MINOR THESIS SUBMITTED AS PART COMPLETION OF REQUIREMENTS OF THE MASTER OF BUSINESS IN ACCOUNTING AND FINANCE

# THE ROLE OF THE INSTITUTIONAL LEAD FUND MANAGERS IN THE MANAGEMENT BUYOUT (MBO) INDUSTRY IN AUSTRALIA: A STUDY OF PROSPECTS FOR THE INDUSTRY

Albie G. Brooks

# CONTENTS


| | | |
|---|---|---|
| Chapter 1 | Introduction, Australian MBO Industry and Research Problem | Page 1 |
| | 1.1 Introduction | |
| | 1.2 Historical Development of MBOs | |
| | 1.3 Characteristics of the Australian MBO industry | |
| | 1.4 Research Problem | |
| Chapter 2 | Literature Review | Page 21 |
| | 2.1 Rationale for and Causes of MBO/LBO Transactions | |
| | 2.2 Evidence Relating to Prospects for MBO industry | |
| Chapter 3 | Research Design | Page 34 |
| Chapter 4 | Research Results and Commentary | Page 36 |
| Chapter 5 | Implications, Opportunities for further Research and Conclusion | Page 59 |
| | 5.1 Implications | |
| | 5.2 Opportunities for Further Research | |
| | 5.3 Conclusion | |
| | References | Page 64 |
| | Appendix A | Page 68 |



The helpful comments of Ray Anderson are acknowledged. Any errors or omissions are of course, the sole responsibility of the author.

# LIST OF EXHIBITS


| Exhibit | Title | Page |
|---|---|---|
| 1.1 | Leveraged Buyout Transactions - United States 1983-1990 | 4 |
| 1.2 | Number of Management Buyouts and Buyins in the United Kingdom 1979-1990 | 4 |
| 1.3 | Estimated Number of Buyouts and Buyins in Europe to the end of 1989 | 5 |
| 1.4 | Summary of Management Buyouts in Australia with a Transaction Value in Excess of $AUD10m | 6 |
| 1.5 | Management Buyouts in Australia with a Value in Excess of $AUD10m | 7 |
| 1.6 | Financing Structure - Sample of Twelve Australian MBOs | 12 |
| 1.7 | Financial Structure - Laurels | 15 |
| 4.1 | Number of MBOs Responding LFMs Had Lead | 36 |
| 4.2 | Number of Deals Lead By LFM Within Specified Transaction Values | 37 |
| 4.3 | Intentions of LFMs with Respect to MBO involvement | 38 |
| 4.4 | Classification Model | 39 |
| 4.5 | Mean Ratings of Factors Likely to Effect the Level of MBO Activity in the Next One to Two Years | 40 |
| 4.6 | Expected Average Value of MBO Transactions in the Next One to Two Years | 47 |
| 4.7 | Expected Number of MBO Transactions in the Next One to Two Years | 48 |
| 4.8 | Expectation of MBO Activity Concentrating in Particular Industries | 50 |

| Exhibit | Title | Page |
|---|---|---|
| 4.9 | Expectation of No MBO Activity in Particular Industries | 50 |
| 4.10 | Expectation of MBOs Resulting in the Privatisation of Companies Listed on the Australian Stock Exchange | 52 |
| 4.11 | Anticipated Changes in the Proportion of Equity to Total Funding for MBOs Executed in the Next One to Two Years, Compared to Previous Levels | 53 |
| 4.12 | Anticipated Changes in the Availability of Funds for Equity Investment in MBOs in the Next One to Two Years Compared to Previous Levels. | 53 |

# 1. INTRODUCTION

Over the last two decades, the extent of corporate restructuring has gathered momentum both in Australia and internationally. In particular, the 1980's signified major developments in financing instruments which facilitated corporate restructuring transactions.

Definitions of corporate restructuring vary, though common elements suggest that it results in a major alteration to a firm's goals and strategies, resulting in changes to the ownership, financing and administration of corporate assets (Bickster and Cher 1991, De Caires 1991). Corporate restructuring may be evidenced in such activities as: merger and takeover activity; organisational downsizing via the disposal of non-core activities; changes in the incentive and compensation arrangements within firms including the increasing use of executive share option schemes and other forms of employee equity participation; alterations to the organisations ownership and control via share buybacks, leverage buyouts, management buyouts and buyins; alterations to the financial structure driven by increasingly sophisticated funding instruments and increasing prominence of leverage.

While the nature of corporate restructuring may take a variety of forms, two popular forms which have increased in prominence over the last two decades are the leveraged buyout (LBO) and management buyout (MBO). Again, definitional problems occur in relation to LBOs and MBOs. In broad terms however, an LBO may be defined as the acquisition of a company by an investor group, using a significant amount of debt (as high as 70-80% of total assets), with plans to pay down the debt from the cash flows generated by the firm and/or from asset sales. An MBO may be viewed as an LBO, whereby the investor group includes members of the current management of the target firm (Yago 1991, De Angelo and De Angelo 1987, Wright et.al. 1991).

Whilst each MBO deal will possess common elements, they will also possess their own characteristics. The overall financial package will commonly include senior debt and subordinated/mezzanine debt as well as equity. Some transactions have also incorporated the use of vendor finance. The equity component of the financial package will commonly include management holding equity status in conjunction with other equity partners. For smaller transactions this joint equity status may not be necessary.

As the development of MBOs is relatively recent, and little Australian research on MBOs has taken place, this research paper focuses on MBOs.

The broad purpose of this research paper is to examine the development of MBOs in Australia and via an empirical investigation, consider the future prospects for the industry as perceived by the institutional lead fund managers directly involved in the MBO industry. The remainder of this chapter will focus on the historical development of MBOs, characteristics of the Australian MBO industry, and outline the research problem addressed by the empirical analysis.

## 1.2 HISTORICAL DEVELOPMENT OF MBOs

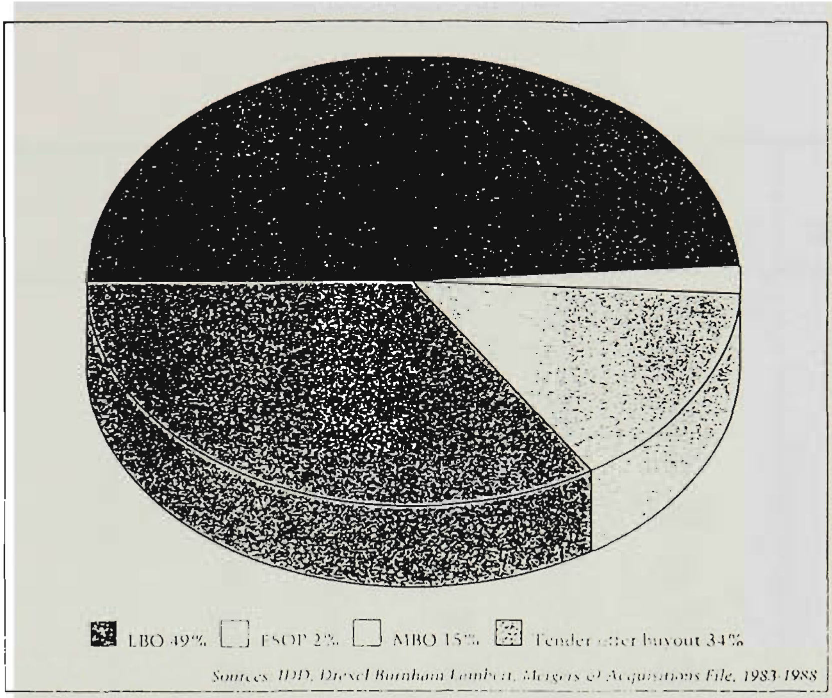
There is little doubt that the concept of the existing management of a firm executing a buyout of the firm is not new. In the latter 1970's and early 1980's however, the rationale underpinning such transactions were further explored and examined, and the development of the financing instruments to facilitate the transactions grew in sophistication. Consequently, in both the United States and the United Kingdom, the concept of what Jensen (1989) refers to as the 'new organisation form' grew rapidly in prominence. Exhibits 1.1, 1.2 and 1.3 provide evidence of this growth in the United States, United Kingdom and continental Europe.

The growth in MBO transactions in Australia during the 1980's has been less significant than in the United States, or United Kingdom. The total number approximates seventy five for the period 1983-1990; with twenty seven of these being in excess of $AUD10 million. The growth in MBO transactions in excess of $AUD10 million[1] is shown in Exhibit 1.4. From Exhibit 1.4 the evidence highlights an increase in the total value of transactions in excess of $AUD10 million, with a similar number of transactions executed each year in the period 1988-1990. The average size of these transactions was $AUD60.44 million, with a combined value of $AUD1,632 million.

[1] The specific data on deals in excess of $AUD10 million has been more accessible than the smaller transactions. As a consequence, Exhibit 1.4 focuses on these transactions.

**EXHIBIT 1.1**

**LEVERAGED BUYOUT TRANSACTIONS - UNITED STATES 1983-1988**

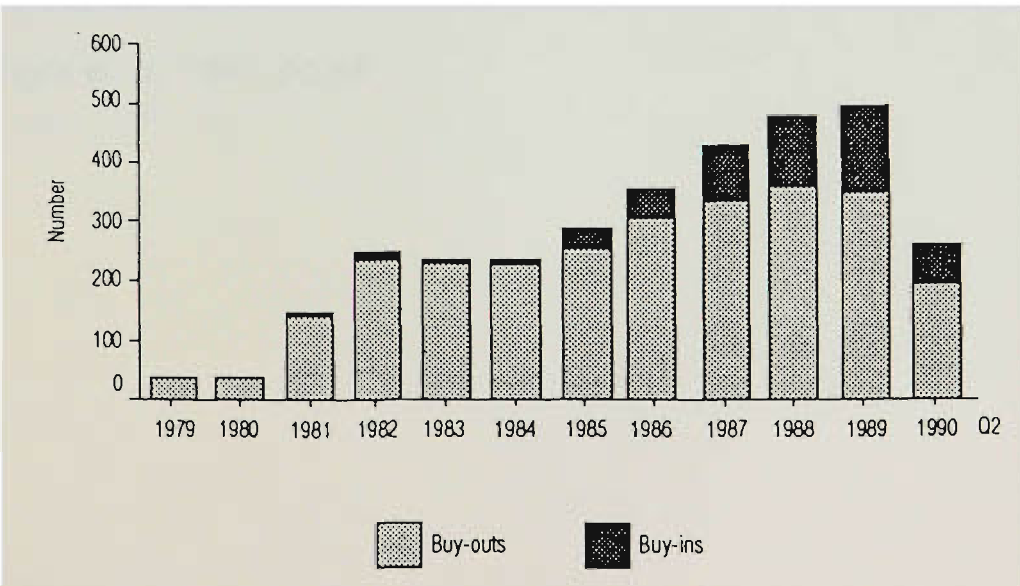



Source: Yago 1991, pg.37.

