Succession Planning 101: When Does a Management Buyout Make Sense?

Want to take most of the pressure and stress out of exiting your business? A management buyout (MBO) might be your best bet. Barbara Cowper explains why an MBO can be advantageous to both buyers and sellers.

After the turbulence of the last few years, a growing number of entrepreneurs are revisiting their succession plans. Regardless of whether they've struggled to keep their business afloat or achieved unprecedented growth, the pandemic, among other things, has inspired many to take a closer look at their exit objectives, timelines, tax obligations, and risk factors—compelling many to look for ways to leave their business.

What is a management buyout?

While some of these sellers are exploring the open market, along with other succession options, others are opting for a management buyout (MBO). An MBO occurs when an owner sells a company's shares to management or key employees—it's an excellent option for owners who have a willing and competent management team behind them.

Not only does an MBO offer flexibility, in that it can be executed through a staged or one-time ownership transition, but it also allows the owner to sell to buyers who have an intimate knowledge of the business. Additionally, it's a very discreet exit option—and one that often comes with affordable costs and low reliance on market forces.

That said, even if you're fortunate enough to have buyers within your company that are a good fit for this type of succession strategy, this road can be more emotionally taxing than others. To make sure both parties are adequately prepared, it's consequently important to keep a few things in mind.

What should owners consider when selling?

If you're an owner, your business is your baby. You watched it grow from a simple idea to a full-fledged operation, and experienced countless ups and downs along the way. This emotional attachment shouldn't be understated or overlooked—as unresolved feelings can potentially put a deal in jeopardy. One way to avoid this outcome is to make sure you're entering an MBO with your eyes wide open.

For instance, if you're looking for the best sale price for your business, you may not get that through an MBO. That said, this type of transaction does offer other upsides—such as increased deal confidentiality, legacy protection, and peace of mind knowing your business is in good hands.

Depending on your preference, an MBO can also allow you to exit your business in phases, so you can gradually let go of your responsibilities, acclimate to a new pace of life and set the new management team up for success. It's also important to note that, for a while at least, you'll likely need to remain involved for financing reasons or to help your customer base and vendors adjust to the new owner or ownership team.

What should management consider when buying?

If you're an employee or manager looking to take over a business, there are countless things you should consider as well to make sure the process goes as smoothly as possible.

First and foremost, it's important to take some time to really envision your new role and determine if it's something you truly want. Making the switch from employee or manager to owner is a big step—and you need to be prepared for the responsibility and be able to confidently take over the business in good faith. In this vein, it may be helpful to embark on ownership training—a trial period, of sorts, which allows you to learn the ins and outs of the new role, first-hand.

If you're part of a buyers group, you'll also need to craft a shareholder agreement that clearly defines the roles, expectations, and responsibilities of each member. If new debt is needed, you must be prepared to meet required financial ratios, cash flows, and debt or equity balances. You should also be aware that you may have to take on personal debt. Additionally, lenders and financing partners will likely want to see a revised business plan, as well as forecasts, to support the transition.

All that said, lenders tend to favour MBOs knowing that the business will be run by a proven management team with the necessary knowledge and experience to drive business growth. As such, they have shown themselves amenable to financing these types of deals.

Final thoughts

When entering an MBO, both parties need to be on the same page and fiercely committed to the process. This means taking the time to fully understand new roles and responsibilities, envision an ideal transition and make sure that vision is clearly communicated to each party.

This approach will also allow you to make the case to equity partners and lenders by outlining a plan that addresses any impacts on the company's organizational structure and demonstrating the appropriate financial ratios, cash flows, debt and equity balances, and management buy-in to support any new debt.

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