, the ability to maintain a cohesive management team, as well as the ability to trigger and implement changes (Birley 2002).

Quantitatively, the Maupin Index allows discrimination whether a company is a candidate for an MBO. The index responds positively (i.e., the company is more viable for an MBO) to (i) the

concentration of shareholding, (ii) the number of years the company has been public, (iii) the ratio between cash flow and asset value, and (iv) dividend yield. On the other hand, the index responds negatively to (v) the ratio of share price to EBITDA and (vi) the ratio of share price to enterprise value. Although with many limitations, this model allows having a first perspective on the viability of an MBO transaction (Maupin 1987).

5. Life cycle and impact of MBOs

The vast majority of MBO transactions can be seen as a stage in the life cycle of a company. After the acquisition, the objective of the new owners is to consolidate the business and, at a later stage, seek an exit again. The most common exit strategy for an MBO in developed economies is a merger or acquisition. Public offering was a very common exit strategy for MBOs during the 1980s. This exit strategy has been more common among large companies or companies that have been spun off from a parent company (DBO). A significant number of MBOs enter insolvency restructuring processes (Wright et. al. 1994, Wright et. al. 2006).

A study on the impact of MBOs in the manufacturing sector in the UK found that an MBO has a significant impact on productivity. On average, companies before the MBO had productivity 2% below the industry average. After the MBO, companies experienced a substantial increase in productivity equivalent to 90% (Wright et. al. 2006).

MBOs have a positive effect on human capital and management processes. An MBO increases employee commitment to the firm, with this change being more positive when the acquiring management team maintains leadership positions in the company. The effect on stock prices for MBOs that have gone public shows positive results (Wright et. al. 2006).

The main complexity of a transaction lies in information and agency problems. An agency problem arises when the incentives in an economic relationship are not perfectly aligned, and one party should act in the best interest of the other. In this case, the management, who is hired by the shareholders of the company, has an incentive to pay the lowest amount possible for the company, even harming the shareholders (Lee 1992).

The most significant challenge is related to information. If it is a private company, the management does not have strict disclosure obligations, so it is possible to manipulate it to obtain a lower selling

price. Additionally, the management may have access to privileged information that allows them to have an accurate valuation of the company, while the owners lack this information, leading to an asymmetric negotiation (Harlow & Howe 1993).

There is evidence that this may be the case in practice. For example, a company's revenues tend to change significantly in the context of an MBO announcement. Particularly, there is a significant drop just before the announcement of revenues. This phenomenon can be associated with the manipulation of accounting information (Wu 1997). Additionally, for the specific case of a DBO, it is noted that these transactions typically occur after a period of abnormal positive returns, but the selling company experiences lower returns after the MBO. This situation suggests that the division is acquired at a lower price than the market value (Lee 1992).

However, there is another argument against the agency problem. A shareholder may prefer to sell to their management team because it reduces the risk of sharing information with competitors if the transaction is not successful. Additionally, the shareholder could be in an unfavorable negotiating position if the transaction is unsuccessful. In this case, the relationship between shareholders and management may deteriorate, so the shareholder has an incentive to close the transaction (Deloitte 2014). For the case of DBOs, it should be noted that evidence shows that, on average, the parent company does not experience losses after completing a transaction (Hite & Vetsuypens 1989).

6. Financial structure of an MBOs

The majority of MBOs have a financial structure that combines debt, equity, or some other hybrid instrument such as mezzanine debt and vendor take backs. The characteristics of these sources of financing may vary, but the acquiring management typically seeks the cheapest source of funding, starting with senior debt and then turning to more expensive funding sources (equity, subordinated debt, etc.). The company's balance sheet must be robust enough to pay all obligations, generate a healthy return for the acquiring management, have room to grow the business, and withstand risk scenarios (Deloitte 2014).

- a) **Debt:** Senior debt is the cheapest source of financing. Debt can include bank debt or leases, both long and short term. Debt can be senior or subordinated, with the company's assets typically used as collateral for the debt (Deloitte 2014).
- b) **Mezzanine financing:** This type of financing is used to bridge the gap between the debt the company can support, the available equity, and the acquisition price. Mezzanine debt is typically more expensive than senior debt and can typically be converted to equity (Deloitte 2014).
- c) **Equity:** Equity consists of the management's liquid resources to pay for the transaction. Management typically does not have enough capital to pay for the transaction, so these resources are provided by specialized private equity funds seeking an investment with an objective return. Equity is not secured, so the investment is lost in case of insolvency. It should be noted that in the case of MBOs, private equity funds do not seek control of the company even when their shareholding is the majority (Deloitte 2014).
- d) **Vendors take backs:** Strictly speaking, this is debt provided by the same shareholders who are selling the company. In this case, the original shareholders extend credit to the management, which is paid back with the same company's cash flows. This type of structure allows completing the transaction with a minimum liquidity requirement, but it requires significant cooperation and coordination between the shareholders and the management (Deloitte 2014).

In developed countries, debt represents ~12% of the capital structure, and mezzanine financing ~8%. It should be noted that the weight of debt tends to increase during periods of low-interest rates (Wright et al. 2006).

7. Final Remarks

MBOs represent a unique and multifaceted aspect of corporate finance, offering a nuanced approach to business acquisition and management. This paper underscores the diversity within MBO transactions, ranging from traditional management-led buyouts to more inclusive models involving employees. The driving force behind these transactions is often the alignment of management incentives with company performance, highlighting the critical role of internal stakeholders in shaping corporate futures. Furthermore, the evolution of MBOs has been

significantly influenced by financial market liberalization and the development of specialized financial ecosystems. The success of an MBO largely depends on the company's ability to generate sustainable cash flows and the effectiveness of its management team. Despite their potential benefits, MBOs are not without challenges, including complex agency and information asymmetry issues. The financial structuring of MBOs, involving a delicate balance of debt and equity, adds another layer of complexity to these transactions. As the landscape of corporate finance continues to evolve, MBOs remain a vital tool, offering a pathway for management teams to steer their organizations towards growth and efficiency, while navigating the intricacies of financial and strategic planning. This paper contributes to the understanding of MBOs, providing insights that can inform both academic research and practical applications in the dynamic world of corporate finance.