**EXHIBIT 1.2**

**NUMBER OF MANAGEMENT BUYOUTS AND BUY INS IN THE UNITED KINGDOM**

**1979-1990**




Source: Wright et. al. 1991, pg.31.

## EXHIBIT 1.3

## ESTIMATED NUMBER OF BUYOUTS AND BUY INS IN EUROPE TO THE END OF 1989

| Country | 1987 | 1988 | 1989 | Total 1980-1989 |
|---|---|---|---|---|
| Austria | 3 | 5 | 5 | 15 |
| Belgium | 4 | 10 | 12 | 52 |
| Denmark | 5 | 20 | 31 | 63 |
| Finland | 5 | 14 | 16 | 40 |
| France | 50 | 100 | 130 | 430 |
| Germany | 8 | 36 | 25 | 111 |
| Ireland | 21 | 14 | 12 | 131 |
| Italy | 3 | 10 | 21 | 52 |
| Netherlands | 30 | 30 | 41 | 245 |
| Norway | 7 | 8 | 8 | 29 |
| Spain | 4 | 8 | 12 | 35 |
| Sweden | 18 | 22 | 32 | 127 |
| Switzerland | 2 | 5 | 24 | 46 |
| UK | 434 | 482 | 503 | 2993 |

Source: Wright et. al. 1991, pg.44

**EXHIBIT 1.4**

| SUMMARY OF MANAGEMENT BUYOUTS IN AUSTRALIA WITH A TRANSACTION VALUE IN EXCESS OF $A10M | | |
|---|---|---|
| Year | Number of Deals | Total Value ($M) |
| 1983 | 1 | 33 |
| 1984 | - | - |
| 1985 | 1 | 30 |
| 1986 | 2 | 54 |
| 1987 | 4 | 232 |
| 1988 | 6 | 295 |
| 1989 | 7 | 412 |
| 1990 | 6 | 576 |
| Average transaction value = $60.44m | | |

Source: Brooks 1992, pg.3

## EXHIBIT 1.5

### MANAGEMENT BUYOUTS IN AUSTRALIA WITH A VALUE IN EXCESS OF $A10M

| YEAR | COMPANY | TRANSACTION VALUE $AM | INDUSTRY PRINCIPAL ACTIVITY | LEAD FUND MANAGER |
|---|---|---|---|---|
| 1983 | Techcom | 33 | Broadcasting | CCI |
| 1985 | Clutha | 30 | Manufacturing/Mining | Capel Court |
| 1986 | Automotive Comp. | 44 | Retail Distrib. - motor | AIDC/CCI |
| | Austoft | 10 | Cane Harvester Prod. | DBSM |
| 1987 | JRA | 82 | Automotive & Retail Dist. | CCI/Byvest |
| | NBN | 95 | Media | Fulcrum |
| | NACO | 42 | Building Supplies | DBSM |
| | PWB Anchor | 13 | Manufacturing-chains & equip. | Byvest |
| 1988 | Orlando | 80 | Wine Making & Distribut. | DBSM |
| | JASCO | 46 | Stationery Supplies | DBSM |
| | Albany Woollen Mills | 17 | Textile Manufacturing | DBSM |
| | Sunbeam Victa | 110 | Manufacturing & Retail Dist. | Byvest |
| | Prok | 12 | Manufacturer of bulk materials | DBSM |
| | Aquarium | 30 | Retail Distribution | Byvest |
| 1989 | Prouds/Edments | 50 | Retail Distribution | AMIL |
| | Ferntree | 41 | Computing | CCI/ Fulcrum |
| | Fortuna | 102 | Building Industry | AIDC/ Capita |
| | Penrice | 71 | Chemical Manufacture | Byvest/ CCI |
| | Cigweld | 100 | Manufacturing-Welding Prod. | Byvest |
| | Bestobell | 18 | Engineering Product Dist. | DBSM |
| | Control Data | 30 | Computing | Boston-Aust |
| 1990 | McEwans | 227 | Retail Distribution | CCI/AIDC |
| | Howe | 10 | Leather Manufacturing | DBSM |
| | Bonriki | 19 | | Wardley |
| | Webforge | 32 | Building & Construction | Pru-Asia |
| | Leigh-Mardon | 270 | Printing & Packaging | DBSM/ Pru Asia |
| | Wrightcel | 18 | Packaging Products | AIDC |

Source: Brooks 1992, pg.23

A conservative estimate of the total value of MBO transactions in Australia, including both small and large deals would be $AUD2 billion. Put in this context the Australian MBO market has played a relatively significant role in the restructuring of corporate Australia, if not to the same levels experienced in the United States and the United Kingdom. Exhibit 1.5 details the summative data provided in Exhibit 1.4 showing the name of the firm, its principal activity, the value of the transaction and the main institutional lead fund manager associated with the deal.

There is no specific evidence as to why the Australian MBO industry has not developed at similar rates to that experienced in the United Kingdom or the United States. Possible reasons which may explain this include:

* much smaller population base in Australia and lower personal wealth levels;
* lower relative level of managers with the required expertise and vision to ensure the success of an MBO target firm after the transaction is executed;
* potential managers of MBO firms more risk averse than their international counterparts;
* less sophisticated financial markets;
* inability of banks and financial institutions to recognise perceived benefits from providing financial support to viable target MBO firms;
* a reluctance on the part of vendors to sell to management, preferring a sale to an external bidder.

## 1.3 CHARACTERISTICS OF THE AUSTRALIAN MBO INDUSTRY

As previously indicated and evidenced in the work of Brooks and Anderson (1991), Brooks (1992), and Brooks and Anderson (1991), the Australian MBO industry developed at a slower rate than the United Kingdom or United States. Exhibit 1.4 indicated a total of twenty seven MBOs in Australia for the period 1983-1990 with a transaction value in excess of $AUD10 million. These transactions provide a total value of $AUD1,632 million out of an estimated $AUD 2 billion, highlighting that 36% of the transactions based on number have generated 80% of the total value.

The evidence available would suggest that the number of transactions above $AUD10 million has decreased since 1990. This slowing in the number and value of transactions is not entirely an Australian characteristic, with a similar occurrence in the United Kingdom during 1990/1991 (KPMG, Corporate Finance, April 1991). This section of the paper will focus on the valuation and financing issues in Australian MBOs, the exit process for MBO firms, and the perceived success of the Australian market.

### Valuation and Financing Issues

Ultimately, the price paid to acquire the target firm will be determined by negotiation between the parties involved. The most common valuation methods used to assist this process would seem to be the capitalisation of earnings method and net asset backing (Brooks and Anderson 1991, Anderson 1991, Brooks 1992), with some limited use of discounted cash flows.

Where a competitive bid should arise it is important that the LFM along with the management team do not allow their arranged funding to be placed under severe strain by bidding beyond the capabilities of the funding and the operational capacity of the firm, as well as reducing the future returns to the investors. In such circumstances the more appropriate outcome will be for the competitive bid to be successful rather than management acquiring the firm at an excessive price. From discussions with some LFMs this would appear to be more the case here in Australia, contrasted with the US experience in the mid 1980's, where the climate would appear to have been more 'fees driven', rather than based on sound commercial logic. This 'fee driven' approach is exhibited by the large number of parties to some leveraged transactions in the late 1980's in the United States. It would appear that the enthusiasm of some participants and advisors was based on the generation of income via fees, rather than the best commercial outcome for the target firm.

The financing package of an MBO will ultimately be dependent upon the particular characteristics of the individual transaction. It is common however, to find a combination of financing instruments including, to greater or lesser degrees: senior debt; mezzanine or subordinated debt; vendor finance; and equity. At any point in time a range of factors is likely to effect the composition of the financing package. These factors would include:

(i) The size of the transaction,

(ii) The availability of equity funds available by the LFM and other institutional investors,

(iii) The personal wealth of the management team which will affect the amount of management equity available for investment in the firm,

(iv) The level of equity, (if any) already held by members of the management team,

(v) The availability of funding from the banking sector and the attitude of banks to providing funds for leveraged transactions,

(vi) The level of interest rates, inflation rate and the terms of the particular funding source(s),

(vii) The availability of mezzanine/subordinated funds held by the financial institutions and the LFMs.

Brooks (1992) analysed a sample of twelve Australian MBOs to determine the financing characteristics. The results of this analysis are shown in Exhibit 1.6.

**EXHIBIT 1.6**

FINANCING STRUCTURE - SAMPLE OF TWELVE AUSTRALIAN MBOs EXPRESSED AS A % TOTAL FUNDING*

| Firm | Senior Debt | Mezzanine Debt | Vendor Finance | Equity (Total) |
|---|---|---|---|---|
| A | 76 | N.A.** | N.A. | 24 |
| B | 48 | 15 | 22 | 15 |
| C | 70 | N.A. | 14 | 16 |
| D | 61 | N.A. | 18 | 21 |
| E | 52 | 17 | 12 | 20 |
| F | 57 | 18 | 15 | 10 |
| G | 55 | 25 | N.A. | 20 |
| H | 57 | N.A. | N.A. | 43 |
| I | 27 | N.A. | 61 | 12 |
| J | 77 | 11 | N.A. | 12 |
| K | 69 | 10 | 11 | 10 |
| L | 68 | 15 | 7 | 10 |
| Mean | 60 | 16*** | 20*** | 18 |

* Total funding of sample equal to $A871.39m
** Denotes not applicable.
*** Mean calculated on those deals using this facility

Source: Brooks 199, pg.12.

The evidence in Exhibit 1.6 suggests that for the sample of MBOs analysed, senior debt as a proportion of the total funding averaged 60%, which is consistent with the United Kingdom experience (Wright et. al. 1991).

The subordinated/mezzanine debt component of the financing package represents an average of 16% for those transactions which included mezzanine debt as part of the overall financing package. Seven of the firms in the sample of twelve did so. Debt classified as mezzanine or subordinated may take a variety of forms, and in most cases in Australia, has been provided by the LFMs or larger institutions. For larger transactions, the total mezzanine component may be as a result of a syndication of funds, with a number of contributors. Traditionally, mezzanine debt has served the purpose of filling a financing gap caused when the senior debt and equity components are insufficient to fund the deal. During the 1980's, two of Australia's leading LFMs had combined investable mezzanine funds totalling $AUD324 million.

