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corporate finance

QUARTERLY INSIGHTS INTO KEY FINANCE MATTERS AFFECTING YOUR BUSINESS

ISSUE 08

ON CORPORATE FINANCE

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THE BENEFITS ARE CLEAR:

WHY MANAGEMENT BUY-OUT OPTION IS A SMART MOVE FOR BUSINESS

IN THIS ISSUE

- RETIREMENT VILLAGE FINANCIAL MODEL
- CAPITAL RAISING FOR SMES & THE CORPORATIONS ACT

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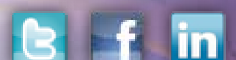


Management Buy-Outs

A management buy-out (MBO) is a process where a company's management team obtain external, and occasionally, internal funding to acquire the company from its current owner. A management buy-in (MBI) involves an external management team obtaining funding to buy in to the company. Funding is typically obtained from specialist private equity (PE) funds who often used debt to supplement their equity investment. Wealthy individuals and family offices are also active in funding MBO's and MBI's.

References in this article to MBO's also refer to MBI's.

MBOs are often overlooked by business owners as a sale option due to the misconception that MBO candidates need to have access to significant capital in order to 'buy-in'. In this article we look at how MBOs can be used as a viable sale strategy by business owners and the steps typically included.

Benefits of MBOs

Advantages of an MBO include:

CONFIDENTIALITY: where there are issues that are commercially sensitive, the vendor may not wish to allow competitors access to the business.

SPEED: buy-outs can be very quick to complete when all parties co-operate.

REDUCED COSTS: typically, compared to other types of sell down strategies, an MBO will be a cheaper transaction. Reduced due diligence requirements, and the possibility of using common bankers may help in this regard.

HIGH CHANCE OF SUCCESS: by having constructive and open discussions between existing owners and management regarding an MBO plan, once pursued, MBO transactions typically have a higher level of success when compared to other types of sell down strategies, such as a trade sale or initial public offering (IPO). All parties know each other, expectations are known and set early, and management's familiarity with the business will generally provide them with less uncertainty regarding the viability of the business.

FLEXIBILITY: most other sale structures usually involve an all-or-nothing approach. MBOs can provide an opportunity to 'stage' a transaction, allowing existing owners to realise a liquidity event earlier than would otherwise be available, provide a gradual sale of the business between owners, and to provide management more time to finance a buy-in.

CONTINUITY/VENDOR SATISFACTION: in many cases, business owners have not only spent many years developing and growing their businesses, but have also established strong relationships and trust with existing management and customers. A successful transition of ownership to management will often leave exiting business owners feeling confident regarding the future of their hard work. Management's detailed knowledge of the business means that an MBO offer will often be seen by a vendor as more credible than other competing offers.

Criteria for a successful buy-out

In order for an MBO to be successful, there are a number of criteria which should be present. These include:

- An experienced and well-balanced management team;
- a business which is commercially sound, on a stand-alone basis, with a history of generating consistent positive cash flows, and be capable of supporting an appropriate funding structure for the MBO;
- a willing vendor and management team, with realistic views regarding valuation; and
- good growth prospects.

Financing a buy-out

It is not essential that management have large amounts of capital available to invest in a business, but they should ideally have "skin in the game" (an investment that is significant for management that will incentivise them to ensure investment objectives are met). There are a number of funding sources which can be accessed to achieve a successful MBO including:

VENDOR FUNDING: funding from either the exiting owners directly, or from the company. There are a number of structures which can be put in place under this option and they work particularly well where existing owners want to pursue a staged exit over a period of time. Employee share ownership plans ("ESOPs") are one option in pursuing a vendor funded MBO strategy.

BANK FUNDING: depending on the existing level of debt of the business, a large portion of the buy-in value could be funded via bank debt. This debt could either be in the form of loans directly to the company (which then on-lends to the management team to acquire equity from the exiting shareholders) or to the management team.

PRIVATE EQUITY: in this scenario, management will usually partner with a private equity funder (a specialist private equity investment fund or a high net wealth individual or family). Funding structures employing the use of private equity funding can vary and will usually combine a mix of debt and equity funding.

The debt servicing capacity of the business needs to be assessed to ensure that this is not based on unrealistic growth assumptions.

The buy-out process

It is important to start planning as soon as possible, particularly where a staged transaction process is preferred. Careful planning, preparing your business for transition and early involvement of management will ensure a successful MBO transaction.

The following stages are typically involved in each transaction:

STEP 1: FEASIBILITY ASSESSMENT

- Determining whether the business meets the criteria outlined above for a successful buy-out, particularly as to valuation, and assessing the proposed buy-out structure. This step usually involves appointing an experienced advisor.