AI Disclaimer: This manuscript was proofread using Chat GPT 4

References

- [1] Birley, S. *et. al.* (2002). Management buyout: Perception of opportunity. *Journal of Management Studies*, 36(1), 109-122 <https://onlinelibrary.wiley.com/doi/abs/10.1111/1467-6486.00128>
- [2] Deloitte Private (2014). Anatomy of a management buyout: Common ailments and remedies when considering a private company buy-out. <https://www2.deloitte.com/content/dam/Deloitte/ca/Documents/deloitte-private/ca-en-14-2672t-anatomy-of-a-management-buy-out-aoda.PDF>
- [3] Ellerman, D. (1993). Management and Employee Buy-Outs in Central and Eastern Europe: Introduction. *Management and Employee Buy-outs as a Technique of Privatization*, 13-30. http://www.ellerman.org/wp-content/uploads/2012/12/CEEPN-MEBO1.CV_.pdf
- [4] Filatotchev, I., Buck, T., & Wright, M. (1992). Privatisation and buyouts in the USSR. *Soviet Studies*, 44(2), 265-282. <https://www.tandfonline.com/doi/abs/10.1080/09668139208412011?journalCode=ceas19>
- [5] Fleming, G. (2018). Corporate restructuring and leveraged buyouts in the Asia Pacific 1980–2010. *Australian Economic History Review*, 58(3), 283-314 <https://onlinelibrary.wiley.com/doi/abs/10.1111/aehr.12165>
- [6] González Bravo, Y. M. (2018). Buyouts por personal corporativo en procesos de privatización: experiencias en economías en transición y consideraciones para su aplicación en América Latina. *Revista Española de Capital Riesgo*, (4). <https://dialnet.unirioja.es/servlet/articulo?codigo=6819606>
- [7] Harlow, W.V. and Howe, J.S. (1993). Leveraged buyouts and insider non trading. *Financial Management*, 22, 109-118 <https://www.jstor.org/stable/3665970>
- [8] Hite, G. L., and Vetsuypens, M. R. (1989). Management buyouts of divisions and shareholder wealth. *The Journal of Finance*, 44(4), 953-970. <https://onlinelibrary.wiley.com/doi/abs/10.1111/j.1540-6261.1989.tb02632.x>
- [9] Jensen, M.C. and Meckling, W. (1976). Theory of the firm: managerial behavior, agency costs and ownership structure. *Journal of Financial Economics*, 3, 305-360. <https://www.sciencedirect.com/science/article/pii/0304405X7690026X>
- [10] Lee, S. (1992). Management buyout proposals and inside information. *The Journal of Finance*, XLVII(3), 1061-1079 <https://www.jstor.org/stable/2328977>
- [11] Lowe, J. and Naughton, T. (1993). Understanding the Australian management buyout (MBO) market. *Economic Papers*, 12(2), 97-108 <https://onlinelibrary.wiley.com/doi/abs/10.1111/j.1759-3441.1993.tb00885.x>
- [12] Lowenstein, L.,(1985). Management buyouts. *Columbia Law Revie*, 85, 730-784. <https://heinonline.org/HOL/LandingPage?handle=hein.journals/clr85&div=37&id=&page=>
- [13] Maupin, R.J. (1987). Financial and stock market variables ad predictor of management buyout, *Strategic Management Journal*, 8, 319-327 <https://onlinelibrary.wiley.com/doi/abs/10.1002/smj.4250080403>

- [14] Muzyka, D. *et. al.* (1996). Trade-offs in the investment decision's of European venture capitalists. *Journal of Business Venturing*, 11:4, 273-287
<https://www.sciencedirect.com/science/article/abs/pii/0883902695001263>
- [15] Renneboog, L., & Vansteenkiste, C. (2017). Leveraged Buyouts: A Survey of the Literature. *European Corporate Governance Institute (ECGI)-Finance Working Paper*, (492).https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2896653
- [16] Sun, P. *et. al.* (2010). Is entrepreneur–politician alliance sustainable during transition? The case of management buyouts in China. *Management and Organization Review*, 6(1), 101-121. <https://onlinelibrary.wiley.com/doi/abs/10.1111/j.1740-8784.2009.00157.x>
- [17] Wright, M. *et. al.* (1994). Longevity and the life-cycle of management buyouts. *Strategic Management Journal*, 15, 215-227 <https://www.jstor.org/stable/2486967?seq=1>
- [18] Wright, M. *et. al.* (2001). Finance and management buyouts: agency versus entrepreneurship perspectives. *Venture Capital*, 3(2), 239-261
<https://www.tandfonline.com/doi/abs/10.1080/13691060110060646?journalCode=tvec20>
- [19] Wright, M. *et. al.* (2006). Management buyouts 1986-2006: past achievements, future challenges, *Center for Management Buyouts Research*, Imperial College
https://imperialcollegelondon.a_box.com/s/qg25ulp7w3vng2ca3cw5likhhiygzmak
- [20] Wu, Y.W. (1997). Management buyouts and earnings management. *Journal of Accounting, Auditing, and Finance*, 12(4), 373-389
<https://journals.sagepub.com/doi/10.1177/0148558X9701200402>