Exhibit 1.6 indicates that the proportion of equity in the total funding for the sample firms ranges from 10% to 43% with a mean of 18%. The contributors of the equity component will in part, be dependent upon the size of the transaction, the personal wealth of the management team, the level of equity previously held by management in the firm, and the willingness of external investors and the LFM to contribute. For smaller transactions the entire equity component may be contributed by the management team, while the evidence for larger transactions suggests management will hold joint equity status with the LFM and possibly other investors. The same two LFMs previously mentioned had combined investable equity funds of $AUD150 million. Brooks (1992) reports that for eleven of the twelve firms reported in the sample in Exhibit 1.6, the proportion of equity contributed by management to the total equity component ranged from 2.9% to 38% with a mean of 16%. Brooks also reports that the mean value for the management contribution as a proportion of the total funding is 3%, which is not dissimilar to the United Kingdom experience (Wright et. al. 1991).

One of the critical underlying forces in MBO transactions is the incentive provided to management by the management team becoming equity holders and the anticipation of an increase in personal wealth achieved through the improved operating performance and efficiency gains of the firm. This incentive aspect can be illustrated by the consideration of the funding structure of an Australian MBO completed in the late 1980s, provided in Exhibit 1.7

**EXHIBIT 1.7**

| FINANCIAL STRUCTURE: LAURELS | | | | | |
|---|---|---|---|---|---|
| PROVIDER | EQUITY $M | % | SUB-DEBT $M | SENIOR DEBT | PROJECTED IRR |
| MANAGEMENT | 0.750 | 32.6 | - | - | 55 |
| INVENTORS | 0.775 | 33.7 | - | - | 55 |
| INSTITUTIONS | 0.775 | 33.7 | 2.4 | - | 28 |
| BANKS | - | - | - | 9.8 | |
| | 2.3 | 100.0 | 2.4 | 9.8 | |

Source: Brooks 1992, pg.18.

In the example of Laurels, management contributed some 32.6% of the total equity component, yet on a total transaction value of $14.5 million, this contribution represented only 5%. The incentive for management is based on the concept that improvements in financial performance over time, causing an increase in equity as a proportion of total assets, has the potential to produce favourable personal wealth outcomes. This potential gain should drive the management to ensure operating improvements and efficiency gains transpire. This structure is also likely to decease the cost effect of agency theory. Under the Laurels structure, management now has the dual role of both manager and owner, overcoming the dysfunctional effect when management and diverse ownership are separated.

Vendor finance has been used in a number of the MBOs in the sample. In fact, it has been used in more deals in the sample than has mezzanine debt, with vendor finance contributing an average of 16% to the total funding for those deals using this facility. Two main reasons can be put forward to explain the use of vendor finance. Firstly, it may be a necessary requirement to enable the deal to proceed, with a facility such as a loan on favourable terms or a deferred payment; a situation in which the vendor is probably not too pleased. Secondly, the vendor may be quite happy to leave funds in the firm, perhaps to share also in any operating and efficiency gains achieved. In such cases the vendor finance is likely to take the form of a minority equity interest.

Little evidence is available about the performance of Australian MBO firms. Studies completed overseas on the operating and management performance of MBO firms indicate favourable outcomes (Bull 1989, Kaplan 1989, Smith 1990). Some evidence is available as to the exit mechanism for a number of Australian MBO firms. Management and investors are likely to realise their investment (usually within a five year time horizon). The two most common exit processes are to enter into a trade sale or seek listing on the Stock Exchange. The more common exit mechanism in Australia has been the trade sale.

Of the firms listed in Exhibit 1.5, Clutha was listed on the main board of the Australian Stock Exchange in 1987, an uncommon exit mechanism for Australian MBO firms. Prok was on-sold to the Finnish industrial group Outokumpu Oy in June 1990, just eighteen months after the MBO, resulting in a 45% capital gain for investment partners (Ralph 1990). Orlando, which earlier acquired Wyndham Estate Wines, giving the group an 18% share by dollar value of the Australian wine market, was sold (via a joint venture arrangement) to Pernot Ricard, Europe's largest beverage distribution house.

Little research has been conducted on the returns achieved by the LFMs from their investment in MBOs. However, Lansdowne (1992) calculated a weighted average annual return of 48% for the five most active funds in transactions in excess of $AUD10 million.

## 1.4 RESEARCH PROBLEM

Given the development in MBO transactions has been slower and at lower dollar values than overseas, this research paper sets out to identify the prospects for the MBO industry in Australia over the next one to two years via an empirical study of the institutional lead fund managers.

The key participants in the MBO industry are: management; banks and financial institutions; institutional lead fund managers; and the vendors.

The empirical evidence in this study is obtained via a questionnaire to the institutional lead fund managers. Discussion on selection of the LFMs as the research subjects, is provided in the research design chapter.

Prospects for the Australian MBO industry as perceived by the institutional LFMs are explored by gathering the following information:

- the relative importance of a given set of factors likely to effect the level of MBO activity in the next one to two years;
- any anticipated changes in the value of individual MBO transactions, and

the number of MBO transactions in the next one to two years;

- whether particular industries are likely to be more, or less conducive to MBO activity;
- whether the historical trend of few MBO acquisitions resulting in the privitization of a company listed on the Australian Stock Exchange is likely to continue; and
- whether there is likely to be any changes in the proportion of equity to total funding in MBO transactions; or any changes in the availability of funds for equity investment in MBOs.

Specifically, this research will provide:

(a) The anticipated number of major participants in the Australian MBO industry. If the LFMs indicate an unlikelihood of continued active participation in the industry, then this is likely to have a dampening effect on the number of MBO transactions;

(b) Those factors considered most important and those considered least important as affecting the level of MBO activity in the next one to two years;

(c) Major changes expected in the number and value of MBO transactions will provide insight into the required need for institutional support including the banking sector, to facilitate such transactions. In addition, any significant increase in the value of MBO transactions, which would indicate larger transactions and hence larger target firms raises issues in relation to the market for corporate control in Australia. With the divestiture plans conducted by some firms (in many cases due to financial distress), corporate control and perhaps more importantly the role of the so named 'entrepreneur' in Australia, the key individual players in corporate Australia are likely to be significantly different in this decade than in the 1980s.

(d) The anticipated debt levels in MBO transactions in the next one to two years. One of the key criticisms of MBO/LBO transactions has been the debt levels employed to execute the transaction. Developments in financing instruments in the last decade facilitated the increasing use of debt finance. Leveraged transactions have resulted in debt accounting for 90% of the total funding package for some deals. In the last couple of years the attraction of debt has diminished. Due to the perceived problems of excessive debt levels and the changing nature of credit assessment by Australian banks one would expect to find an anticipated increase in the level of the equity component of the financing structure for MBO transactions in the next one to two years.

(e) The extent of availability of funds for equity investment in MBO transactions. The ability of the LFMs to attract investors to contribute to equity funds is an important consideration in the future funding of MBO transactions. The expectation is that institutions and individuals are likely to be less enthusiastic about contributing to formal equity funds conducted by the LFMs for investment in MBO transactions, resulting in lower levels of equity funds available for investment in MBO transactions. The unlisted equities market is likely to take on a further dimension with the removal of the Second Board from the Australian Stock Exchange. It might be argued that competition for unlisted equities will increase, placing pressure on the level of equity funds available for MBO transactions.

In this context, two identifiable research problems are considered:

(i) whether LFMs who are no longer active participants in the Australian MBO industry view the prospects for the industry differently from those LFMs who continue to be active.

(ii) whether LFMs who predominantly operate at the lower end of the market view the prospects for the Australian MBO industry differently from those LFMs who operate (or have operated) predominantly at the middle to upper end of the market.

# CHAPTER 2 LITERATURE REVIEW

The purpose of this literature review is to trace the literature which addresses the rationale for, and consequences of MBO transactions in the context of the development of MBO activity in Australia. Secondly, literature relating specifically to issues raised by the empirical analysis will then be addressed.

## 2.1 RATIONALE FOR AND CAUSES OF MBO/LBO TRANSACTIONS

While Berle and Means (1932), raised substantive issues relating to ownership and control of the public corporation, the literature relating to MBOs both as a transaction form and an organisational form developed during the 1980's.[2]

The key rationale (or causes) for MBO transactions include:

Reduction in Agency Costs

The principal-agent relationship and the consequential monitoring or agency costs as identified by Jensen and Meckling (1976), required in the public corporation with large and diverse stockholder interests are significantly reduced after the taking private of a

---

[2] MBOs may be viewed specifically as a transaction form whereby little else may change, or alternatively the attention may be focused on the creation of a new organisational form with emphasis on the role of management and improved operating performance.

public corporation via an MBO. Hseih, Easterwood and Singer (1987) referred to this as the control hypothesis. It makes sense that such a cost reduction should transpire. Indeed, Bruijn et. al. (1990) argue from their study that the improved performance of MBO firms can in part be attributed to the reduction in agency costs via increased management motivation and the utilisation of an appropriate reward structure. In addition they identified a reduction in the time frame for decision making; again a cost reducing outcome.

An interesting question in relation to agency costs is whether the existing monitoring costs are simply replaced by another set of monitoring costs particularly for those transactions involving third party equity investors. That is, are the monitoring costs between management and shareholders simply replaced by a second set of monitoring costs between management and joint equity investors? Investigation of this concept is beyond the scope of this paper.

In Australia there have been very few 'going private' MBO transactions, indicating at least that the monitoring cost reduction hypothesis achieved when a publicly listed corporation is taken private in an MBO transaction, has not been a driving force in Australia. Two examples of 'going-private' transactions using an MBO as the vehicle were Clutha and Fortuna. Clutha has since been relisted on the Australian Stock Exchange, while Fortuna was placed in receivership in August 1990.

Free Cash Flow Theory

Michael Jensen (1986, 1988, 1989) developed the theory of free cash flow as a means of explaining the benefits of MBO/LBO transactions and the control function of debt. He defines free cash flow as:

> "cash flow in excess of that required to fund all projects that have positive net present values when discounted at the relevant cost of capital" (Jensen 1986, p.323).

Jensen contends that the management of corporations are more likely to waste the firms free cash flow by investing in projects or diversification plans which will not generate returns above the cost of capital, when in fact such free cash flow should be paid to shareholders if the firm is to be efficient, and shareholder wealth maximised. Underpinning this wastage of free cash flow is the perceived willingness of management to increase the resources at its disposal even if this may not be in the best interests of the firm partly due to the inappropriate reward structures existing in many public corporations. Jensen (1986) refers to this concept as the agency costs of free cash flow.

Stewart (1991) supports the wastage of free cash flow view by stating:

> "the risk of an unproductive reinvestment of cash flow has proved to be most acute in mature companies that have sound profitability with little growth potential but insist upon growing rapidly anyway" (Stewart 1991, p.481).

Free cash flows can be diverted to shareholders via stock repurchase programmes by borrowing the required funds. In this context the management of the firm is then committed to using the free cash flow to meet debt requirements, hence introducing the issue of the control function of debt. Simply increasing and decreasing dividend payments does not necessarily bond management to its commitment. However, such bonding is evident when debt is used.