STEP 2: PREPARING A BUSINESS PLAN

- Preparation of a document that sets out management's strategy, details of the business, financial performance, position and prospects, and competitive position.
- This document forms an important element in the funding process as it acts as a buy-out proposition, and can help to maximise interest from potential founders and optimise funding terms and costs.

STEP 3: FINANCIAL STRUCTURING AND TAX PLANNING

- Once the value of the business has been assessed or agreed, the proposed capital structure will determine the cost of equity for incoming investors (management and/or private equity).

A key element in finalising the financial structure is determining the amount that will be invested by the management team. This will be a function of the proposed debt and third party (private equity) capital investments.

Advice should be obtained to understand the taxation implications of alternate transaction structures such as a share or asset sale and deferred consideration.

STEP 4: CAPITAL RAISING

The MBO team and their advisers will present the business plan to financial institutions, and/or private equity investors. Expressions of interest and indicative term sheets will be sought from potential investors.

The MBO team will work closely with the capital provider, as their business partner, to grow the business. Various considerations in selecting a capital partner include:

- experience in similar transactions;
- alignment of business and financial objectives; and
- cultural and personality fit with the MBO team.

STEP 5: VENDOR NEGOTIATIONS

Once indicative offers have been received, negotiations can commence and key issues resolved. It is preferable for negotiations to be led by the MBO advisor to ensure that a good relationship between the MBO team and the vendor is maintained.

Once key terms have been agreed, a non-binding Heads of Agreements is entered into between the MBO team and the vendor.

STEP 6: DUE DILIGENCE

Institutional investors and lenders will usually undertake some form of due diligence. The object of this process is to confirm the financiers' understanding of the current state and potential of the business, and assess key value drivers and risks and forecast financial performance and long term growth prospects.

Vendors should be well prepared with due diligence files prepared containing all relevant financial, commercial and legal information.

STEP 7: PROJECT MANAGEMENT TO COMPLETION

It is important that the MBO process is well managed. This involves detailed planning to ensure the project runs smoothly. This usually requires appointing an experienced advisor to manage all aspects of the transaction.

This will minimise distractions for the management team and allow them to focus on operating the business.

STEP 8: POST COMPLETION

At completion, any funding institution and management will make their equity subscriptions in the business, intra-group loans

will be funded, the bank(s) will provide their finance and the acquisition of the business will be complete.

The final stage of the buy-out process is the period after completion during which statutory filings are made at the relevant registries, documents to effect a transfer of title to assets are stamped, stamp duty are filed and changes to title to assets have been communicated to relevant registries.

Conclusion

It is important for owners considering an MBO as a possible exit strategy to start planning as soon as possible, particularly where a staged transaction process is preferred. Key elements of success include:

- maintaining a good relationship between MBO team and vendor;
- determining a fair value for the business;
- determining the funding structure;
- selection of capital partners; and
- appointment of an experienced advisor.

Retirement Village Financial Model

Retirement villages operate under different legislation in each state and are best defined as a complex of residential premises that offer a range of communal facilities and services to residents who are predominately retired persons aged 55 years and over.

The Trends in Australia

5% of Australians over the age of 65 reside in retirement villages, significantly lower than other developed countries. There is a consensus in the industry that there is room for significant growth. Knowing the trends and integrating them into a financial model will mean investors and operators of retirement villages are one step closer to long term viability. Below are some key trends in Australia;

- Australia has an ageing population. The population over 65 is expected to reach eight million by 2050;
- in the last 40 years, life expectancy has increased by 10 years. People on average are healthier and more independent;
- average age of entry is 76. However, the average age of entry is expected to increase and the length of tenure is expected to reduce;
- main reason for new entrants entering into retirement villages are to downsize or for future health concerns and to free up capital to fund retirement. Those entrants see it as a lifestyle decision and not a "bricks and mortar" investment. The retirees like the independence, emergency support and facilities offered and noted reputation and affordability as the two highest ranking factors in selecting a retirement village.

Retirement Village Fee Structure

Retirement village fee structures can seem complicated and are considerably different from a standard residential home purchase.

The contract entered into with the resident can be broken down as follows, see Table 01 (top right).

The Financial Model

The village operators' return on their initial investment is only realised upon the sale of the residents unit both initially and "resale" following departure of a resident. There can be significant uncertainty in predicting the:

- tenure of the resident;
- sale price at exit of the resident; and
- unit turnover over the life of the retirement village.

It is paramount that investors and operators understand these aspects in preparing their village financial model given the changing market trends. Due consideration needs to be given to the valuation assumptions to be used in the financial model. Inappropriate assumptions can result in significant variances in operators return on investment.