In MBO and LBO transactions this control function of debt is particularly important. The public corporations free cash flows are diverted to shareholders via a premium paid on acquisition, and the debt used to execute the buyout now bonds the management team to its use of the firms free cash flow.

The notion discussed above in relation to free cash flow and leverage is more likely to be appropriate for mature firms with relatively stable cash flows. Firms in start up or high growth phases are not likely to have the free cash flow and will need access to the financial markets for the required capital (Jensen 1986).

In Australia, little reference has been made to the notion of free cash flow. However, there is some argument that a number of so named entrepreneurial companies in the mid to late 1980's made wasteful and inappropriate uses of the resources available to the management of the firms. This drive for diversification via horizontal growth and acquisitions has since shown that growth for growths sake is not necessarily the appropriate path for firms to undertake.

Some may argue that the debt undertaken to fund this unnecessary growth was the problem. A more solid argument is not in relation to the debt itself but more importantly the use to which it was put and the price paid to achieve the acquisitions. As stated in the previous section, Australia has not been able to generate many MBO transactions of publicly listed firms, and hence the arguments in relation to free cash flow and MBOs cannot be tested in an Australian context at this stage.

However, a number of Australian MBOs have resulted from the buyout of divisions of larger organisations, which does raise the issue of the control which the management of the division had over the cash flows generated by the division. If in fact much of the cash flows generated were added to the corporate resource pool and not available to the division then the possible reasons underlying the execution of an MBO become a little more clear. The independence and control acquired by management over the resources of the subsidiary/division following an MBO, facilitate the appropriate use over the free cash flows generated by the subsidiary/division.

Other factors may give rise to a divestment decision by the parent company. Some conglomerates are down-sizing by returning to core operating activities or exiting from some markets or countries of operation. In each case there is the opportunity for management teams to initiate an MBO transaction.

Taxation Considerations

Lowenstein (1985 and 1986) puts the proposition that the major motivating factor in MBO transactions is the tax savings generated. He identifies three types of tax savings. The tax deductibility of interest payments increases the attractiveness of debt compared to equity and the non deductibility of dividend payments. In addition, the need to write up assets when significant premiums above book value have been paid may result in an increase in deductions for assets. Thirdly, the Accelerated Cost Recovery System in the United States, permits the write-off of equipment and real estate over shorter time periods. Lowenstein supports his view on the basis of a study of 27 buyout proposals and more specifically the buyout of Fred Meyer Inc. In the more specific study he found little else had changed in an operational or performance sense within the firm after the buyout, therefore begging the question as to why the transaction was necessary. His conclusion being that it must be the tax breaks accruing to the firm and the individuals involved which provided the motivation.

Another interesting development in MBOs is the Employee Share Ownership Plan (ESOP). ESOPs can provide a significant tax benefit to the firm, and have become a common tool not only in the overall structuring of MBO transactions, but by non MBO firms.[3] The evidence available in Australia would suggest that very little use has been

---

[3] For a more detailed discussion of the creation and operation of ESOPs and the associated costs and benefits see Stewart, G. Bennett, 1991 The Quest for Value, Harper Collins, USA, pp.516-542; or
Scholes, Myron S. and Wolfson, Mark A., 'Employee Stock Ownership Plans and Corporate Restructuring: Myths and Realities', in The Battle for Corporate Control:

made of ESOPs in MBO transactions.

The different tax systems in countries renders the effect of MBOs and LBOs on the taxation commitment of the firm and the individuals directly involved in the transaction requiring consideration in the context of the country in which the transaction was executed.

Reduction in Direct Costs of Public Ownership

For MBOs of publicly listed corporations De Angelo et. al. (1984) argue that there is a substantial gain to the firm through the reduction in registration, listing and other stockholder servicing costs incurred by public companies, as well as the cost of increased reporting requirements and stock exchange listing rules.

Whilst some legislative and other compliance costs may be reduced, it is difficult to see this proposition being the major driving force behind an MBO involving a publicly listed corporation.

Increased Management Motivation and Incentives

A regularly cited requisite for success in MBO is the existence of highly skilled and competent management. The term 'entrepreneur' is sometimes used to explain the type

---

Shareholder Rights, Stakeholder Interests and Managerial Responsibilities, Irwin, USA, pp.485-516.

of management required. The problem with the title of entrepreneur is that it carries with it certain connotations which may not necessarily be appropriate. In Australia, during the 1980's for example, the labelling of a number of then leading business executives as entrepreneurs may well have been misplaced.

In MBOs, management motivation is crucial to the improved operational performance and the realisation of efficiency gains. The need for management to be able to display the appropriate skills necessary to deliver such improvements leads to the 'entrepreneur' label. An overall appreciation of what an entrepreneur should be capable of is desirable. Wright and Coyne (1985) set out to achieve this when they view the entrepreneur in this wider context.[4]

Whether MBOs are more likely to attract the entrepreneur with such skill levels is mere conjecture, but there is little doubt that management of extreme quality is necessary. These qualities may not necessarily be reliant on one person only, but may in fact be a combined quality management level.

If the management team is so crucial to the success of an MBO then it is important that the motivation, incentive, and compensation ingredients, are present in any deal structure.

---

[4] Wright, M. and Coyne J., 1985, in Management Buyouts, Croom Helm, Great Britain, state the essential characteristics of an entrepreneur as: "... alertness, judgement and action; of skills of co-ordination and management; the ability to assess risks and the preparedness to take them, of perception, and determination; to be a force for change in business." p.47.

A key issue in relation to the involvement of management in MBO transactions is the expected improvement in the firm's operation through gains achieved by improved management motivation as a result of the stock ownership (or in some cases increased stock ownership) now held by members of the management team. De Angelo et. al. (1984) also discuss the advantages of managerial rewards being more closely tied to managerial performance. Managers are in effect, encouraged to undertake projects which are profitable and hence have a positive effect on the financial interest they have in the firm. Compensation arrangements which reward better performance for the firm are perhaps more possible in firms which are held privately than those with disperse public stock ownership (De Angelo et. al. 1984 and, De Angelo and De Angelo 1986).

Under-utilised Leverage Capacity

A further source of MBO motivation is the identification that the firm has under-utilised its borrowing or leverage capacity. Kieschnick (1989) points out the relationship between this and the tax benefits derived from increased leverage. It is a reasonable expectation however, that the MBO candidate has some leverage capacity so as to take advantage of the increased debt required to execute the MBO transaction.

Takeover Defence Mechanism

Michel and Shaked (1986) argue that MBOs are a defensive strategy against takeover offers from external entities. Underlying this notion is the job security that would arise from a successful MBO offer contrasted with the acquisition of the firm by an external entity, where job continuation may not be guaranteed.

<u>Risky Arbitrage Hypothesis</u>

Kieschnick (1986) puts the view that a firm may be viewed as a collection of assets/projects that have higher values if broken up rather than remain intact under the 'going concern' values. Through a restructuring of the firms assets/projects composition there is the opportunity for a 'risky arbitrage'. Management have the greater opportunity of executing this arbitrage due to their knowledge of the firm and its assets/project composition. The gains to the management accrue from the capital gains resulting from the restructuring. This concept of 'reverse synergy' has gained increased momentum in recent times.

None of the above issues have been tested for validity as explanations for MBO transactions in Australia. A few studies overseas have attempted to do so. Kieschnick (1989) found little support for the tax savings argument in his study on management performance in MBOs. He did however conclude that entrepreneurial management explained much of the efficiency and operating gains achieved by MBO firms. Maupin et. al. (1984), though not testing the rationale developed to support MBO transactions, did study the financial and stock market ratios characteristics of publicly listed firms and MBO firms finding four key variables which could assist with the identification of firms as being likely or unlikely MBO candidates. These four variables being: the level of company stock held by management prior to the MBO; the cash flow to net worth ratio; cash flows to total assets ratio; and the dividend yield ratio.

## 2.2 EVIDENCE RELATING TO PROSPECTS FOR MBO INDUSTRY

Little of the academic literature has explored the prospects for the MBO industry. Much of this has been explored in the professional literature and at conferences on the buyout industry.

Much of this literature centres on financing structures and likely changes. The need for more conservative financing structures, with increases in the equity proportion of the total funding and likely restrictions on the availability of senior debt from the banks are common forecasts (Cameron 1991, Curran 1991, Ames 1990). On the other hand the banks are still likely to provide funding for well structured, quality transactions (Cameron 1991).

The importance of the abilities and strength of the management team continue to be highlighted (Hichens 1990, Cameron 1991), while at least in the United Kingdom the trend of fewer going private transactions of firms listed on the stock exchange is likely to continue (KPMG Corporate Finance, January 1991).

Gart (1990) forecasted a reduction in LBO activity essentially due to the financial problems of some LBO firms and the deterioration in the high yield bond market (commonly referred to as the junk bond market). This view would be shared by most practitioners and academics. He also argues that LBO transactions will be financed more conservatively, with debt being paid down by improving operations rather than by breaking up companies. Interestingly, Australian MBO deals have not historically relied heavily on asset disposals for debt reduction. Indeed, the Fortuna MBO in 1989 is one which did rely on asset disposals in order to reduce the debt burden. The lack of success in the asset disposal programme contributed to the downfall of the firm (Australian Financial Review, August 23, 1990). At the same time, Gart (1990) recognises that buyouts will continue through a desire of individuals to own and run companies over the longer term.

Three years ago, Ray Block, the Chief Economist at DBSM Ltd (now SBC Dominguez Barry), argued for conservative financial ratios suggesting operating cash flow to financing charges should be at least 1.7 times in Australian MBOs (Block 1989). At the same time he identified the increasing use of debt by both firms and individuals. It was not just the MBO industry that was facilitating the debt growth. Block argued that the market would be the ultimate restraint factor on debt usage. In this way it could be argued that the market would cause such restraint by the successes and failures in the industry. At the same time, Landsdowne (1989) regarded the outlook for MBOs as favourable identifying four key factors to explain the favourable outlook. These four factors being: interest rate reductions; aggressive chasing of deals; further developments in financing instruments; and the development of the management buy-in (MBI).

In January 1991, David Saunders of Byvest argued that the climate then was as good as any previously for the MBO industry, with a reduction in asset values from excessive levels in the late 1980's, and the downturn in the Australian economy. At the same time however, he recognised the greater caution by banks and financial institutions, resulting not only in the access to debt finance more difficult, but also raising the required equity level in any financing structure (Sydney Morning Herald, January 29, 1991). In addition, Tilley (1989) stated that MBOs were here to say, suggesting that as long as a responsible approach was taken to the leveraging of the firm, MBOs would be an attractive vehicle for successfully changing the ownership of Australian businesses.