Key assumptions used in the financial model of three ASX listed companies which operate in the retirement living space are set out in Table 2 below.

If you are interested in further discussing the content of this article, please feel free to contact one of our directors at PKF Lawler Corporate Finance. ■

Table 1

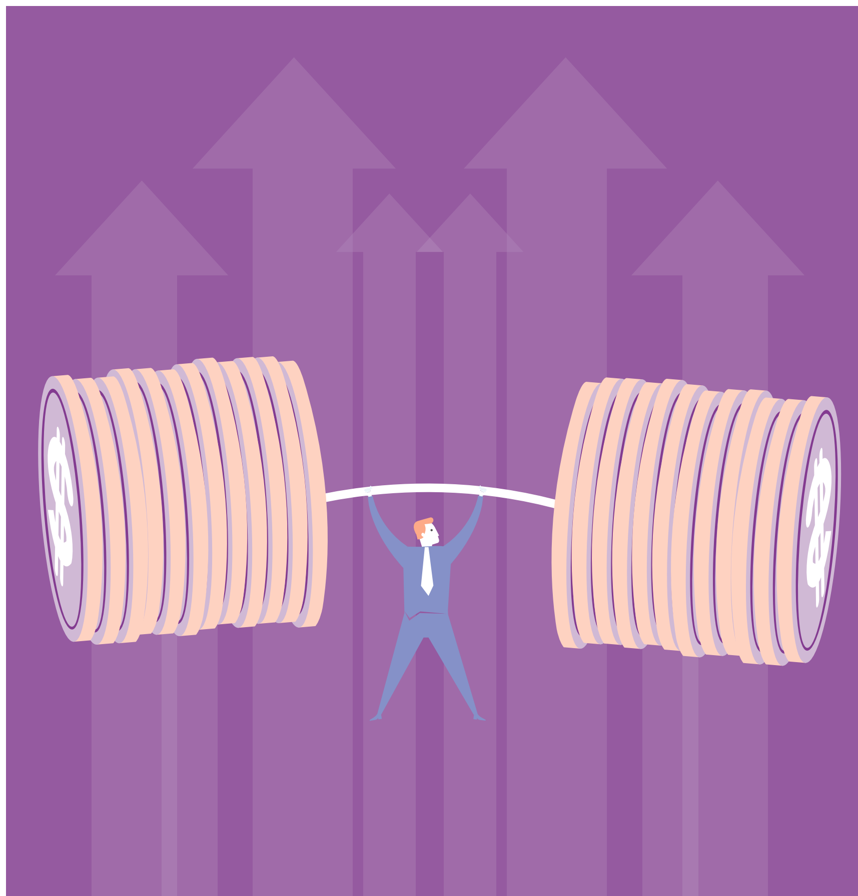
Fee	Details
Waiting list fees	A fee charged to the applicant to cover some administrative expenses and can sometimes be refunded upon entry to the village.
Entry Fee	In Australia there a number of alternate models. Typically the resident pays an 'ingoing contribution' amount or pays an amount in exchange for the right to occupy the strata title and is commonly structured as an interest free loan. This can be the most significant single payment made by the resident.
Ongoing Fees	These fees are usually controlled under state legislation to a cost recovery basis and will cover the ongoing costs incurred in maintaining facilities and common areas. The fee is usually indexed by CPI. However a larger than CPI increase is sometimes allowed.
Special or One Off Levies	A retirement village may need more money than is collected in ongoing fees; these costs can be recovered through a special levy. This can only be proposed once per year and will usually require residents approval.
Departure Fees	Upon departure, residents typically pay an 'exit' or 'deferred management' fee. This fee is the point at which the operator generates a return on their large upfront capital investment. In Australia, the fee usually comprises of: • a share of the capital gains from the sale of the unit; and • an annual charge predominately between 2% - 3% for the duration of the residents' tenure and is usually capped at 25% - 35%. This fee is designed to compensate the operator for their upfront investment.

Table 2

Key Valuation Assumptions	FY 2014	FY 2010	Movement %	Company
Weighted average discount rate	12.80%	12.78%	0%	Stockland Corporation (ASX: SGP)
Weighted average 20 year growth rate	3.80%	4.00%	-5%	
Average length of stay of future and current residents	9.9 years	12.0 years	-18%	
Weighted average discount rate	12.50%	12.50%	0%	Aveo Group Limited (ASX: AOG)
Weighted average 20 year growth rate	3.66%	5.00%	-27%	
Average length of stay of future and current residents	10.0 years	9.0 years	11%	

Source: ASX Market Results Presentation 2014 and 2011; PKFCF analysis

Capital Raising for SMEs & the Corporations Act



Whether it be to fund business expansion, a new business idea or to establish an investment fund which pools together funds from a number of investors, the need for small entities to raise capital requires careful consideration of the capital raising provisions contained in the Corporations Act 2001 ("Corps Act") to ensure that disclosure obligations are met.

Where to start?

For a entity looking to raise capital the requirement to prepare and lodge a disclosure document (i.e. a prospectus, offer information statement or profile statement) is the default position under the Corps Act. This can be a very costly exercise, especially for smaller capital raisings.

Preparation of a disclosure document is not required when the capital raising meets one of the exemptions set out in Section 708 of the Corps Act. There are eleven (11) exemptions under Section 708 as follows:

- Small scale offerings;
- Offers to sophisticated investors;
- Offer to professional investors;
- Offers of securities to people associated with an entity;
- Certain offers to present holders of securities;
- Issues or sales for no consideration;
- Compromise or arrangement under Part 5.1;
- Deed of company arrangement;
- Takeovers;
- Debentures of certain bodies; and
- Offer by exempt bodies.

The three most common exemptions relied upon by small entities looking to raise capital without preparing disclosure documents documents are displayed in Table 3.

Crowd Funding

Crowd funding in Australia is currently not specifically regulated, nor is it prohibited. However, in August 2012, the Australian Securities and Investment Commission (ASIC) released guidance not only for entities looking to raise capital through this medium, but also for promoters of crowd funding (i.e. the operators of crowd funding websites). This guidance confirmed that the capital raising provisions contained in the *Corporations Act* do need to be considered even where non-equity rewards are offered (e.g. a product, future discount etc.).

Crowd funding activities may fall within the managed investment scheme provisions of the *Corporations Act* which would trigger disclosure requirements. If you are pursuing crowd funding you should seek legal advice.

The Federal Government is currently considering recommendations from various sources, including a report released in March 2014 by the Corporations & Market Advisory Committee, which are aimed at clarifying the legal position of crowdfunding and making crowdfunding more accessible to retail investors. The Federal Government is expected to announce its official position in late 2014.

Seek Advice

The legal aspects of a capital raising are complicated with the potential for severe criminal penalties applying to directors, other management and promoters who breach these provisions.

If you are interested in raising capital, please feel free to contact one of our directors at PKF Lawler Corporate Finance to discuss your situation. ■

Table 3

Capital Raising Exemption	Criteria
Small Scale Offerings	This exemption applies to small capital raisings. There are strict conditions which need to be met under this exemption, which are summarised below: • limited to the offer of securities to no more than 20 investors in any 12 month period; • limited to the raising of no more than $2 million in any 12 month period. When considering whether the $2 million ceiling applies, any amounts unpaid on partly-paid securities will be included, as well as monies payable on the exercise of any options issued; and • the offer cannot be advertised and can only be made to persons who are likely to be interested in the offer having regard to: (i) previous contact between the person making the offer and that person; or (ii) some professional or other connection between the person making the offer and that person; or (iii) statements or actions by that person that indicate that they are interested in offers of that kind.
Offers to Sophisticated Investors	For a capital raising to fall within this exemption, investors must meet the definition of a "sophisticated investor". An investor will meet the definition of a "sophisticated investor" if they satisfy one or more of the following criteria: (a) the minimum investment under the capital raising is at least $500,000; (b) the minimum investment under the capital raising plus any amounts previously paid by an investor for the same class of securities add up to at least $500,000; (c) confirmed by a certificate given by a qualified accountant, the investor has: (i) net assets of at least $2.5 million; or (ii) a gross income for each of the last two years of at least $250,000 per year; or (d) the offer is made to a company or trust controlled by a person who meets the requirements of (c)(i) or (ii) above. While there is some confusion in the industry, it is generally accepted that a SMSF can only qualify as a professional investor under the $10m asset exemption. When dealing with SMSF investors, we recommend that legal advice be sought.
Offers to Professional Investors	Generally, an investor will be classified as a "professional investor" if they fall within one of the following categories: (a) the investor holds a financial services licence; (b) the investor is a body regulated by the Australian Prudential Regulation Authority (APRA); (c) the investor is a body registered under the *Financial Corporations Act 1974;* (d) the investor is a superannuation fund, approved deposit fund, pooled superannuation trust or public sector superannuation scheme and the investor has net assets of at least $10 million; (e) the investor controls at least $10 million; (f) the investor is a listed entity (e.g. a public company listed on the Australian Securities Exchange); (g) the investor is an exempt public authority; (h) the investor carries on a business of investment in financial products, interests in land or other investments and for those purposes, invests funds received following an offer or invitation to the public; or (i) the person is a foreign entity that, if established or incorporated in Australia, would be covered by one of the preceding paragraphs.

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