## CHAPTER 3 RESEARCH DESIGN

As mentioned in Chapter 1, the nature of the empirical component of this research paper was a questionnaire to the institutional lead fund managers (LFMs). There are a number of key participants in the MBO industry: management, banks and financial institutions, institutional lead fund managers, and vendors.

The LFMs were selected as the research subjects for a number of reasons. Firstly, the LFMs are one of the constants in the MBO industry. In most cases for each MBO there is a LFM involved who has taken a pro-active role in the transaction. This role will include: the arrangement of funding for the transaction with banks and financial institutions; conducting a comprehensive review of the firm, its management and operation; working closely with management; liaising with the vendor; and possibly contributing equity and/or subordinated finance for those deals which are ultimately executed. Secondly, because of this broad based involvement, the LFMs are likely to be in the best position to respond to questions which are spread across a number of areas relating to MBO transactions. Thirdly, the number of LFMs active in the Australian MBO market is small, with seven LFMs identified for purposed of the study. Due to prior communication with the LFMs, the likelihood of a response from each was quite high.

To further encourage responses, the questionnaire was designed with only eight questions, many of which had several parts. As part of the pre-testing process a draft questionnaire was sent to two LFMs on September 3, 1991, for completion and comment regarding comprehension and clarity. One of the questionnaire's with some comments was returned. A follow-up by phone to the other rendered no major changes required. With minor alterations, the final questionnaire was mailed to research subjects in the second week of October 1991. A copy of the questionnaire is provided in Appendix A.

Responses were received from six of the seven research subjects, representing a response rate of 86%. The high response rate is a product of the small sample size and the fact that most of the respondents were known personally. Follow-up activities with the non-respondent proved unsuccessful. The contact person had since left the firm and it would appear that MBO appraisal and investment in Australia was no longer a priority for the LFM concerned.

# CHAPTER 4 RESEARCH RESULTS AND COMMENTARY

This chapter provides details of the results of the research study as well as discussion and commentary on the results. Responses to each of the questions are provided in the respective exhibits in the order the questions were provided in the questionnaire.

The first question had two components. The first part asked how many MBOs the organisation had acted as LFM for? The results are provided in Exhibit 4.1. For anonymity purposes the LFMs are labelled A through to F.

**EXHIBIT 4.1**
**NUMBER OF MBOs RESPONDING**
**LFMS HAD LEAD**

| LFM | NUMBER |
|---|---|
| A | 11 |
| B | 8 |
| C | 41 |
| D | 4 |
| E | 6 |
| F | 5 |
| TOTAL | 75 |

The second part of the question requested the LFMs to identify the number of MBO deals which they had lead within specified transaction values. The results are provided in Exhibit 4.2

| EXHIBIT 4.2 NUMBER OF DEALS LEAD BY LFM WITHIN SPECIFIED TRANSACTION VALUES | | | | | | |
|---|---|---|---|---|---|---|
| | RESPONDENT LFM | | | | | |
| $ | A | B | C | D | E | F |
| 0 - 500,000 | | | 22 | | | 1 |
| 500,001 - 1,000,000 | | | 12 | | | |
| 1,000,001 - 2,500,000 | | 1 | 5 | | 2 | 1 |
| 2,500,001 - 5,000,000 | | | 2 | | | 1 |
| 5,000,001 - 10,000,000 | 2 | | | | | 2 |
| 10,000,001 - 25,000,000 | 4 | 1 | | | 1 | |
| 25,000,001 - 50,000,000 | 3 | 1 | | 2 | 1 | |
| 50,000,001 - 100,000,000 | 1 | 3 | | 1 | | |
| 100,000,001 - 200,000,000 | | 1 | | | 2 | |
| > 200,000,000 | 1 | 1 | | 1 | | |

Respondent C has by far led the greatest number of MBO transactions in Australia. Exhibit 4.2 however, indicates that all of these transactions have been below $AUD5 million, with approximately half of them below $AUD500,000. Respondent F has also predominantly operated at the lower end of the market (below $AUD10 million).

While respondents A, B and E have completed transactions below $AUD10 million, this area of the market has not been the focus of their activity. Respondents, A, B, D and E have centred their activities at the middle to upper end of the MBO market, completing totals of 11, 8, 4 and 6 deals in total; the majority of which were above $AUD10 million.

Question two sought to identify whether the LFM expected to continue to act as a lead fund manager in MBO transactions over the next one to two years. The results are shown in Exhibit 4.3.

| EXHIBIT 4.3<br>INTENTIONS OF LFMs WITH RESPECT TO MBO INVOLVEMENT | | | | |
|---|---|---|---|---|
| **Question** | **Yes** | | **No** | |
| | **%** | **No.** | **%** | **No.** |
| Do you expect your institution to act as LFM in MBO transactions over the next one to two years? | 5 | 83 | 1 | 17 |

Exhibit 4.3 indicates that of the responding firms, only one at the time of completing the questionnaire, did not intend to continue to be an active participant in the MBO industry. This respondent - respondent B - had completed its initial charter of establishing an MBO fund, structured so as to allow MBO investment over a five year time horizon and to monitor and realise those investments in the subsequent 5 years. No new deals were to be sought within this monitoring and realisation time frame. Within two weeks of returning the questionnaire, respondent D had made the decision to exit from the Australian MBO market, essentially due to the decision of the international parent company. This respondent, for purposes of the analysis, has been classified as having exited from the market; and though this was not the initial response, it is not likely to significantly influence interpretation of the survey results.

Question 3 set out to identify the perception of respondents to a listed set of factors likely to affect the level of MBO activity in the next one to two years. Respondents were asked to rate each factor in the range of 1 to 7, where 1 = little effect and 7 = significant effect.

To facilitate further analysis on the responses, a multiple classification model has been used. Firstly, respondents were classified as either Category 1 or Category 2 respondents. A Category 1 respondent is defined as one operating predominantly at the higher end of the market, with at least 65% of their transactions above $AUD10 million. Category 2 respondents are defined as those operating predominantly at the lower end of the market, with at least 65% of their transactions below $AUD10 million.

Category A respondents are those who intend to remain active in the MBO industry over the next one to two years. Category B respondents are those who do not intend to remain active in the MBO market, or who are no longer active in the Australian MBO industry.

This classification model is used specifically in relation to Question 3, and will be further utilised when discussing the results of other reported responses.

**EXHIBIT 4.4**
**CLASSIFICATION MODEL**

| Category | Number of Respondents |
|---|---|
| 1 | 4 |
| 2 | 2 |
| A | 4 |
| B | 2 |

A mean rating result has been calculated for the individual ratings provided for each specific factor listed in Question 3. The results are provided in Exhibit 4.5.

**EXHIBIT 4.5**
**MEAN RATINGS OF FACTORS LIKELY TO EFFECT THE LEVEL OF MBO ACTIVITY IN THE NEXT ONE TO TWO YEARS**

| | Overall Mean | Category 1 Mean | Category 2 Mean | Category A Mean | Category B Mean |
|---|---|---|---|---|---|
| Interest rate levels | 3.16 | 3.00 | 3.50 | 3.50 | 2.50 |
| Finance availability: | | | | | |
| (i) Senior debt | 5.16 | 5.75 | 4.00 | 5.50 | 4.50 |
| (ii) Mezzanine/Sub-ordinated debt | 4.33 | 5.00 | 3.00 | 3.75 | 5.50 |
| (iii) Equity (non-management) | 5.33 | 6.25 | 3.50 | 5.25 | 5.50 |
| Management initiative/ enthusiasm | 4.50 | 4.25 | 5.00 | 5.00 | 3.50 |
| Willingness of vendor to sell to management | 4.67 | 5.00 | 4.00 | 5.00 | 4.00 |
| Asset values | 5.16 | 5.00 | 5.50 | 5.75 | 4.00 |
| Personal wealth of management | 2.33 | 3.25 | 0.50 | 2.25 | 2.50 |
| State of recession/ upturn in economy | 5.16 | 4.75 | 6.00 | 6.25 | 4.50 |
| MBO perceived as too risky | 4.33 | 5.25 | 2.50 | 4.50 | 4.00 |
| MBO ownership structure no longer regarded as favourable | 2.50 | 4.00 | 1.50 | 2.00 | 3.50 |

* Category 1 respondents are those who are defined as operating at the higher end of the market, with at least 65% of their transactions above $AUD10 million.
* Category 2 respondents are those who are defined as operating at the lower end of the market, with at least 65% of their transactions below $AUD10 million.
* Category A respondents are those who indicated an intention to remain active in the MBO industry.
* Category B respondents are those who either indicated an intention not to remain active in the market, or who are no longer active in the MBO industry.
* Note: Scale of 1 to 7 where 1 = little effect and 7 = significant effect.

Based on the overall mean ratings, the highest rating factor was the availability of non-management equity funds, with senior debt finance availability, asset values and the state of recession/upturn in economy factors, receiving equal second highest ratings.

Interestingly, the two factors receiving the lowest mean ratings were the personal wealth of management, and the concept that the MBO structure was no longer regarded as favourable.

At least from the point of view of the LFMs in general, the MBO structure has not yet lost favour as a viable organisational structure; while the constraining factors are more likely to relate to funding availability and the state of the Australian economy. Of course, the funding issue and state of the economy are not mutually exclusive. The lack of confidence which accompanies recessionary conditions is likely to be reflected in the lending practices of the banking and financial sector. This is likely to be further exacerbated with the banking sector attempting to resurrect its own performance in the light of bad debt losses resulting from unprofitable lending policies. Despite the financial viability of an MBO transaction, banks may not adopt a favourable attitude towards a leveraged transaction.

While having included personal wealth levels as one of the contributing reasons to MBO activity levels in Australia being less than a number of overseas countries in Chapter 1, the LFMs do not consider it as having a significant effect on the level of MBO activity in

Australia over the next one to two years.

In order to facilitate comparative analysis, two classification models were applied to the responding data for this question. First of all, respondents were classified as either Category 1 (those operating predominantly at the highest end of the market) and Category 2 (those operating predominantly at the lower end of the market). Interestingly, Category 1 respondents, on average, rated each of the finance availability variables as having a more significant effect on MBO activity in the next one to two years than Category 2 respondents. The availability of senior debt, mezzanine/subordinated debt and non-management equity were each rated significantly higher by Category 1 respondents than Category 2 respondents. A valid interpretation of this is that the level of difficulty in raising suitable funding for MBO transactions in excess of $AUD10 million is likely to be much more difficult than raising a lower level of funding for smaller MBO transactions. At least this appears to be the perception of the LFMs.

Three other factors rated significantly higher by Category 1 respondents were: personal wealth of management; MBO perceived as too risky; and MBO ownership structure no longer regarded as favourable. Quite clearly the larger transactions will require a higher equity contribution by management than the smaller transactions. With an anticipated increase in required equity levels, potential management teams may experience difficulties raising their contribution to the equity component.

The higher funding requirements for the larger transactions may explain why the "MBO perceived as too risky" factor rates more highly with Category 1 respondents. At more than twice the rating of the Category 2 respondents, the higher absolute levels of debt may be unattractive to potential lenders and investors. It is worth noting that on a relative basis, little difference may occur. However, lenders and investors might spread $AUD50,000 for example, across a number of smaller deals, rather than lend/invest in one larger transaction. This may be perceived as a more attractive outcome which has been built into the rating by respondents.

Thirdly, the significantly higher rating given to the "MBO ownership structure no longer regarded as favourable" factor may provide an indication about the future use of unlisted equity funds. While MBO transactions were pursued rigorously during the previous decade, and while they will be pursued in the future, perhaps there is some feeling that alternative or expansive forms of investment opportunities will also be pursued, at least by Category 1 respondents.

The only factor which Category 2 respondents rated significantly higher than Category 1 respondents was the state of the recession/upturn in economy factor. Perhaps the widespread effect of recessionary pressures is perceived by the LFMs as constraining the willingness of management groups of smaller organisations to pursue an MBO as a vehicle to achieving ownership status.

The second classification model used was to classify respondents as Category A (those indicating an intention to remain active in the MBO market), or Category B (those who either intended not to remain active, or who are no longer active).

Category B respondents, on average, rated two of the three finance availability issues higher, though not by any significant amount. As the two issues related to subordinated/mezzanine debt and non-management equity (which LFMs are usually responsible for raising), then this may support their decision to exit from the MBO market. That is, the decision to exit may have been partly due to a perceived increased difficulty in raising further equity and subordinated/mezzanine debt funds. As would be expected Category B respondents also rated the MBO ownership structure no longer regarded as a favourable factor, higher than Category A respondents. The perception that the unlisted equity market may no longer focus on MBO activity compared to alternative unlisted equity investment forms may be more highly held by Category B respondents than Category A respondents.

Category A respondents (those intending to remain active in the MBO market) rated senior debt availability, management initiative/enthusiasm, asset values, and the state of the recession/upturn in the economy, significantly higher than Category B respondents.

Quite clearly the attitude of the banks towards MBO transactions is likely to have a significant effect on the level of MBO activity in the next one to two years. This is supported by the rating allocated by Category A respondents. The current plight of banks operating in Australia would tend to suggest that the availability of senior debt finance for leveraged transactions is likely to be minimal. This issue is supported by the literature discussed earlier in Chapter 2.

The requirement to seek out suitably competent and interested management teams to pursue an MBO is of the utmost importance. Category A respondents have quite clearly recognised this, given the higher rating to the 'management initiative/enthusiasm' variable.

Three explanations are evident here. Firstly, management teams may not be fully aware of the MBO as an organisational form. Secondly, as suggested earlier in the paper, management in Australia may be more risk averse in general terms than their international counterparts. Thirdly, LFMs may consider that the level of competent management teams to take part in an MBO may have diminished.

The 'asset values' factor rating may be considered in line with the state of recession/upturn 'in the economy' factor rating. With the economy recessed, asset values are lower, which would suggest it is more likely to encourage MBO activity. On the other hand, Category A respondents regard the state of the economy to be a critical factor governing the level of MBO activity in the next one to two years. Interestingly however, a sustained upturn in the economy is likely to produce higher asset values.

Perhaps, this is related as much to business and investor confidence as anything else. The higher the level of uncertainty about the general state of the economy and asset values, then activity in the MBO market is likely to be dampened.

Related to these issues is the rating given to the 'interest rate levels' factor by each category. Neither Category 1 and 2 nor Category A and B respondents rated this variable very high (the highest rating being 3.5 by Category 2 and Category A respondents).

The evidence here would tend to suggest that interest rate levels are not considered to be a driving force behind MBO activity (and therefore are not a major constraining factor either). This is an interesting outcome, given the attention given to interest rates by the media, the comments put forward in some of the literature, and the level of debt finance used.

Respondents were asked to comment on any other factors considered relevant. Two respondents made comments:

> "The most important factor will be the availability of businesses with appropriate characteristics. Good candidates for MBOs are few and far between", and,

> "Price... is probably the most important influence on MBO activity. With a good price you have no problem funding..."

Question 4 had two components. The first sought to identify whether the LFMs expected the average value of MBO transactions in the next one to two years to significantly decrease, slightly decrease, remain about the same, slightly increase, or significantly increase.

The relative proportion of respondents indicating the expected value for MBO transactions in the next one to two years is provided in Exhibit 4.6.

**EXHIBIT 4.6**
**EXPECTED AVERAGE VALUE OF MBO TRANSACTIONS IN THE NEXT ONE TO TWO YEARS**

| Expect to: | Overall Proportion | Number of Respondents |
|---|---|---|
| Significantly decrease | - | - |
| Slightly decrease | 33% | 2 |
| Remain about the same | 50% | 3 |
| Slightly increase | 17% | 1 |
| Significantly increase | - | 1 |
| | 100% | 6 |

The second part of Question 4 sought to identify whether the LFMs expected the number of MBO transactions in the next one to two years to: significantly decrease, slightly decrease, remain about the same, slightly increase or significantly increase.

The results are provided in Exhibit 4.7.

**EXHIBIT 4.7**
**EXPECTED NUMBER OF MBO TRANSACTIONS IN THE NEXT ONE TO TWO YEARS**

| Expect to: | Overall Proportion | Number of Respondents |
|---|---|---|
| Significantly decrease | 33% | 2 |
| Slightly decrease | - | - |
| Remain about the same | 17% | 1 |
| Slightly increase | 50% | 3 |
| Significantly increase | - | - |
| | 100% | 6 |

Exhibit 4.6 indicates that there is no general consensus about anticipated changes in the value of MBO transactions in the next one to two years. Nevertheless, only one respondent expected the value to increase slightly. This respondent was a Category 2 respondent and hence operated at the lower end of the market. No Category 1 respondent expected the value of MBO transactions to increase, though two of them expected the value to slightly decrease. The majority of the respondents expected the value of MBO transactions to remain about the same.

Again, in relation to the expected number of MBO transactions in the next one to two years, no general consensus was achieved. Indeed, there were conflicting views between the respondents. Both Category 2 respondents expected an increase in the number of MBO transactions over the next one to two years, indicating that at least at the lower end of the market there is the perception by the LFMs specialising at this level, that the market will be buoyant. Respondents who perceived an increase in the number of MBO transactions cited the following as reasons: Upturn in the economy, lower interest rates, and investors returning to the market.

The two respondents expecting a significant decrease are both Category 1 respondents, though one is also a Category B respondent, having exited from the market. The reasons provided for their response are worth citing:

> "In many cases vendors either (1) still believe their assets are worth the same as in 1987/8; or (2) do not want to show capital losses in their profit and loss accounts, which are already poor; or (3) banks are not lending money to new customers at the moment and are extremely reluctant to lend where the borrowings of a company might increase"; and
>
> "The jaundice with which high leverage is now viewed - sometimes unjustifiable - will hamper MBO activity significantly".

These two comments suggest that at least in the eyes of the particular LFMs the volume of MBO activity will be influenced by the current attitude towards debt levels, and the price asked by vendors. The debt level issue is supported in the literature previously discussed in Chapter 2. Interestingly, the one respondent who expects the number of MBO transactions to remain about the same has historically been the most active participant at the higher end of the market, having completed eleven MBO deals (respondent A).

Question 5 was broken into two parts, and focused on whether the LFMs expected MBO activity to be concentrated in any particular industry, or alternatively whether there were any industries where they did not expect any MBO activity. The results are provided in Exhibits 4.8 and 4.9.

**EXHIBIT 4.8**
**EXPECTATION OF MBO ACTIVITY CONCENTRATING IN PARTICULAR INDUSTRIES**

| Question | Yes | | No | |
|---|---|---|---|---|
| | % | No. | % | No. |
| In the next one to two years do you expect MBO activity to be concentrated in any particular industry/industries? | 17 | 1 | 83 | 5 |

**EXHIBIT 4.9**
**EXPECTATION OF NO MBO ACTIVITY IN PARTICULAR INDUSTRIES**

| Question | Yes | | No | |
|---|---|---|---|---|
| | % | No. | % | No. |
| Are there any specific industries where you would not expect any MBO activity in the next one to two years? | 83 | 5 | 17 | 1 |

In terms of a concentration of MBO activity in any particular industry, the overwhelming majority indicated a negative response, with only one respondent providing a positive response. This respondent commented "manufacturing businesses with solid asset bases as well as strong and predictable cash flow" as the reason for the positive response.

Other respondents also indicated by comment, the possibility of a concentration in the manufacturing sector, though they did not go so far to respond positively to the specific question. While not stating a particular industry, one respondent suggested "unpredictable or cyclical industries (commodities, building) will always remain less suitable for MBOs".

Whether there were any industries where MBO activity might not be expected, the overwhelming majority believed there would be. Such industries as resources, agriculture, food processing and real estate were provided by respondents as examples of industries where activity might not be expected.

Interestingly, the comments provided for this question were more specific than the previous one, suggesting the identification of non-suitable sectors is more achievable than suitable sectors/industries. The comments provided for the previous question were more broad in nature. Given that a significant number of completed MBO transactions in Australia have been in the manufacturing industry, it is quite feasible to expect many future transactions to be in this broad industry classification.

While in the United States the use of an MBO to take a company listed on the Stock Exchange has been common (referred to as 'going private' transactions), such transactions in Australia have been rare. Question 6 asked the LFMs whether they expect this trend of very few 'going private' transactions using an MBO as the vehicle to continue. The results are shown in Exhibit 4.10.

**EXHIBIT 4.10**
**EXPECTATION OF MBOs RESULTING IN THE PRIVATISATION OF COMPANIES LISTED ON THE AUSTRALIAN STOCK EXCHANGE**

| Question | Yes | | No | |
|---|---|---|---|---|
| | % | No. | % | No. |
| Very few Australian MBOs have resulted in the privatization of a company listed on the Australian Stock Exchange. Do you expect this trend to continue? | 100 | 6 | - | - |

The data in exhibit 4.10 quite clearly shows that the historical trend of very few MBOs arising from the privatisation of companies listed on the Australian Stock Exchange is likely to continue, with all respondents providing a positive response. Reasons provided for this included: difficulties with due diligence; the ability for 'greenmailers' to frustrate; and, too complicated. The issue of corporate control was raised by one respondent with the following comment:

> "There are far too many hurdles in the case of listed targets, not the least of which are the competition for control and listed company pricing factors."

Question 7 focused on the equity component of the MBO financing structure. It had two components. Firstly, whether the LFMs believed the proportion of equity to total funding in the next one to two years would: significantly reduce, slightly reduce, remain about the same, slightly increase, or significantly increase compared to previous levels. The results are provided in Exhibit 4.11.

**TABLE 4.11**
**ANTICIPATED CHANGES IN THE PROPORTION OF EQUITY TO TOTAL FUNDING FOR MBOs EXECUTED IN THE NEXT ONE TO TWO YEARS, COMPARED TO PREVIOUS LEVELS**

| | |
|---|---|
| Significantly reduce | - |
| Slightly reduce | 17% |
| Remain about the same | - |
| Slightly increase | 33% |
| Significantly increase | 50% |
| | 100% |

Secondly, Question 7 sought to identify whether the LFMs expected the availability of funds for equity investment in MBOs by institutions to: significantly reduce, slightly reduce, remain about the same, slightly increase, or significantly increase compared to previous levels. Exhibit 4.12 contains the results.

**TABLE 4.12**
**ANTICIPATED CHANGES IN THE AVAILABILITY OF FUNDS FOR EQUITY INVESTMENT IN MBOs IN THE NEXT ONE TO TWO YEARS COMPARED TO PREVIOUS LEVELS**

| | |
|---|---|
| Significantly reduce | 17% |
| Slightly reduce | 17% |
| Remain about the same | 17% |
| Slightly increase | 17% |
| Significantly increase | 32% |
| | 100% |

Five of the six respondents expected the proportion of equity to total funding for MBOs executed in the next one to two years to increase; two of them expected a slight increase, while three of them expected significant increases. Given the attention to leveraged transactions and the accompanying high debt levels, it is not surprising to find the LFMs perceiving required increases in equity levels. Brooks (1992) reported an average equity to total funding component of 18% (Exhibit 1.6, pg 12) for a sample of Australian MBO transactions above $AUD10 million. The required increases in this equity component could result in proportions of 25% to 40%. As discussed in Chapter 1 this expected increase in equity proportion (and hence, decrease in gearing levels) is supported by the literature.

Reasons provided by respondents tended to focus on the belief that lenders are unlikely to tolerate the gearing levels of the past. Other comments included a reduction in the availability of mezzanine funds and that co-investors and lenders would be seeking less risk.

The requirement of an anticipated higher equity component in the funding structures for MBO deals has significant implications for the industry. Firstly, LFMs would need to increase the size of their equity funds available for investment if they still wished to pursue the same number of transactions, or alternatively, be more selective with their contribution to the equity component of the total funding package. Secondly, LFMs may have to seek out smaller deals so as to achieve the higher equity levels.

As LFMs perceive increased trepidation from the banking sector towards leveraged transactions, an inability to raise the equity levels required is likely to constrain MBO activity.

As LFMs use a number of the large superannuation, life insurance offices and financial institutions to support their equity funds, the availability of more equity for MBO investment is partly dependent upon the attitude of these institutions to MBO transactions.

The data in Exhibit 4.12 attempts to provide some light on the perception of LFMs to the attitude of the institutions to MBO transactions, by focusing on the anticipated availability of funds made available by institutions for equity investment in MBOs. The responses are conflicting, with close on 50% expecting an increase in available funds; two respondents expecting a reduction, and one expecting available funds to remain about the same.

Comments from those respondents expecting an increase included: "increased awareness of returns as more data becomes available" and, "institutions will look for new ways to invest when the listed market is overpriced".

However, the one respondent (a Category B respondent) who expected a significant reduction commented: "the general disfavour with which MBOs are viewed will reduce funding availability".

One explanation for the diversity in responses is that the desire of the LFM to continue or extend its involvement in the MBO industry will, in part, be dependent upon its desire/ability to raise the necessary equity funds. This factor may have underpinned the response to this question, as each of the LFMs may be at different stages of their involvement in the MBO industry.

## SUMMARY

The following evidence can be highlighted from the empirical investigation undertaken:

1. Two LFMs have focused on MBO activity at the lower end of the market, having completed 60% of the transactions by number, accounting for 20% of the total value. The other four LFMs responding to the questionnaire have focused their activities in the middle to upper sections of the market.

2. In general terms, the factors most likely to effect the level of MBO activity in the next one to two years are the availability of non-management equity funds, the availability of senior debt finance, asset values, and the state of the Australian economy.

   It would appear that the MBO will continue to be a viable organisational form, and that the personal wealth of management is unlikely to have significant influence over the level of MBO activity.

3. Those LFMs operating at the middle to upper end of the market rated all but one of the factors likely to effect MBO activity as being more significant than LFMs operating at the lower end of the market. The most significant factors likely to effect MBO activity according to these LFMs relate to the availability of funding.

4. LFMs who have exited or intend to exit from the MBO market, view the availability of non-management equity and mezzanine debt, and the decrease in the attractiveness of the MBO structure as likely to have a more significant effect on the level of MBO activity in the next one to two years than LFMs who intend to remain in the market.

   On the other hand, LFMs intending to remain active perceive the availability of senior debt, management initiative/enthusiasm, asset values, and the state of the Australian economy, to be likely to have a more significant effect on activity levels than LFMs who have exited from the market.

5. Other than one LFM operating at the lower end of the market, no LFM expected an increase in the value of MBO transactions.

6. The volume of MBO transactions at the lower end of the market may increase, while at the upper end of the market less activity is the more likely outcome according to the responses of the LFMs.

7. MBO activity in the next one to two years is more likely to be focused in the broad classification of the manufacturing industry, with the unlikelihood of any significant levels in the resources, agricultural, food processing or real estate sectors of the economy.

8. The historical trend of not commonly using an MBO transaction to privatise a firm listed on the Australian Stock Exchange is likely to continue.

9. The required proportion of equity to total funding in MBO transactions in the next one to two years is non-conclusive from the evidence, though more respondents expected some increase than a decrease.

   The stage the LFM is at in relation to its MBO activity may be a driving force behind this lack of conclusiveness. Due to the conflicting responses no decisive conclusion can be drawn in this area in relation to the two broad research problems identified.

# CHAPTER 5 IMPLICATIONS, OPPORTUNITIES FOR FURTHER RESEARCH AND CONCLUSION

This chapter outlines the implications of the empirical study conducted, opportunities for further research and conclusion.

## 5.1 IMPLICATIONS

Based on the results of the empirical investigation it would seem a number of implications arise.

Firstly, the involvement of the LFMs in the MBO market is likely to be reduced in the next one to two years, particularly those who have traditionally been active in the middle to upper end of the market. If the LFMs intend to remain involved in the unlisted equities market, then alternative forms of investment to pure MBO transactions is likely. There would appear to be some evidence of this with LFMs widening the net to seek investments in the broader development capital field, but not exclusively in MBO transactions.

Secondly, the concern of LFMs in raising non-management equity funds for MBO transactions, raises the question of what uses the superannuation funds, life insurance offices, large financial institutions and individual investors are likely to make of their available investable funds normally targeted for such investment. While a number of these organisations have targeted only very small portions of their portfolio of funds for MBO investments, the amount is still substantial given the size of the Australian MBO market. The portfolio decisions and funding allocation by these organisations is critical to MBO activity, particularly as larger equity proportions in the total funding package are now required.

As funding availability appears to be one of the critical factors affecting MBO activity levels, the attitude of the above institutions and the banking sector to MBO transactions is paramount.

If the banking sector adopted a more pro-active approach, viable MBO transactions would gain financial support. The required tightened lending criteria now used by the banks should not preclude viable MBO transactions.

As some of the LFMs active during the past decade in the MBO industry have now exited, perhaps the opportunity for adequate financial returns via MBOs is going to be increasingly difficult in this decade.

## 5.2 <u>OPPORTUNITIES FOR FURTHER RESEARCH</u>

The opportunities for further research in relation to the Australian MBO market include similar studies to the one conducted here of other participants in the industry. For example, a current examination of the banking sector's attitude to funding MBO transactions, given the importance of the funding issue, would be a viable research project.

The replication of studies conducted overseas, particularly those relating to performance, would seem desirable. Studies evaluating the performance of MBO firms such as those conducted by Bull (1989), Kaplan (1989), and Smith (1990), in an Australian context, would add to the body of knowledge on the Australian MBO industry.

Further studies which test the factors indicated as rationale for MBO transactions may be viable, as would international studies which contrast the development and prospects of the Australian MBO market with overseas countries. Case or field research of Australian MBO firms would provide further insight into the organisational change and effect on managers as owners of MBO firms.

## 5.3 **CONCLUSION**

This research paper has in broad terms, traced the development of the MBO industry in Australia, and provided the results of an empirical study of the LFMs involved in the Australian MBO industry with respect to the prospects for the industry.

More specifically, Chapter 1 highlighted the slower rate of development of MBOs in Australia compared to the United States, United Kingdom and some countries in Continental Europe. In addition, the characteristics of the Australian MBO industry were explored, including valuation and financing issues, and exit mechanisms.

Chapter 2 included a discussion of the literature relating to the rationale for MBO transactions and the prospects for the MBO industry. Chapter 3 outlined the research design, while Chapter 4 provided the results and accompanying commentary of the empirical study of the LFMs with respect to the prospects for the Australian MBO industry in the next one to two years. In short, the results from the study would suggest that: fewer LFMs are likely to be active in the next one to two years than during the previous decade; funding availability, asset values, and the state of the Australian economy are key factors likely to affect the level of MBO activity in the next one to two years; the value of MBO transactions is likely to decrease compared to prior levels, the upper end of the market is likely to experience a reduction in transaction volume, while the lower end of the market will remain buoyant; future activity is likely to be centred in the manufacturing industry; very few 'going-private' transactions via an MBO vehicle are likely; and greater levels of equity as a proportion of total funding are likely.

As discussed in Chapter 4, for a number of the responses there was a perceived difference between the LFMs operating at the middle to upper end of the market to those operating at the lower end of the market, and between those LFMs who have exited, or intend to exit from the market compared to those who intend to continue to remain active.

## REFERENCES

Ames, B.C. 1990, 'The Senior Debt Crisis?', *Proceedings of the UK Buyout Conference*, Business Research International, London.

Anderson, R.H. 1991, 'Leveraged Buyouts in Australia', Paper presented to Third Pacific Basin Conference, Seoul, Korea.

& Brooks, A.G., 1991, 'Current Research into Leveraged Buyouts', Paper presented to Banking and Finance Conference, Australian Institute of Bankers, July 1-2, Melbourne.

Berle, A. & Means, G. 1932, *The Modern Corporation and Private Property*, MacMillan, New York.

Bickster, J.L. & Chen, A.H. 1991, 'The Economics of Corporate Restructuring: An Overview, in *The Battle for Corporate Control: Shareholders Rights, Stakeholder Interests and Managerial Responsibilities*, ed. A.W. Sametz, Irwin, U.S.A., pp.375-398.

Block, R., 1989 'Corporate Debt and the Leveraging of MBOs', *Proceedings of the Management Buyout Conference*, Sydney.

Brooks, A.G. 1991, 'Leveraged Management Buyouts: The Australian Experience', *Proceedings of the AAANZ Annual Conference*, Brisbane.

1992, 'Leveraged Management Buyouts in Australia', Paper presented to British Accounting Association Annual Conference, University of Warwick, Coventry, 13-15 April.

Bruijn, R.P., Bruining, J., Herst, A.C. & deJong, A.C. 1990, 'Corporate Restructuring in the Netherlands: Management Buyout Performance and Agency Theory', Paper presented to Seventh International Conference of Europeanists, Washington, 23-25 March.

Bull, I. 1989,'Management Performance in Leveraged Buyouts: An Empirical Analysis', in *Leveraged Management Buyouts: Causes and Consequences*, ed. Y. Amihud, Dow Jones-Irwin, New York, pp.69-94.

Curran, S. 1991, 'Equity All Dressed Up and Nowhere to Go', *Proceedings of the UK Buyout Conference*, Business Research International, London.

DeAngelo, H., and DeAngelo, L. 1989, 'Management Buyouts of Publicly Traded Corporations', *Financial Analysts Journal*, May-June, pp.38-49.

DeAngelo, H., DeAngelo, L., and Rice, E. 1984, 'Going Private: The Effects of a Change in Corporate Ownership Structure', *Midland Corporate Finance Journal*, Summer, pp.35-43.

DeCaires, B. 1991, *Corporate Restructuring*, Euromoney Books, London.

Gart, A. 1990, 'Leveraged Buyouts: A Re-examination', *SAM Advanced Management Journal*, Summer, pp.38-46.

Hichens, A. 1990, 'Buy-Outs - Key Elements for Their Success', *Proceedings of the Buyouts - Their Future Conference*, London.

Hseih, Easterwood and Singer 1987, 'The Role of Large Shareholders in the Control of Corporations: Evidence from Going Private Transactions', Paper presented to Financial Management Association meeting, New York.

Jensen, M. 1986, 'Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers', American Economic Review, 76, pp.323-29.

1988, 'Takeovers: Their Causes and Consequences', *Journal of Economic Perspectives*, Winter, pp.21-48.

1989, 'Eclipse of the Public Corporation', *Harvard Business Review*, Sept-Oct, pp.61-74.

Jensen, M., & Meckling, W., 1976, 'The Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure, *Journal of Financial Economics*, Vol.3, pp.305-360.

Kaplan, S. 1989, 'Sources of Value in Management Buyouts', in *Leveraged Management Buyouts: Causes and Consequences*, ed. Y. Amihud, Dow Jones-Irwin, New York, pp.95-102.

Kieschnick, R. 1987, 'Management Buyouts of Public Corporations: An Empirical Study', Unpublished PhD dissertation, University of Texas.

1989, 'Management Buyouts of Public Corporations: An Analysis of Prior Characteristics, in *Leveraged Management Buyouts: Causes and Consequences*, ed. Y. Amihud, Dow Jones-Irwin, New York, pp.35-67.

KPMG Corporate Finance, 1991, 'Management Buyout Statistics', *KPMG International Network Local Service*, April.

Landsdowne, I. 1989, 'Overseas Developments and Their Relevance to Australia', *Proceedings of Management Buyout Conference*, Sydney.

1991, 'Who's Who in Australian Buyouts', *Australian Business Weekly*, November, pg.40.

Lowenstein, L. 1985, 'Management Buyouts', *Columbia Law Review*, May.

1986, 'No More Cosy Management Buyouts', *Harvard Business Review*, January-February, pp.147-156.

Maupin, R., Bidwell, C., and Ortegnen, A. 1984, 'An Empirical Investigation of the Characteristics of Publicly Held Corporations that Change to Private Ownership via Management Buyouts', *Journal of Business Finance and Accounting*, 11, pp.435-450.

Pollard, I. 1988, *Financial Engineering: Philosophies and Precedents*, Butterworths, Sydney.

Ralph, P. 1990, 'Prok MBO Reaps Dividends', *Australian Financial Review*, June 29.

Saunders, D. 1991, 'MBOs Set to Flourish in Downturn', *Sydney Morning Herald*, article by Stephen Ellis, 29 January.

Scholes, M. & Wolfson, M. 1991, 'Employee Stock Ownership Plans and Corporate Restructuring: Myths and Realities', in *The Battle for Corporate Control: Shareholder Rights, Stakeholder Interests and Managerial Responsibilities*, ed. A.W. Sametz, Irwin, U.S.A., pp.485-516.

Smith, A. 1990, 'Corporate Ownership Structure and Performance: The Case of Management Buyouts', *Journal of Financial Economics*, Vol.27, pp.145-164.

Stewart, G. 1991, *The Quest for Value*, Harper Collins, U.S.A.

Wright, M., & Coyne, J. 1985, *Management Buyouts*, Croom and Helm, Kent.

Wright, M., Thompson, S., Chiplin, B., & Robbie, K. 1991, *Buy-Ins and Buy-Outs - New Strategies in Corporate Management*, Graham and Trotman, London.

Yago, G. 1991, 'Corporate Restructuring in the United States', in *Corporate Restructuring*, ed. B. DeCaires, Euromoney Books, London, pp.29-44.

## APPENDIX A

# LEVERAGED MANAGEMENT BUYOUT RESEARCH ACTIVITY

QUESTIONNAIRE TO MBO INSTITUTIONAL LEAD MANAGERS

**CONFIDENTIAL**

Research conducted by:

Albie Brooks
Lecturer in Accounting
Department of Accountancy and Law
Victoria University of Technology, Footscray
P.O. Box 64
Footscray 3011
Australia

DEFINITIONS

LEVERAGED MANAGEMENT BUYOUT (MBO): The buyout of a firm involving a number of the existing management using a significant level of leverage supported only by the firm's assets and cash flows. While each deal will possess its own characteristics, the overall financial package will commonly include senior debt and mezzanine/subordinated debt as well as equity. Management will usually hold equity in conjunction with other equity partners.

LEAD FUND MANAGER (LFM): The financial organisation who directly assists the management of the target firm to execute the buyout. The LFM will commonly undertake a thorough analysis of the target firm, arrange funding, and in many cases become equity partners in the MBO.

**PARTICULARS OF RESPONDENT:**

RESPONDENT'S NAME AND
TITLE..........................................................................................................

NAME OF INSTITUTION...................................................................................

ADDRESS......................................................................................................

..................................................................................................................

TELEPHONE:.............................................. FAX:..............................................

1. a. How many MBO's has your organisation been the lead manager for?..........................................................................................................

   b. Please indicate the number of deals in which your organisation has acted as LFM within the transaction value ranges:

| | |
|---|---|
| $ 0 - 500 000 | ☐ |
| 500 001 - 1 000 000 | ☐ |
| 1 000 001 - 2 500 000 | ☐ |
| 2 500 001 - 5 000 000 | ☐ |
| 5 000 001 - 10 000 000 | ☐ |
| 10 000 001 - 25 000 000 | ☐ |
| 25 000 001 - 50 000 000 | ☐ |
| 50 000 001 - 100 000 000 | ☐ |
| 100 000 001 - 200 000 000 | ☐ |
| > 200 000 001 | ☐ |

2. Do you expect your institution to continue to act as Lead Fund Manager in MBO transactions over the next one to two years?......YES / NO

   Please give reasons:

..........................................................................................................................................

..........................................................................................................................................

..........................................................................................................................................

..........................................................................................................................................

3. What effect do you believe each of the following factors will have on the level of MBO activity in the next one to two years?

(Please rate each factor in the range of 1 to 7, where 1 = little effect and 7 = significant effect)

Interest rate levels ☐

Finance availability:

(i) Senior debt ☐

(ii) Mezzanine/Subordinated debt ☐

(iii) Equity (non-management) ☐

Management initiative/enthusiasm ☐

Willingness of vendor to sell to management ☐

Asset values ☐

Personal wealth of management ☐

State of recession/upturn in economy ☐

MBO perceived as too risky ☐

MBO ownership structure no longer regarded as favourable ☐

Other (please specify) ☐

..........................................................................................................................

..........................................................................................................................

..........................................................................................................................

..........................................................................................................................

..........................................................................................................................

..........................................................................................................................

4. a. Do you expect the average <u>value</u> of MBO transactions in the next one to two years to:

significantly decrease ☐

slightly decrease ☐

remain about the same ☐

slightly increase ☐

significantly increase ☐

Please give reasons:

.......................................................................................................................................

.......................................................................................................................................

.......................................................................................................................................

.......................................................................................................................................

.......................................................................................................................................

b. Do you expect the <u>number</u> of MBO transactions in the next one to two years to:

significantly decrease ☐

slightly decrease ☐

remain about the same ☐

slightly increase ☐

significantly increase ☐

Please give reasons:

.......................................................................................................................................

.......................................................................................................................................

.......................................................................................................................................

.......................................................................................................................................

5. a. In the next one to two years do you expect MBO activity to be concentrated in any particular industry/industries? YES / NO

Please comment including industries:

..........................................................................................................................................

..........................................................................................................................................

..........................................................................................................................................

..........................................................................................................................................

b. Are there any specific industries where you would <u>not</u> expect any MBO activity in the next one to two years? YES / NO

Please comment including industries:

..........................................................................................................................................

..........................................................................................................................................

..........................................................................................................................................

6. Very few Australian MBO's have resulted in the privatisation of a Company listed on the Australian Stock Exchange. Do you expect this trend to continue?.......................................................YES / NO

Please give reasons:

..........................................................................................................................................

..........................................................................................................................................

..........................................................................................................................................

7. a. For MBO's executed in the next one to two years, do you expect the proportion of equity in the total funding to:

significantly reduce ☐
slightly reduce ☐
remain about the same ☐
slightly increase ☐
significantly increase ☐
compared to previous levels?

Please give reasons:

.......................................................................................................................

.......................................................................................................................

.......................................................................................................................

.......................................................................................................................

.......................................................................................................................

b. Do you expect the availability of funds for equity investment in MBO's by institutions to:

significantly reduce ☐
slightly reduce ☐
remain about the same ☐
slightly increase ☐
significantly increase ☐
compared to previous levels?

Please give reasons:

.......................................................................................................................

.......................................................................................................................

8. Would you be prepared to take part in a follow up interview to this questionnaire........................................................YES / NO

PLEASE RETURN THE QUESTIONNAIRE IN THE PRE PAID ENVELOPE PROVIDED

THANK YOU FOR YOUR TIME AND CO-OPERATION